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PASSIVE INVESTMENT OPPORTUNITIES
IN LOW INCOME HOUSING

By

ALAN R. CERF

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by

Alan R. Cerf, CPA, Ph.D.

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ABSTRACT

There is an urgent need for the development of low income housing. Congress has provided a significant incentive through the low income housing tax credit for individuals and corporations to participate in this development. Corporations and individuals may both offset a specified amount of tax credits against tax liability arising from active income and portfolio income as well as passive income. Corporations benefit in addition from operating losses. Individual investors benefit from operating losses if they have passive income from other sources.

An examination of typical rates of return offered at this writing indicates both affluent individuals and corporations should consider a low income housing investment for a place in their investment portfolio. Projected after tax returns from public offerings currently are in the range of 9 to 11 percent based on tax benefits only. Returns for private offerings are projected considerably higher. Since corporations (other than subchapter S, personal service corporations and closely held corporations) can offset non passive income with losses from low income housing investments, after tax returns in the range of 20 to 25% are projected.

Individuals contemplating an investment must project at least ten years of taxable income sufficient to use the available tax credits. There should be no need for liquidity and they should not be subject to the alternative minimum tax. If they have unsheltered passive income to use as an offset to losses generated by the investment their returns will be enhanced. If an individual taxpayer has losses generated from real estate in which he actively participates he can not use these losses as well as the low income housing tax credits to offset non passive income.

A careful analysis of the risks involved in the potential investment is essential. The decision to invest in a publicly syndicated low income housing partnership or a private placement requires a comparison of expected returns and a comparison of expected risks with alternative opportunities. There are the normal risks of investing in real estate and the particular risks of investing in low income housing. Since returns are generally projected on the basis of tax benefits rather than cash distributions or property appreciation, tax risks are particularly important. Many of these risks are examined in this paper.
INTRODUCTION

The low income housing credit (LIHC) was introduced to stimulate the creation and rehabilitation of low income housing. Congress perceives an important need in this area. There is particular need because other tax incentives were removed in the Tax Reform Act of 1986. In addition certain low income housing projects that were developed under Federal programs in the 1960s are now being converted to regular housing thereby reducing much needed supply. Congress has extended the credit until the end of 1990.

OBJECTIVES

To stimulate investment the risk adjusted rates of return from low income housing must be competitive with alternative investments. Capital is attracted through both public partnerships such as those sponsored by the major brokerage firms and by private placements. Corporations may invest on their own or in combination with a tax exempt entity.

This paper examines the question of whether the LIHC will attract individual and corporate investors. Here we will examine the rates and return and the relevant risks involved. Particular attention will be given to the questions an investor should ask before considering whether low income housing should be added to his or her investment portfolio.

The LIHC provides a 9 percent tax credit for new construction expenditures and rehabilitation for projects without federal assistance. New construction and rehabilitation which has received other federal assistance receives a 4 percent tax credit. The credit is claimed annually over a ten year period. The project must be maintained for at least 15 years. Detailed requirements are to be found in Section 42 of the Internal Revenue Code.
There are maximum income requirements for tenants and restrictions on the rent that is charged. There are minimum set-aside provisions which require that a project have a certain percentage of low income units. There are recapture provisions if requirements are violated during the life of the project.

BACKGROUND

As far back as 1949 Congress recognized the problem of low income housing. A national goal of providing "a decent home and a suitable living environment for every American family" underlies the housing act of 1949. The federal government supported low income housing primarily through publicly owned and operated housing for nearly a decade. Beginning in the 1960s a new approach was taken. Private developers, owners and managers were attracted to develop low income housing.

Since 1961 almost 2 million privately owned, federally subsidized units for low income households have been constructed. Since the early 1980s supply of low income housing has fallen behind demand. Low income households have been forced to pay a disproportionately high percentage of their income to rent.

A variety of factors threaten the stock of low income housing. A recent report to Congress by the National Low Income Housing Preservation Commission (NLIHPC) outlines some of the factors.¹

Rental assistance contracts are expiring. A particularly large effect will be felt between 1997 and 1999.

Given the changes in tax benefits for real estate and the expiration of rent subsidies owners face diminished after tax returns and reduced cash flows. This reduces their ability to meet repair and maintenance costs as well as to meet debt payments. The Tax Reform Act of 1986 (TRA) has had a serious negative impact on the supply of low income housing. Whereas non-profit organizations are motivated by the desire to solve serious low income housing problems, private investors are attracted by rent supplements, attractive interest rates and tax benefits which result in attractive expected rates of return. Prior to the TRA taxable losses from depreciation could be used to offset other types of personal income such as salary, dividends and interest. Prior to the TRA general partners could buy and resell properties to new owners who received favorable depreciation under the accelerated cost recovery system (ACRS). Typically the new owners paid cash, assumed the mortgage and executed a longer term second note.

In 1986 the TRA phased out the primary tax benefit associated with low income housing by introducing the passive loss rules. These rules required that real estate losses (with certain exceptions) cannot be used to offset salary income or portfolio income. The reduction of tax rates also reduced the attractiveness of low income housing. Instead of losses being deducted at a 50 percent tax rate, the rate was now only 28 percent (33 percent for some taxpayers.) The difference in rates between ordinary income and capital gains was removed. This removes the ability of deducting losses against a high ordinary rate and then paying tax sometime in the future at a lower capital gain rate. This reduces the amount of gain that can be kept.

The NLIHPC report states that if the government does nothing the stock in the low income housing inventory is in grave jeopardy of losing its status as low income housing. This is because a substantial number of owners are likely to prepay their mortgages. An even larger number are likely to default over the next 15 years. The prediction is that
defaults are likely to occur around 1992 and again at the end of the century. Prepayments are likely to occur between 1991-1994 with the maximum level in 1992. The need for stimulants to low income housing is well supported.

As notes on older properties mature owners may not be able to pay off the second note at maturity and the result will be the property will revert to the second note holders.

Reduction of the stock of low income housing likely will arise because more and more owners will become eligible to prepay their mortgage as their lows reach their twentieth anniversary. Of 645,000 units 334,000 are eligible to be prepaid during the next 15 years. The peak opportunities are between 1991 and 1995.

The low income housing credit is one of many alternative ways Congress is attacking the problem. For the LIHC to accomplish its objective it must attract investors. Whether risk adjusted returns are adequate to do so is the concern of this paper.²

WHO SHOULD CONSIDER INVESTING?

To benefit from an investment engaged in development of low income housing a potential investor should be able to forecast with reasonable accuracy that they will have sufficient income to be able to benefit from the tax benefits during the life of the project. They should also realize the investment is illiquid. In fact it is important that the development of a secondary market in limited partnership units be prevented. Otherwise the partnership will be considered "publicly traded" and as is explained in the section on risks investors will lose tax benefits. Individual investors will have different tax considerations than corporations so they will be considered separately below.

² How the LIHC compares with alternative methods of stimulating low income housing is not discussed here. The NLIHPC report has an excellent discussion of the merits of alternative plans.
Individuals

Under the 1986 Act passive losses are generally only deductible from passive income and not from non-passive income or from portfolio income. The passive activity loss and credit limitations of the 1986 Act, as modified by the 1989 Act, contain an exception which applies to low income housing. This exception provides that the passive activity credit restrictions will not apply to the amount of such qualified credits generating a federal income tax benefit equal to the amount of benefit that would be derived by the taxpayer from a deduction equal to $25,000.

For individual investors in the 28% tax bracket in 1990 and thereafter, this is equivalent to allowing up to $7,000 each year of low income credits (tax rate of 28% times $25,000 = $7,000). The $25,000 amount is worth more for a taxpayer in the 33% marginal tax bracket and would be worth more if tax rates are raised in the future.

Does the individual taxpayer have passive income from other activities? Taxpayers with passive income achieve higher returns because they can use losses and credits to offset passive income and then use remaining credits to offset non-passive income and portfolio income up to $25,000.

An investment will generate both tax losses and tax credits. If a taxpayer has both eligible losses and credits, the losses must be used before the credits. Losses are allowable to offset income from passive activities other than income from partnerships which are treated as publicly traded partnerships under the Code. Tax credits are also allowable to offset income from passive activities. Any credits remaining but not losses may then be used to offset up to $25,000 of nonpassive income and portfolio income.

If losses are not allowed to be used in the current year as a result of the passive activity limit they may be carried forward indefinitely to be used against passive income in the future.
Under the 1989 Act there are no income limitations on a taxpayer's ability to utilize low income credits on up to $25,000 of active or portfolio income. Prior to enactment of the 1989 Act, only individuals with an adjusted gross income of $200,000 or less (disregarding passive losses) could utilize the full $25,000 allowance. This change in the law should stimulate consideration of low income housing investments by affluent individual taxpayers who previously could not obtain the tax benefits.

Does the investor have tax credits from other investments? The amount of low income credits that are allowed in the current year may be restricted under the rules that limit the use of all business tax credits. This limit may be a factor if an investor has other types of business tax credits. Currently the limit on the use of all business tax credits is $25,000 of tax liability plus 75% of tax liability in excess of this amount. Low income credits limited by this rule can be carried back three years and forward for 15 years.

Does the individual taxpayer already benefit from the $25,000 deduction against non-passive income allowed for investors who actively participate in real estate? If this is the case the taxpayer may not also use the low income housing tax credit.

If a taxpayer expects to be subject to the alternative minimum tax the credits will be of no benefit as an offset. Note that low income credits are not a preference item for purposes of the alternative minimum tax.

Transferability of units is restricted in most offerings because the limited partnership units will not be publicly traded. However a taxpayer may still sell units, make gifts of units, or bequeath the units.

Corporations

Corporations, other than S corporations or personal service corporations, can generally use the low income credit against taxes on all income (except the alternative minimum tax)
and can use losses to reduce taxable income. Thus the potential rate of return for
corporations is considerably higher than that for individuals where the amount of credits
used is limited. Currently after tax internal rates of return in excess of 20% are projected
for corporate developments.

Corporations that are not closely held and are not personal service corporations that
reasonably expect to have sufficient federal taxable income from all sources to utilize the
low income credits and losses may benefit from a investment in a low income housing
development.

Corporate investors may carry back unused low income credits to the three years
preceding the unused credit year but unused low income credits may not be carried back to
taxable years ending prior to January 1,1987. Corporate investors may carry forward unused
low income credits to each of the 15 taxable years following the unused credit years.

Closely held corporations can only use the low income credit against tax attributable to
active business and passive activity income and not against portfolio income. Personal
service corporations can only use the low income credit against tax liability arising from
passive activities, and do not qualify for the $25,000 allowance.

Corporations may be motivated by financial return to invest. They also may be
motivated by the goal of providing affordable housing and/or improving public relations.
Banks and savings and loans may be motivated by getting community reinvestment points.
Other corporations may wish to create goodwill which might in the future pay off in getting
approval for other developments.

Some corporations shy off because there expertise is in other areas and they do not
feel comfortable with low income housing. Some corporations do not feel comfortable with
projecting taxable income over the next ten years. However, the attractive potential returns
indicate corporations should consider low income housing investments.
REQUIREMENTS

The requirements for a low income housing project to qualify for low income credits are summarized briefly. The requirements have significant complexities and reference to the Code should be made for details. A good explanation is found in M.J. Novogradac and E.J. Fortenbach, "The Low Income Housing Tax Credit: Planning After Receiving The Credit Allocation or Commitment, Tax Management Real Estate Journal, vol. 5, no. 6, June 1989, Tax Management Inc., Washington D.C.

An owner of a low income housing project is entitled to receive a credit in each year of a 10 year period equal to the annual credit percentage times the portion of the basis of a property that qualifies for the credit.

A qualified low income building is a residential rental property that satisfies one of two minimum set-aside tests. The first test requires that 20% or more of units in the project must be occupied by individuals who have incomes of 50 percent or less of area median income, adjusted for family size. Alternatively the minimum set-aside requirement is met if 40 percent or more of units in the project are occupied by individuals who have incomes of 60 percent or less of area median income, adjusted for family size. For either test gross rent is limited to 30% of the applicable income limit.

Credit Percentage

Credit percentages are adjusted monthly by the Treasury to yield a credit with a present value of 70% of the rehabilitation or new construction costs and 30 percent of

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3 IRC, section 42.

4 A more extensive explanation is to be found in M.J. Novogradac and E.J. Fortenbach, Low-Income Housing Tax Credit Handbook, Clark Boardman Company, Ltd., New York, New York, 1990.
acquisition or federally subsidized costs. The 70% present value works out to approximately a 9% credit and the 30% to approximately a 4% credit.

Non federally subsidized new construction or non federally subsidized substantial rehabilitation projects are eligible for the 9 percent credit. For 1990 a rehabilitation must include capital expenditures in connection with rehabilitation of a building during a 24 month period allocable to the low income units in the building in an aggregate amount equal to the greater of (1) 10% of the adjusted basis of the building as of the start of such period or (2) $3,000 per low income unit.

Federally subsidized new construction or federally subsidized substantial rehabilitation projects are eligible for the 4 percent credit. For purposes of the credit, federal subsidies include only tax-exempt financing and below market federal loans, the proceeds of which are used directly or indirectly with respect to the project or the operation thereof. State and local low income loans and other state and local subsidies are not included.

Under the 1989 Act, new owners who acquire existing projects are eligible to receive low income housing credits if they incur substantial rehabilitation expenditures. A 9 percent credit applies to the substantial rehabilitation expenditures and a 4% credit applies to the cost of acquisition.

**Qualified Basis**

The qualified basis multiplied by the applicable percentage determines the amount of the credit. The qualified basis is generally the proportion of the "eligible basis" in a qualified low income housing project attributable to low income units. This proportion is the lesser of (1) the proportion of occupied low income units to all residential rental units (whether or not occupied) in the project,or (2) the proportion of floor space in the occupied
low income units to the total floor space of the residential rental units (whether or not occupied) in the project.

In general the "eligible basis" of a project is its adjusted basis determined without regard to the adjusted basis of any non-residential portion of the project. It does not include the cost of land.

RATES OF RETURN

The LIHC will stimulate investment if it provides investors a risk adjusted rate of return that is competitive with other similar risk investments. Rates of return are determined by cash distributions, appreciation in valuation of investment, and tax benefits. Tax benefits result from the LIHC and from allowable deductions if the project generates operating losses.

Rates of return are computed here based on prospectus material from several "typical" public offerings currently available from major brokerage firms. These are after tax rates of return.

The actual tax credit for a project is a function of the expenditures eligible for the nine percent and/or the four percent credit. These credits are then passed through to the limited partners. Several offerings indicate credits for the limited partners will be approximately 1.5 times investment. For example a $10,000 investment would generate $15,000 of tax credits over the life of the investment. Private offerings may offer a larger ratio of credits to investment. These credits are achieved over a ten year period. The project must be held 15 years. Calculation of rates of return obviously must take into account when these credits are received.
Because of the riskiness of low income housing projects, most projections assume no cash distributions and increase in the value of the investment. If there are cash distributions and/or there is appreciation in the value of the projects, rates of return will be increased.

The internal rate of return on the offering in Table I is 9.8 percent. A total of $15,000 of credits is available during the life of the project. A taxpayer is assumed to invest $10,000 in a limited partnership. The schedule allows time for the money to be invested in qualifying project. Here it takes three years to achieve the full annual $1,500 credit. Note the project must be held for 15 years or the credits are recaptured. It is also assumed the investor does not have passive income to offset the passive losses from the project so there is no benefit from the operating losses of the project during the period. The only deduction allowed is the $10,000 in the last year on the assumption the project is worthless and the taxpayer writes off her $10,000 investment in the final year. At the assumed 35% combined federal and state tax rates this results in a $3,500 tax saving in the last year. If the project is worth its original cost at the end of the period then the internal rate of return rises to 11.6%.
Table 1

Determination of Rate of Return for a Public Low Income Housing Investment

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>Tax Credit</th>
<th>Tax Deductions</th>
<th>Total Tax Saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$10,000</td>
<td>300</td>
<td>0</td>
<td>300</td>
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<td>1,500</td>
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<td>2001</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
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</tr>
<tr>
<td>2005</td>
<td>0</td>
<td>$10,000 (a)</td>
<td>3,500 (b)</td>
<td></td>
</tr>
</tbody>
</table>

Totals $10,000 $15,000 $10,000 $18,500

Internal after tax rate of return = 9.8%.

(a) Investment is assumed worthless at the end of the period. Write off is equal to amount invested.

(b) Tax savings are equal to tax credit plus 35% of deductions.
Table II assumes an investor is able to use passive losses as well as the tax credit. Passive losses may be offset against passive gains. The resulting internal rate of return is 13.5%. Benefits of deductions are calculated at a 35 percent combined federal and state tax rate. For example, in year 3 the tax benefit is $1,850. This is the sum of the $1,500 tax credit and the $350 benefit from the operating losses.

Rates of return projected for private offerings are considerably higher. Potential returns for corporations that are financially able to support an entire project are above 20%. Corporations are able to use losses as well as credits against taxable income.

The low income housing tax credit provides an assured return over ten years because of the tax credits. This assumes there are no recapture problems and that the taxpayer has sufficient income to use the available credits. If the project does in fact generate cash flow and/or the investor can use the passive losses generated by the project the rate of return is increased. Even greater returns may be realized if the project has value at the end of the 15 year period.

These returns appear likely to stimulate investor interest. There is a further upside potential if the project yields any cash distributions and/or the property has value at the end of the 15 year period. Whether these returns will in fact stimulate investment depends on the investor’s appraisal of risk. The next section investigates the risk involved and considers the questions an investor needs to have answered in relation to a specific project.
Table II

Determination of Rate of Return
If Taxpayer is Able to Use Operating Losses and Tax Credits

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>Tax Credit</th>
<th>Deductions</th>
<th>Total Tax Saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$10,000</td>
<td>$300</td>
<td>$300</td>
<td>$405 (a)</td>
</tr>
<tr>
<td>1991</td>
<td>1,200</td>
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<td>1,550</td>
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<tr>
<td>1992</td>
<td>1,500</td>
<td>1,000</td>
<td>1,850</td>
<td></td>
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<td>1993</td>
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<td>1995</td>
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<td>1997</td>
<td>1,500</td>
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<td>1998</td>
<td>1,500</td>
<td>1,000</td>
<td>1,850</td>
<td></td>
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<tr>
<td>1999</td>
<td>1,500</td>
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<td>2001</td>
<td>300</td>
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</tr>
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</tr>
<tr>
<td>2005</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

Totals $10,000 $15,000 $10,000 $18,500

Internal Rate of Return = 13.5%.

(a) Tax savings equals tax credit plus 35% of deductions.
RISKS

The decision to invest in a public low income housing partnership or a private placement requires a comparison of expected returns and a comparison of expected risks. This section considers the risks that are involved in low income housing projects.

Returns from low income housing investments (hereafter referred to as (LIH)) arise from tax benefits from tax credits and tax losses, cash distributions during the life of the investment, and possible capital appreciation on disposition.

Most projects are sold on the basis of the tax benefits. Because of uncertainty of cash distributions or capital appreciation these are usually not taken into account. Considering that tax benefits are the major incentive for investment our first consideration will be the risks that the tax benefits will not be achieved. Many of these risks involve technical tax considerations. Therefore it is recommended that a potential investor review these risks with their professional tax advisor prior to investing.

Tax Risks

Reading a prospectus on a LIH project indicates numerous possible risks. In most offerings all conceivable risks are listed. This helps to alleviate the possibility of suit if a problem does result. The likelihood of these risks is not set out for the investor. So what does the investor do? Since it is impossible to set up a partnership which does not have these risks an investor must determine the likelihood of these risks materializing. Professional advice is valuable but because many of these risks depend on future events professional advisors cannot provide any sort of a guarantee that these risks will not occur.
Recapture of Low Income Housing Tax Credits

Probably the most likely tax risk is the possibility of recapture of credits. If the project does not qualify for credits or if the project does not continue to meet the requirement to be treated as low income housing during the required 15 year compliance period, the limited partners may lose those credits or a substantial portion might be recaptured with interest.\(^5\)

In addition to the recapture of credits non-deductible interest on the recapture amount is imposed at the statutory tax deficiency rate from the year in which the credits recaptured were originally claimed to the year of recapture. If the number of apartment units in a property rented to qualified low income tenants drops below the number of units that were used in the formula pursuant to which the low income credit was calculated, recapture will apply to the low income credits applicable to such units. Disposition also may cause recapture.

Another potential recapture event might arise if the Partnership obtains nonrecourse acquisition financing from a non profit organization and the amount of such loan is included in eligible basis on which low income credits are claimed. If such loan is not fully repaid by the end of the compliance period with respect to the property financed with such loan the limited partners will be required to recapture the low income credits taken that were attributable to such loan.

Since by definition a limited partner does not have management control what can an investor do to minimize these risks? The answer appears to be that the limited partner is completely dependent on the managers of the projects.

\(^5\) The recapture rules provide that a portion of the previously claimed credits equal to the excess of the credits claimed over the amount of credit that would have been available if the credits were claimed on a straight-line basis over 15 years instead of on a straight line basis over 10 years must be reported as additional tax liability in the year of the recapture.
In public placements the investor must look at the past experience of the management as indicated in the prospectus. Some assurance may be obtained from the selling organization's reputation. Hopefully, a major investment banker will have made a careful study of the past history and competence of the general partner.

**Limits on Losses and Credit from Passive Activities**

Each investor must determine if it is likely that they will during the compliance period be able to use the credits and losses generated by the investment. Will the investor have sufficient income to create $7,000 of tax liability at the 28 percent tax bracket? Is the individual likely to have passive activity income which can be offset by passive losses from the investment? For individuals $7,000 of low income credits may be used to reduce income from all sources. For corporations (other than Subchapter S, closely held, and personal service) tax losses and credits generally may be used to offset tax liabilities that arise from other sources.

**Avoid Classification as a Publicly-Traded Partnership**

It is important to distinguish a public offering from a publicly traded partnership. Public offerings of low income housing partnerships are sold to the public but the partnership units are not subsequently traded in the market.

It is necessary that care be taken to avoid treatment as a publicly-traded partnership. Such classification could cause treatment of the partnership as a corporation in which losses could not be passed through to the limited partners. In addition losses could not be offset against other passive income.

Under the 1987 Tax Act, income and losses of a partnership classified as a publicly-traded partnership are characterized as passive income and losses from a separate
activity. This rule does not apply to low income credits. Losses from an investment in a publicly-traded partnership can only be used as an offset against income subsequently generated by the partnership and income from a publicly traded partnership cannot be sheltered by losses or credits (other than possibly low income credits) from other passive activities. Thus it is important that the partnership should not be listed for trading on an established securities market or on an over-the-counter market. In addition it is necessary to ensure that interests will not be readily tradeable on any secondary market.

Audit Risks

The IRS has extended its audit of partnership tax returns and particularly those involving tax shelters with losses of over $25,000. In addition to possible disallowance of losses or credits relating to the investment an audit may discover other items to be disallowed and result in additional tax, non deductible interest and possible penalties.

Audits of a low income housing partnership is likely and thus the likelihood of an audit of each individual limited partner is increased.

Questions for your Advisor

There are numerous additional tax risks on which opinion of legal counsel is usually obtained. Even with a legal opinion there is still risk because the IRS may not agree with the legal opinion.

Investments should be reviewed for opinions with respect to the following:

(1) Will the allocation provisions of the Partnership agreement be materially respected? The IRS might challenge the allocation between the general and limited partners of income, gain, deductions, losses and credits if they believe that they are without substantial economic effect.
(2) Will Section 183 of the Code operate to limit the extent to which Partnership losses and credits will be allowed. Section 183 generally provides that deductions, losses or credits that are derived from "activities not engaged in for profit" are not allowed except to the extent of gross income derived from such activity? The test for Section 183 is applied based on facts and circumstances that exist from time to time. The IRS has indicated that it would not apply Section 183 in the case of projects involved in development of housing for low and moderate income families. But there can be no assurance they might not apply this section in the future to disallow deductions of Limited Partners. Thus it is desirable that there be a reasonable expectation over time that the Partnership will make an economic profit other than the tax benefits that are generated by the Partnership.

(3) Are you subject to the alternative minimum tax? Low income credits may not be used to reduce the alternative minimum tax. They are not preference items used in its calculation.

(4) Are purchase money notes used to acquire interest in local partnerships? If so will the purchase money debt be treated as true indebtedness for tax purposes?

(5) Are the limited partners "at risk" in respect to their investment so that the low income credits and losses may be used?

(6) Is it likely that the Master Partnership and any subsidiary Local Partnerships be treated as partnerships for federal income tax purposes rather than as associations taxable as corporation?

(7) Are the interest and depreciation deductions likely to meet the requirements of the Code?

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Real Estate Risks

Real estate is inherently a risky investment. A potential investor must consider both normal risks of real estate investment and also specific risks involved with government assisted projects.

Certain costs such as debt service, real estate taxes and insurance do not decline if occupancy rates decline. Thus there is a danger that income may not exceed costs. In certain situations fixed costs may not be met resulting in possible foreclosure. This in turn may result in adverse tax consequences to the limited partners.

Rental income is a function of rental rates and of occupancy rates. These in turn are impacted by general and local economic conditions and changes in these conditions. They are influenced by adverse use of neighboring real estate and changes in zoning laws and the supply of alternative units on the market.

Operating expenses are influenced by inflation. Certain costs such as real estate taxes and utilities may increase more rapidly than rents. Operating expenses may increase beyond the rent level permitted by regulatory agencies under subsidy or other government assisted programs. They may increase beyond the maximum level of rentals on housing units set aside for low income tenants that is necessary to maintain eligibility for Low Income credits.

There are numerous other questions that the investor should consider such as the following:

(1) Are Purchase Money Notes used in acquiring Local Partnership interests in Local Partnerships owning existing complexes with the intention that they will be paid from the proceeds of sale or refinancing of the property. If so, is it likely that the property can be sold or refinanced on favorable terms prior to the maturity of the Purchase Money Note. If not, the Partnership could lose its interest in the Local Partnership.
(2) Is it likely that proceeds of sale will be sufficient to pay the balance due on the mortgage loan or any other outstanding indebtedness to which the Property is subject?

There can be no certain answer to the above questions because they are a function of future events. However they also depend upon the leverage used in the project which the investor can appraise. The investor can appraise the financing of a property and the likely debt service level that would be required to be maintained to service such debt. The current rent levels and occupancy rates and the future expected rates can be compared to the debt service level.

(3) Will properties in the construction phase be acquired? If the cost of completing the development exceeds estimated costs, the partnership and the general partners may not be able to make up the deficiency. Then the limited partners may have to advance funds to make up the deficiency so the development can be completed.

(4) Is the Partnership intending to acquire properties that are unspecified at the time of investment?

(5) What restrictions are there on the activities of the general partners? If the general partners can participate in ownership and management of other residential developments which compete with the development there may be conflicts of interest. Conflicts may develop in allocating management time, services and functions between existing business interests and any future business interests. Conflict of interest may result if the construction company and or the management company are affiliates of the general partners.

(6) What are the restrictions involved as a result of the use of state or local subsidies. In order to provide an attractive rate of return many projects will require state or local support. This means the project must then satisfy the requirements of the regulatory authorities and abide by their restrictions. These restrictions may limit the partnerships ability to increase rents and make distributions of cash flow.
(7) What are the restrictions as a result of the use of special financing from state or local agencies? These include certain restrictions on additional financing. The authority providing the special financing may impose various occupancy and rental restrictions on the development which last as long as the financing remains outstanding.

(8) Are the financial resources of the general partners sufficient to provide help to the development if needed?

(9) Is the management likely to see that rents are collected and the project is managed efficiently?

(10) Is the compensation paid to the general partners reasonable? Are they in excess of fees that would be charged for similar services by an independent party?

(11) Is there likely to be sufficient diversification in the geographical location of the properties? This is to reduce the likelihood that an economic decline in a particular area of the country would be detrimental to the investment.

(12) Is there sufficient and proper insurance on the project? If there is a casualty and the project is not rebuilt within a prescribed period there will be recapture of the credits.

Examination of potential risks indicates of the importance of careful analysis before investing. The majority of these risks can be alleviated if the property is efficiently managed. This in turn points up the importance of having management with a strong past performance record.

PUBLIC SYNDICATIONS

Tax credits are often quoted to potential investors as a certain percentage of investment. For example, an investor may be told that she would receive $1.50 of tax credits for each $1.00 invested. This means a $10,000 investment will receive $1,500 of credits each year.
over a ten year period.

The tax credits awarded by the state to the building owner is based on the four or nine percent credit times the qualifying basis. Developers that have received these awards from the state are approached by syndicators who will purchase the project and in turn sell limited partnership interests to investors.

The following indicates how this might occur. A developer has been awarded a 3 million tax credit from the state for a project. He is approached by a syndicator who is willing to put in 2 million of equity so that he will be able to offer investors $1.50 of credit for $1.00 of investment. Then financing is arranged to accommodate an acceptable degree of leverage. The acceptable degree of leverage is partially a function of the projected occupancy rate, projected rents, projected costs, and necessary reserves. Reserves are particularly important because cash flow usually goes down rather than up because of the difficulty of raising rents and because costs can increase.

Investments of public offerings tend to be diversified geographically. They may also be diversified by objective. For example one recent offering diversifies as follows. One group of investments is in rural areas. Here there is potential for good cash flow but an unlikely potential for a major upside gain. Another classification of investment is in suburban areas close to cities. The objective is that these areas will become in greater demand as the cities grow in the next fifteen years. The final classification is investments in deteriorated inner city neighborhoods. Here there is the opportunity of receiving considerable government assistance. If in 15 years there is a turnaround in the neighborhood there is opportunity for considerable capital gain from the investment.

For example, one offering includes an investment in the Bronx area of New York City across from a city college redevelopment. Gross proceeds allocated for investment to the project are $3,745,000. The allocation of low income credits is approximately $535,000 per
year for 10 years. The property consists of seven six-story buildings comprised of a total of 224 units. The building, which was originally constructed in 1925, is composed of a brick and wood frame. The proposed rehabilitation includes the renovation of the entire building and the installation of new electrical, heating and plumbing systems. The building will also receive a new elevator system. There are 112 one-bedroom units, 82 two-bedroom units and 30 three-bedroom units. Of the 224 units in the complex 45 units will be rented for a 20 year period to families whose incomes will not exceed 50% of the local median income, and 35 units will be rented for a 15 year period to families whose incomes will not exceed 60% of the local median income. The remaining 144 units will be rented at market rate without any tenant income restriction. Increases in rent at the market rate units will be subject to city rent stabilization guidelines.

The local partnership purchased the building and land from the city for approximately $224,000. Aggregate rehabilitation costs are expected to be approximately $21,000,000.

Construction and permanent financing for the purchase and rehabilitation of the complex comes from a New York City Community Preservation Corporation first mortgage loan in the amount of $1,408,986, a $12,725,765 second mortgage loan from the New York City Participating Loan Program, and a third mortgage loan in the form of a HODAG in the amount of $3,804,242. Such HODAG is funded by HUD and subsequently loaned to the local partnership through the New York City Department of Housing Preservation and Development. During the construction phase of the development the first mortgage loan bears interest at the rate of 2% per annum over the prime rate of Bankers Trust Company, the second mortgage loan bears interest at the rate of 1 1/4% per annum and the third mortgage loan bears no interest during the period. The permanent phase of the financing will bear interest as follows: the first mortgage loan will bear interest at the rate of 11.5% per annum for a term of 49 months. The $12,725,765 second mortgage loan will bear
interest at the rate of 1% per annum, for a term of 30 years. The third mortgage loan will bear interest at the rate of 1% per annum for a term of 40 years, however, no payments are required for the first 20 years.

Private Offerings

Private offerings usually have one project. An investor in this case must rely on her knowledge of the developer, the project and the managers. The investor may be able to inspect the property and have more intimate knowledge of the property than they would have with many properties in a public offering. There may be an advantage in that a much higher percentage of investment goes into the project because of proportionately less marketing, syndication, legal and accounting costs. The choice will vary depending on the investors sophistication and the specifics of each potential investment.

CONCLUSION

There is an urgent need for the development of low income housing. Congress has enacted an incentive for investors to participate by providing that a certain amount of tax credits can be used to offset active income and portfolio income as well as passive income. Investors may also benefit from operating losses if they have passive income from other sources.

An examination of typical rates of return offered at this writing indicates both affluent individuals and corporations should consider a low income housing investment for a place in their investment portfolio. Projected after tax returns from public offerings currently are in the range of 9 to 11% based on tax benefits only. Returns for private offerings are projected considerably higher. Since corporations (other than subchapter S, personal service
corporations and closely held corporations) can offset non passive income with losses from low income housing investments, after tax returns in the range of 20 to 25% are projected.

Individuals should be able to project at least ten years of taxable income sufficient to use the available tax credits. For some offerings an additional two years should be allowed to allow time for the project to fully generate the credits. There should be no need for liquidity and they should not be subject to the alternative minimum tax. If they have unsheltered passive income to use as an offset to losses generated by the investment their returns will be enhanced.

If an individual taxpayer has losses generated from real estate in which he actively participates he can not use these losses as well as the low income housing tax credits. Taxpayers who have tax credits from other sources must consider the overall limits on all business tax credits.

A careful analysis of the risks involved in the potential investment is essential. The decision to invest in a publicly syndicated low income housing partnership or a private placement requires a comparison of expected returns and a comparison of expected risks with alternative opportunities. Particular care must be taken in analyzing the potential risks. There are the normal risks of investing in real estate and the particular risks of investing in low income housing. Since most investments are based primarily on the tax benefits and not on expected cash flow or capital appreciation, particular care must be taken in examining the tax risks. These are the risks that governmental requirements will be violated and that the tax credits will be recaptured.

Large public offerings stress geographic diversification and because they have a number of properties have a potential of having capital appreciation in one or more of these properties. Also there is the advantage of having a major investment banker performing the due diligence.
Private offerings tend to have one property. An investor in this case must rely on her knowledge of the developer and the management. The investor may be able to inspect the property and have more intimate knowledge of the property than they would have with a public offering. There may be an advantage in that a higher percentage of investment goes into the project because of proportionately less marketing, syndication, legal and accounting costs. The choice will vary depending on the investors sophistication and the specifics of each potential investment.