

Affordable Housing and “The Tax Overhang”
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What is “Tax Overhang” and why is it an issue?

- A. Traditional real estate investment motivations are absent in assisted housing investment.
 - 1. Increasing cash flows vs. limited dividend.
 - 2. Capital appreciation vs. affordability covenants, transfer restrictions.
- B. Existing assisted housing investment a creature of the Tax Code.
 - 1. Designed to be a tax deferral mechanism with investment “return” determined by ability to use tax losses.
 - 2. Deductions in excess of investment create “negative capital account”.
 - 3. Upon transfer (voluntary or involuntary) or reduction in indebtedness (nonrecourse indebtedness added to original investment called “basis”), creates taxable income.
- C. Distinct housing programs created similar tax issues, but for different reasons.
 - 1. Older assisted properties (§236, §221d3).
 - a. Historical operations resulting in large tax losses - large negative capital accounts.
 - b. Historical operations resulting in small positive cash flows - small residual receipts accounts available for distribution.
 - c. Age of property - capital needs deplete replacement reserve accounts available for distribution.
 - d. Low interest rate debt creates relatively large mortgage principal amortization payments after twenty years. “Phantom income” where taxable income exceeds cash flow.
 - 2. Newer assisted properties (FHA-insured with §8 subsidy).

- a. Original underwriting tended to underfund replacement reserves, operating expenses.
 - b. Property frequently located where conventional investment would not build (inner city, rural).
 - c. Combination of inflation, automatic adjustment factors, original underwriting creates contract rents in excess of “fair market”.
- D. “Tax Overhang” in a nutshell.
1. Large negative capital accounts of current owner (usually a partnership);
 2. Inability of purchaser to provide cash purchase price without government assistance;
 3. No extra monies in residual receipts or replacement reserves; and/or
 4. Contract rents in excess of fair market rents—
 5. Result: ABSOLUTELY NO INCENTIVE TO OWN OR TO TRANSFER.

Real Life Examples

- A. Characteristics
1. Adequately maintained (i.e., decent, safe, sanitary), but large capital needs an issue.
 2. Small replacement reserve balances; likely to have no residual receipts.
- B. Original owner: a limited partnership.
1. Investment objectives.
 - a. Taxable losses for many years.
 - b. Sheltered minimal cash flow.
 - c. Perhaps long term appreciation.
 - d. Sufficient income to pay expenses and nominal cash distribution.
 2. Investment results.

- a. Tax losses initially, but now taxable income generated by small depreciation deductions and large payments to principal.
- b. Nominal cash distributions.
- c. No appreciation likely due to location; physical needs; low-income covenants; inability to refinance.
- d. The tax dilemma.

The Solutions

- A. Death.
- B. LIHPRHA.
- C. Mark-to-Market.
- D. Sale.
- E. Thinking “out-of-the-box”.
 - 1. Transfer to entity willing to covenant affordability for a long period of time / perpetuity; transfer price of \$1 plus debt; no tax to owners in above circumstances.
 - 2. Under any proposed transaction involving this portfolio, there should be enacted a targeted tax relief on the non-cash portion of any income or gain.

APPENDIX 1: CHART OF HOUSING POLICY and TAX POLICY

<u>YEAR</u>	<u>HOUSING POLICY</u>	<u>PRODUCTION</u>	<u>TAX POLICY</u>
1965	HUD Act; Section 23 Annual Contribution Contract		70% maximum tax bracket
1968	National Housing Act Section 236; Section 221(d)(4)		
1969		600,000 units	Accelerated depreciation; Section 167(k); Creation of NHP; Tax-exempt bonds; Favorable recapture
1974	Housing & Community Dev. Act Section 8; GNMA tandem program		
1976			"At risk" rules; no limit on losses
1981		1,400,000 units	ERTA: 50% tax bracket Short depreciation; "new"="used"
1982			TEFRA: special LIH depreciation
1983	Section 8 monies terminated		
1984			No accrued/cash interest
1986		0	TRA: 28% tax bracket; tax-exempt restrictions; passive/portfolio; LIHTC; retroactive
1987	Restriction on Section 236/ 221(d)(3)BMIR refinance		UBTI for T/E investors; MLP; REIT
1990	LIHPRHA	360,000 of 900,000 from LIHTC (40% of production)	
1993			39.6% tax bracket
1994			Permanent LIHTC
1995			
1996			20%/25%/39.6% capital gain
1997	MAHRAA		

APPENDIX 2
HISTORY OF AFFORDABLE HOUSING POLICY
AND RELATED INCOME TAX POLICY

A. The 1937 Housing Act.

1. Public housing intended to be temporary housing for families dislocated by the Great Depression and a changing economic system. Defined as a stepping stone leading away from economic dependency and substandard living conditions to "safe, decent, and sanitary" housing and upward mobility.
2. Believed that decent shelter would be enough to promote this stepping stone. Seemed to work for a time.

B. Section 23 (Housing and Urban Development Act of 1965).

1. Public Housing Authority ("PHA") would lease housing from private owners at market rent and then sublease to lower-income people.
2. The Federal government would pass the monies for subsidies to the PHA's through an Annual Contributions Contract. In 1974, PHA's were taken out of the chain and HUD paid the difference between Federally determined market rent and 25% of the income of renter.

C. The National Low Income Housing Commission estimated in its 1968 report that the nation needed to produce six million affordable housing units. Far less than a third of that goal was produced.

D. National Housing Act of 1968: Section 236 and Section 221(d)(3)BMIR.

1. Used mortgage subsidy / below market interest rates as form of subsidy.
2. Tenants limited to certain income ranges.
3. Creation of National Housing Partnerships.

E. The 1969 Tax Reform Act.

1. Combined tax policy and housing policy for the first time.
2. Provided preferential treatment for low income housing.
 - a. More favorable tax recapture.
 - b. Section 167(k).

- c. Tax-exempt bonds.
- d. Section 1039 rollover provisions.

F. The Private Sector Responds - the heavy assisted housing production of the 70's.

1. Production reached over 1.5 million units despite changes in programs and increasing inflation.
2. The Housing & Community Development Act of 1974.
 - a. Radically altered national housing policy by effectively curtailing the traditional Public Housing Program.
 - b. Leased housing would become the major housing subsidy vehicle for lower-income people.
 - c. The program, called "Section 8" due to placement in original 1937 Act, would take over and combine with Section 23.
 - d. Contracts called Housing Assistance Payment Contracts could have a life of up to 40 years.
3. High inflation during the period.
 - a. Increased operating costs for owners.
 - b. In 236, 221(d)(3), 23, PHA programs, costs not offset by increasing rent because either (a) no corresponding increase in tenant income; and/or (b) inability to increase rents fast enough.
4. Because of these and other factors public and privately owned housing for lower-income people began to suffer physically and fiscally.

G. Policies of the 80's - rental housing swept into politics of "tax" abuse.

1. Tax law changes in 1981 and 1982 increased demand for investment and began the "tax roller coaster ride".
 - a. Shorter depreciation period for all real estate; preferential for low income housing.
 - b. No depreciation difference between "new" and "used" real estate.

- c. Ability to deduct accrued interest without significant limitation.
2. Congress in 1982 repealed the authorization for Section 8 new construction due to budget problems and the long length of HAP contracts.
3. Tax Act of 1984 removed borrower's ability to deduct accrued interest without corresponding recognition of income by the lender. No low income housing exception; first Congressional loss of low income housing's favored position.
4. 1986 Tax Act removed old incentives for the creation and preservation of low-income housing.
 - a. Concept of "buckets" of income -- active, passive, portfolio.
 - b. Income from real estate investment becomes "passive". Passive losses non-deductible. Passive income always recognized, even if no cash received.
 - c. Interest income ("portfolio") always recognized, even if no cash received.
 - d. Real estate depreciation period lengthened.
5. 1986 Tax Act added Low Income Housing Tax Credit as incentive for low-income housing. Initially directed toward corporate and individual investors. Later tax law changes removed the program's usefulness to individual investors.

H. Policies of the 90's.

1. The Housing Act of 1990.
 - a. Policy perspective: "We can not afford as a nation to lose one single unit of housing for lower income individuals and families."
 - b. Fosters the idea of self-sufficiency.
 - c. All State Housing Agencies must have a comprehensive five year housing plan to receive Federal money.
2. Low Income Housing Preservation and Homeownership Act ("LIHPRHA").
 - a. Directed toward preserving and revitalizing high-conversion-value Section 236 and 221(d)(3)BMIR insured / financed properties.
 - b. Did not address revitalizing balance of portfolio - the "great gray".

- c. Modified in 1995.
 - i. Advocates transfer to a “priority purchaser”.
 - ii. Provides grant for costs.
- d. Currently not unfunded.
- 3. Expiring Section 8 contracts.
 - a. Interplay with FHA mortgage insurance (primarily §221d4).
 - b. MAHRHA “Portfolio Re-engineering”. Will it / can it work?
- 4. Relevant concerns and questions.
 - a. Cost to government/cost to owner.
 - b. Revitalization of properties.
 - c. Stabilization/funding of reserves.
 - d. Capacity of owner and operator.
 - e. Interest of owner and operator.