

Tax Credit Recapture Risk Structuring the Sale of Your LIHTC Asset

Since elimination of the IRS bonding requirement for property dispositions prior to the 15th year, many buyers and sellers have asked us: How are your transactions being structured? The answer: we have seen diverse practices in how buyers and sellers have negotiated through tax credit recapture risk in the absence of the bonding requirement.

Tax credit recapture has historically been a risk every LIHTC owner, and particularly tax credit syndicator, has carefully managed against. Recapture exposure arises from the code provision that any decrease in qualified basis during a tax year will trigger a tax equal to the sum of the accelerated portion of the credit taken in prior years with respect to the decrease in qualified basis, plus interest. A decrease in qualified basis occurs when any portion of a LIHTC project is not in compliance with Section 42 of the code or if a project is sold prior to the end of the compliance period. Prior to the changes to the law, there was a special rule that eliminated the immediate recapture for a property sale if the seller posted to the IRS a bond for the amount and term specified by the IRS; the property was still required to operate, in compliance, for the balance of the compliance period. To the joy of many, and disappointment of a few bonding companies, the Housing and Economic Recovery Act of 2008 eliminated the bonding requirement. Among the arguments used in calling for its elimination was that the IRS had never called a bond in the history of the program, to our knowledge, and it was an unnecessary administrative burden.

Although the IRS bond requirement disappeared, the risk of tax credit recapture remains and continues to be a hot button in negotiations between buyer and seller. As before, contract language still assigns responsibility for any tax credit noncompliance to the buyer for issues after closing while the seller retains liability for noncompliance issues prior to the sale. This typically involves indemnifications, representations and covenants from the buyer that they will maintain compliance and pro-

vide notifications if, for some reason, there is a compliance problem. It also typically involves an indemnification by the seller to the buyer that the buyer will be compensated for issues arising under the seller's ownership.

However, we note considerable diversity in practice in how transactions are structured to account for recapture risk, both in terms of the type of assurances sellers require and what buyers will accept as conditions of the transaction. Sellers realize that if recapture were triggered, with no bonding company involved, they need to manage the risk of recovery from the buyer more diligently. Sellers have requested a variety of provisions (see below) in their purchase agreements depending on how they perceive both the recapture risk and the buyer credit risk.

Common Contract Provisions

- **Buyer contract representations, covenants and indemnities.**
- **Buyer to provide compliance information for the balance of compliance period.**
- **Guarantees from the buying entity or principals of buyer.**
- **Buyer's financial statement and requirements for ongoing buyer financials for remainder of compliance period.**
- **Bond provided by buyer to benefit of the seller (rather than IRS). Terms, amount and who pays for the bond are negotiated elements.**

There really is no "correct" way to structure for this risk—it is very situational. However, these issues are often significant points of negotiation and should be carefully factored into each transaction. Like other transaction issues, how this point is resolved in the negotiation typically involves tradeoffs that include price, the size of the buyer pool and potentially, the willingness of certain buyers to

execute, even after they enter contract negotiation.

From the perspective of the selling general partner, addressing how the issue will be handled early with your limited partner is very important. In many cases, limited partners or their investors may have a very specific risk concern, or viewpoint, on what sort of structure they require in order to provide their consent to a transaction. If limited partners have not previously considered this issue, weeks or months can be added to the sales process. From the perspective of the potential buyer, understanding what the seller will require to address recapture risk is equally important. Some buyers are unwilling to consider personal guarantees for recapture and simply forego the opportunity; other buyers see recapture as a very low risk and in their control to prevent.

On a related note, owners who have sold a property in the past that required the old IRS bond have asked whether they can get a refund now that the bond is no longer required. The answer to this question is generally no. The vast majority of bond agreements declare premiums earned at inception and the premium generally was paid up front, not over time. If the bond happens to be paid annually rather than up front (unusual) then the IRS does have a process for discontinuing the bond requirement (details on how to do this in Rev. Proc. 2008-60).

The good news is that LIHTC property sales, prior to the end of the 15th year, continue to get done. From our experience, the most important point is to be proactive with this issue and realize that there are implications to price, timing and the size of the buyer market.

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Back to the Basics: Leasing Up in a Downturn

For years, many tax credit property managers we interact with were able to maintain steady property operations without breaking a sweat. Now, amidst a more challenging market, some of these same managers are struggling to sustain operations. Why? The new challenges of a weaker economy are catching some property managers off guard. More effort is now required for the same result and management shortcomings are magnified.

As transaction advisors, we observe firsthand how important management is to the value of a property. With over 70 LIHTC property closings since the beginning of the recession in 2008, we witnessed time and again the negative impact property management issues can have on property operations and value. Compiled below are some of the basic areas of property management where we believe property and asset managers alike should refocus their attention in an effort to ensure operations are sustained during this difficult economic climate. It is always surprising to discover how many of these areas are not given the priority they deserve, or are being overlooked all together.

Understand Your Submarket

Know your targeted renter profile and ensure your property has a marketing message tailored to highlighting the unique advantages of your community. An in-depth understanding of your residents, why they live in your building and what surrounds your property will allow you to appropriately attract new residents. Your resident profile should be developed based on the advantages of your community. For example, its proximity to employers, schools, bus routes, shopping centers and recreation. Or maybe the property's amenity package, on-site day care center or the fact that it is the only community in the area with a business center. Each community will not attract the same resident; find out your unique advantage within your submarket.

Know Your Competition

Truly understanding who you are competing against is the only way to compete. One of

the easiest yet most valuable ways in property management to accomplish this is through conducting routine market surveys. By not constantly analyzing current market trends in concessions and asking rents, you are denying yourself critical information. Without knowing how other properties are structuring their leases, there is no precise way to know if money is being left on the table, or if prospective tenants are being priced out.

Advertising

Marketing budgets are tight. However, you still need to attract residents. For this reason, it is more crucial than ever to understand what is working and what is draining your marketing budget. Find out how every prospect heard about the property and allocate your resources accordingly. You want to align your marketing resources with your targeted resident profile to ensure you are getting your message out to the right people, whether it is via Internet rental sites, newspapers, flyers or sandwich boards. Depending on your target audience, the best advertising medium might actually be free; i.e. Craigslist, Facebook, Twitter. Never hurts to take advantage of these!

Presentation

Obvious but often overlooked. The impression your property leaves prospective residents with starts with the curb appeal and signage and goes down to the organization and cleanliness of the leasing office, as well as the leasing staff's approach. Ensure you have the maintenance resources and leasing staff in place which will demonstrate to prospective tenants that the property is managed by professionals who care about the community, and thus their residents. All other things being equal, a prospect's decision may come down to something as simple as the impression they walk away with after their first site visit.

Leasing Metrics

The axiom, you can only "manage what you measure" applies to asset management. The asset manager in today's environment needs accurate, complete and timely information to react effectively to market conditions.

Surprisingly, we find inaccurate reporting even for the most basic vacancy, delinquency, concessions and bad debt data—this may have been overlooked in better times, but is crippling in today's world. Beyond the basic monthly numbers, it is advisable to establish a weekly reporting system and ensure you have visibility to the leading indicators of property leasing performance. Sometimes collecting this information may be incremental work for the property management group, but in other cases an existing report already exists within the property management software and just not in use (obtaining a list of all available leasing reporting from the software may be a place to start). Among the most important weekly metrics: move ins/outs, rental activity and tenant notice activity, detail tracking of the source of traffic, tracking of which sources are resulting in rentals, and tracking of traffic not renting and why. Seeing this information in the form of a trend analysis is usually most revealing.

Producing and analyzing leasing metrics on an ongoing basis will help minimize the impact of negative market trends on operating results. From an asset management point of view, we find that if this information is not being frequently discussed with property management, there is far less focus on emerging trends and properties are under-managed.

Review Lease Expiration Report

Everyone has heard that it is less expensive to retain an existing client than earn a new one; the same concept applies to multi-family residents. Managers should be doing everything they can to hold on to good residents. With enough lead time, managers can follow up with residents whose leases are expiring and potentially prevent someone from moving out. Contacting a tenant six months prior to their lease expiration is good practice. Then continue to follow up after establishing a timetable that works for your resident profile. Consider implementing an incentive for current residents to renew their lease early.

Closing Skills / Follow-Up

Perhaps the easiest, most effective and cost efficient tool at a manager's disposal is their ability to close, yet it takes a disciplined staff to ensure it is executed. Leasing agents

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Q&A With a Property Manager



Kellie Falk-Tillett is a Managing Director at Drucker & Falk Real Estate. She is responsible for the overall operations of multifamily management services.

How do you think the leasing market is different than it was 2 or 3 years ago?

We have seen some decline, but our Section 42 product has not declined as significantly as our conventional product in the last few years. In some of the smaller markets, Greensboro, NC for example, where the market is soft, LIHTC properties are performing only slightly better than our market-rate properties. However, we certainly haven't seen much LIHTC rent growth recently.

How have you adapted to this leasing environment? What are you doing different that you didn't have to do 3 years ago?

Managers have to be on their best behavior. What's working is we are becoming more creative. We're doing more resident referral programs. We're paying for stuff that we wouldn't have paid for before; for instance, for affordable housing we're paying the liability insurance instead of billing the resident. It's hard to tack that on even though it's not much of a charge. We're trying to do everything we can to keep the rents low.

Is competition tougher than it was a few years ago?

Not as much for Section 42 properties, although I can tell you that in some of the markets where income and rents are higher, competition is a little stiffer. They are now competing with market-rate properties that have reduced their rent so significantly that it is almost the same as our LIHTC units. In smaller markets where rents are lower, we've been fine.

What do you hear most out of owners that you

manage for? What are their biggest concerns right now?

Evictions, skips, and turnover expenses. More than anything we are seeing the number of skips increase - more than I've seen since probably the early '80s. You've got people who are losing jobs, situations where they have become financially stressed, and they just can't pay the rent. They're just leaving in the middle of the night.

What would you say is the number one reason people are moving out?

I'm not entirely sure, everyone says something different. If I had to guess, judging by the evictions and skips, I would say loss of job.

How many days out before lease expiration are you looking to start contacting the tenants?

We require a 60-day notice anyway, so we start contacting some residents as early as 90 or 120 days prior to their lease expiring. We recently found out that some of our properties were just letting people go month-to-month, out of fear that approaching them with new lease terms would cause them to think about moving. We had to coach our staff to try to get these tenants back on the lease.

What is the best way to retain your current tenants?

Maintenance. That is the number one reason why people choose to move out, maintenance problems. If you are consistently responsive to maintenance calls, it goes a long way to keeping residents happy. Who wants to have their toilet break then not get it fixed for 24 hours?

What do you hold as company policy for following up with prospective residents?

We are signed up with a company called *Lead Tracking Solutions*. Their software forces our employees to follow up via email or a phone call depending on which one the prospect requests. Each morning, it makes it so they can't actually log on and

start working until they have completed several follow up tasks. It's a great program. By next year we should have nearly all our properties on it.

Is it difficult to retain talent in this market?

It's strange that you ask - so here we are in this bad economy, everyone losing their job, and we are still letting people go for not performing! I tell them, "Now you know you just heard the unemployment rates on the news, and yet you still come in late, and you're not trying hard enough!" But in the same breath, we have been able to pick up some really good people who have been laid off for other reasons. We have better than average retention, but this industry can be a revolving door.

How are you motivating your staff in this leasing environment?

It depends on the market. Some of the markets' real estate commission laws don't allow us to pay per lease. Where they do allow it, we pay them a lower base salary and then we pay commission. In markets where they don't allow commission, we will bonus the property for the staff to share. Or we might pay a little bit higher salary in those markets that restrict leasing bonuses.

What are some of your favorite advertising mediums?

I'm a big internet person. I've told my staff that I prefer them not to use any print. If they insist, I only allow one print medium. And with *Lead Tracking Solutions* we can actually track and see if it is performing. So we will reevaluate that after six months or so. But I really think the internet is the way to go. There are many different options out there, Apartments.com, ForRent.com, ApartmentGuide.com, even Craigslist.

Would you use the internet to market a senior community?

You know, I hear this argument all the time, and I don't agree with it. We are seeing a huge increase of internet usage with seniors, especially with Facebook. Many of our properties have their own Facebook fan pages.

Market Spotlight: Dallas/Fort Worth

Smaller Deals Getting Done in the Metroplex

Occupancy rates in the two major cities of the Metroplex are expected to merge this year for the first time since 2003. In Fort Worth, vacancy has begun to decline in response to rent adjustments by local owners. In Dallas, meanwhile, development is surging, with more deliveries on the way in the second half of the year. As a result, the 200 basis point gap in vacancy between the two MSAs has dissipated to 110 basis points as of mid-2009. With Class A vacancy pushing higher in Dallas due to supply-side pressure; the market wide rate is expected to settle in the mid-9% range by year end. A rebound in the local job market and declining development activity in 2010 will likely lead to a jump in household formation, pushing absorption rates higher and returning the market to a more localized competitive environment.

Local buyer activity will set the tone for the investment market during the next six months as some buyers move off the sidelines. Transaction velocity is significantly lower among out-of-state investors, especially from California, where deal flow slowed by 73% in the most recent 12-month period. The properties that are changing hands with outside capital are much more in line with traditional Texas-based deals, as older and smaller assets are trading. A combination of tight credit markets, which have made larger loans more difficult to obtain, and limited cash are the primary drivers for the shift. The local investment climate is expected to be one of the first to rebound as the credit markets thaw, due primarily to low per-door prices and robust population growth.

ECONOMY

Payrolls are expected to retract by 73,000 jobs in 2009, an annual decline of 2.5%. Last year, 2,400 positions were created in the Metroplex, despite deep cuts in the fourth quarter.

HOUSING & DEMOGRAPHICS

Changes in home values will have a muffled effect on apartment demand in the Dallas/Fort Worth area. Since a steep increase in market wide prices never materialized, the modest correction is unlikely to lure a significant number of renters into ownership.

VACANCY

In 2009, a significant wave of new development will be the primary driver of a 230 basis point increase in vacancy to 9.6%. Last year, vacancy rose 120 basis points.

RENTS

Asking rents are forecast to end 2009 at \$780 per month, a 0.9% decline, while effective rents slip 3.1% to \$697 per month.

SALES TRENDS

Buyers are seeking deals with a short-term cash flow horizon. As a result, top-tier properties will remain the slowest movers in the Metroplex, while stabilized Class B assets should attract investor attention if they are priced reasonably.

SUBMARKET VACANCY RANKINGS

1	Northwest Denton County	5.3%
2	North	5.6%
3	Far North	6.2%
4	Oaklawn/Uptown/CBD	6.2%
5	Lewisville	6.6%
6	Carrollton/Addison/Coppell	6.9%
7	South Irving	7.0%
8	Hurst/Bedford/Euleus	7.2%
9	Garland	7.2%
10	Mesquite/Seagoville	7.3%

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Note: Metro-level employment growth is calculated using seasonally adjusted quarterly averages. Sales data includes transactions valued at \$500,000 and greater unless otherwise noted. Source: Marcus & Millichap Research Services, Bureau of Labor Statistics, CoStar Group, Inc., Economy.com, National Association of Realtors, Real Capital Analytics, Reis, TWR/Dodge Pipeline, U.S. Census Bureau.

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should place two to three follow-up phone calls per prospect and consider sending a personalized note highlighting the advantages of the community. In theory, agents should follow up with prospects until they sign a lease with you or another community. If they lease from a competitor, take the opportunity to ask them why, and use that information to improve.

A study conducted before the recession found that barely half of all prospective tenants are followed up with at all. Take advantage of these odds and make sure you are following up more aggressively than your competition.

Most of this appears to be common sense, yet we repeatedly run across management staff who are not following these steps. During a difficult leasing environment, these steps are more critical than ever to ensure your property operations are not negatively impacted.

Tax Credit Group: Current LIHTC Activity

	Closed	Escrow/Mktg.	Total
Properties	239	16	255
Units	34,285	2,998	37,283
States	34	10	-
Dollar Volume	\$1,517,573,843	\$121,365,853	\$1,638,939,696

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