MEMO TO: National Council of State Housing Agencies (NCSHA)

FROM: Coalition to Preserve Affordability of LIHTC Housing

RE: Best Practices for Assessing Compliance for LIHTC

DATE: 2/28/17

Based on our work with our low-income clients and our communities, we are increasingly concerned about the early release of Low Income Housing Tax Credit (LIHTC) developments from their use restrictions. Our focus started with the specific, and still worrisome, issue of “planned foreclosures,” but in our handling of cases and our evaluation of data from housing finance agencies (HFA), we are also very concerned about the apparent large number of early releases that go beyond the planned foreclosure context.

We support the National Council of State Housing Agencies (NCSHA) in creating best practices for evaluating compliance in order to address these concerns and to ensure that developments stay affordable during the full term of the initial compliance and extended use period. This memo describes specific areas in which we think NCSHA guidance would be particularly helpful.

Legal services programs have a direct interest in maintaining the availability of quality affordable LIHTC-financed housing for our clients. This interest is consistent with the mission of HFAs to both finance the development of such quality affordable rental housing and to protect the public investment in such units by monitoring for compliance with all appropriate requirements.

Before outlining specific issues, it is important to note that as a general matter HFAs should only allow developments to end their low-income use restrictions for the specific reasons outlined in the Internal Revenue Code. The Code only allows for a release of a development’s affordability guidelines in two limited circumstances: foreclosure and qualified contract. We believe that HFAs should not expand these exceptions.

- **Housing Finance Agencies should take specific steps to reduce the likelihood of planned foreclosures**.

As the market throughout the country has begun to rebound, we have started to see instances of “planned foreclosures,” which are actions by partners in LIHTC developments that are designed to result in a foreclosure, or deed-in lieu, and thus contemporaneously wipe out the affordability restrictions on these properties. Since the Treasury Secretary has not yet acted to block such schemes or to provide guidance to HFAs (nor signaled any impending commitment to do so), HFAs should take steps to minimize the risk and likelihood of planned foreclosures and thus any future opportunities for lost units, and to keep in line with what other states have done.

These concerns are not theoretical. A recent lawsuit filed in the Western District of Michigan describes an entity that appears to have engaged in planned foreclosures in several states. *Complaint, Thompson v. Eenhoorn, LLC*, 1:17-cv-00021 (W.D. Mich. Jan. 6, 2017). Prior to the lawsuit, the Michigan State Housing Development Authority wrote to the IRS on September 19, 2016 outlining its concerns with the entity that is subject to the lawsuit.

Here are some steps that HFAs can take:

- *Limit the ability of developers that have engaged in planned foreclosures to obtain future credits*.

Pennsylvania has recently instituted a strong policy against planned foreclosures by putting in its proposed draft 2017 Qualified Allocation Plan the following: "The Agency may reject an Application from any Applicant (or related entity) who participates in a transaction or program to achieve early termination of a Restrictive Covenant Agreement as determined by the Agency in its sole discretion."

- *Provide limits on planned foreclosure in restrictive covenants or other long term use restriction instruments*.

In many states, the language of the restrictive covenants in use presents a risk that they are automatically terminated upon the execution of a deed-in-lieu. These self-executing restrictive covenants are extremely harmful.

An approach used by the Maryland Department of HCD appropriately seeks to interpose the agency as a barrier to self-execution, by permitting the agency, in its discretion, to block any automatic termination upon the agency's determination that the foreclosure is pre-textual, as stated in the IRC:

> Termination Prior To Expiration of Extended Use Period.
>
> (a) This ELIHC shall terminate prior to the expiration of the Extended Use Period with respect to the Project or any Building upon the date the Project or such Building is acquired by foreclosure or deed in lieu of foreclosure; provided, however, this ELIHC shall continue in full force and effect if the Secretary of the Department determines that such acquisition by foreclosure or deed in lieu of foreclosure is part of an arrangement with the Owner, a purpose of which is to terminate this ELIHC.

> (b) Notwithstanding the foregoing, if any party acquiring the Project or a Building by foreclosure (or instrument in lieu of foreclosure) fails to record an agreement terminating this ELIHC and provide the Administration with written notice thereof, the Project or Building, as applicable, shall remain subject to this ELIHC, and the eligibility of such party to receive Tax Credits shall not be adversely affected, if such party continues to comply with Section 42 of the Code and the terms of this ELIHC.

In Ohio, OHFA recently revised its restrictive covenant by removing the self-executing nature of a foreclosure-related termination. The section now states:

> Agency may terminate this RC prior to the end of the Restriction Period as a result of, and on the date that, the building(s) in the Project is (are) acquired by foreclosure or an instrument given in lieu of foreclosure as provided in Section 42(h)(6)(E)(i)(I) of the Code, unless the Internal Revenue Service determines that such acquisition is part of an arrangement with the Owner in which a purpose of such arrangement is the termination of the Extended Use Period.

- *HFAs should encourage existing developments to execute and record amended restrictive covenants that include strengthened language*.

While amending current restrictive covenant forms should help for future developments, this alone will not have a remedial effect on developments that are currently in operation, unless the HFA has reserved the right to make these types of changes in the agreement itself or in HFA regulations. HFAs should offer incentives for developments to amend their current restrictive covenants, which could be in the form of points on future applications or reduction in fees.

- **Housing Finance Agencies should create substantive standards and procedural steps to evaluate requests for Qualified Contract purchases**

We are also seeing a problematic loss of affordable LIHTC developments through the Qualified Contract (QC) process outlined in the Internal Revenue Code. Through a public records request, we have learned of a significant number of units throughout Ohio that have been released prior to the end of their extended use period due primarily through the QC process. Other states have also experienced terminations under the QC process, unless they have required a waiver of this option by owners of LIHTC developments.

As we stated above, our clients' interest in accessing quality affordable housing is consistent with the HFAs' mission to develop such housing and protect the public's investment. To promote these goals, we have particular suggestions.

Agencies should consider requiring applicants for a future allocation of credits to waive their QC rights, as permitted by the IRC and as is the current practice in at least some states. The QC process offers no countervailing public policy benefits that would justify the loss of affordable housing. The formula price established under IRS regulations often exceeds actual market value, thus presenting owners with an easy exit after the compliance period, since no rational buyer would overpay for the property.

HFAs should not simply accept any request by an owner to exit early based on the qualified contract process. Agencies should specify the information needed to evaluate the request, provide tenants notice of the request so that tenants have input, and then evaluate the request based on substantive standards. Furthermore, entities (and their affiliates) that seek the qualified contract process should be subject to a sanction on subsequent applications, which could be in the form of reduced points.

- **HFAs should require that tenants receive notice when a owner anticipates a foreclosure or requests a qualified contract**.

Tenants play a key role in preserving affordable housing and insuring compliance with the tax credit program. They can provide information to the HFAs who are assessing a qualified contract request or scrutinizing a foreclosure, and they can also take steps on their own, through the restrictive covenant to enforce rules against non-compliant owners.

As a result, HFAs should require developments applying for a qualified contract or who are anticipating foreclosure (e.g., as triggered by a notice of default) to notify tenants of these events. The cost of notice is minimal and the benefits for maintaining compliance are large.

- **HFAs should build incentives into their Qualified Allocation Plans for maintaining and even extending affordability**

Many states HFAs have built in incentives for maintaining and extending affordability into their Qualified Allocation Plans (QAPs). These incentives are consistent with the goal of LIHTC program to provide sustainable affordable housing. HFAs should strongly consider including such incentives into QAP to ensure lasting affordability.

As we discussed above, where an agency has not required waiver of QC rights for all applicants, we believe HFAs should carefully scrutinize QC requests. In addition to developing substantive and procedural guidelines for those requests, several HFAs have also taken steps to limit QC requests through their QAPs. For example, in Arizona's 2017 QAP, an applicant that waives its ability to request a QC will receive 10 points in the scoring. Iowa's QAP provides 25 points on its scale for a similar agreement. In Colorado, a developer can earn an increasing number of points on its application for the longer it agrees to waive its ability to request a QC. These are a few of many examples.

State HFAs have also used the QAP to extend affordability beyond the standard compliance and extended use period. For example, in Idaho, an applicant receives 15 points if it provides low-income use for 25 years after the initial 15-year compliance period, and as part of this, the applicant waives its right to request a QC until one year before the expiration of the full 40-year period. In Michigan's system, a developer can earn up to five additional points for agreeing to a longer affordability requirement (up to 45 years).

- **HFAs should analyze data regarding early terminations, releases, and foreclosures to determine trends**.

In addition to creating procedures to evaluate QCs and to combat unnecessary foreclosures, HFAs must review their internal data to detect trends regarding QCs and foreclosures. They should also determine if particular entities are taking advantage of the system. The data should not only inform their monitoring of current developments, but it should also inform their QAP process.

- **HFAs should require developments to include reference to the good cause standard in tenant leases**.

Tenants, as a general matter, already have the right to enforce the low-income use restrictions. However, if tenants do not have any provisions or addenda to their leases referring to the development's LIHTC status, they are extremely unlikely to know their rights. As a practical matter, Courts may not look past the lease to determine the rights of the parties.

In response, several states, including Ohio, Pennsylvania and California, have required LIHTC developments to include a lease addendum. Such an addendum can both inform the tenant and other people that the tenant is in a LIHTC development and it can also incorporate basic protections such as the good cause requirement. These required lease provisions are more likely to improve compliance by letting tenants and other parties know about their rights.

We thank you for your time and attention to this matter, and we would greatly appreciate any opportunity to discuss these recommendations. Our interest in affordable housing for our clients is consistent with the goals of HFAs to develop such housing, and we believe a conversation on these issues would promote these shared goals. We have included contact information for members of our coalition who would appreciate any conversation on these topics:

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