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Recapture Exposed

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It's one of the biggest fears of the low-income housing tax credit industry — recapture. The subject haunts investors, syndicators, developers, lenders, lawyers, accountants and property managers alike. It is the dirty word of the industry that no one wants to hear—especially when the context involves one of his or her projects. Hopefully you will never need to face this ugly villain, but occasionally it is necessary to take the monster out of the closet and expose it so that we can understand the risks and what needs to be done to avoid those risks.

What is Recapture?

In an ideal world, a low-income housing property delivers low-income housing tax credits (LIHTCs) to its owners over 10 years (the tax credit period) and the property earns the credits over 15 years (the compliance period). Owners receive the benefits of a dollar for dollar reduction of their tax liability and the program provides housing to low-income households as designed. Everyone is happy.

Unfortunely, we do not always live in an ideal world. Because credits are earned over 15 years and claimed over 10 years, there is a portion of the credits being claimed in years one through 10 that has not yet been earned. These credits are often referred to as the accelerated portion of the credits. This scenario can be compared to an employee receiving an advance on his or her paycheck for work to be performed in the future.

Should the property fail to operate as planned, the accelerated credits may have to be returned to the Internal Revenue Service (IRS) proportionate to the percentage of the property failing to operate as planned. Extending the paycheck comparison, if the employee quit before completing all of the work for which the advance was paid, then the employee would be required to pay back the employer for the unearned portion of the advance. In the same way, an owner of a property who does not continue his responsibility to provide affordable housing for the full compliance period must pay back the amount of credits claimed but unearned. This is called recapture.

How Is Recapture Triggered and How Do I Avoid It?

Recapture occurs either through a disposition of the building or a decrease in the qualified basis of a building from one year to the next. A decrease in the qualified basis of the building occurs either through a decrease in the applicable fraction of a building, or a decrease in the underlying eligible basis of the building. In summary, the three triggers of recapture are disposition, noncompliance and casualty loss.

Disposition

Trigger: The sale of an LIHTC property to a new owner can trigger recapture of the credits previously claimed by the original owner. The original owner is not fulfilling his duty to operate the low-income property for the remainder of the compliance period; therefore, he is not earning the accelerated portion of the credits claimed.

Exceptions and Remedies: The Housing Act of 2008 made recapture triggered through disposition of a building unlikely. The act indicated that buildings disposed of after July 30, 2008 can avoid recapture if it is reasonably expected that the building will continue to be operated as a low-income

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building for the remaining compliance period. If the buyer of the property intends to step into the shoes of the seller and continue operating the property as a low-income housing project, there is no recapture of previously claimed credits. The old requirement of posting a surety bond to avoid recapture applies to dispositions that occurred before July 30, 2008.

Noncompliance

Trigger: A decrease in the applicable fraction of a building occurs when previously qualified units no longer qualify for the program. This can happen by moving an over-income household into a low-income unit, charging rents above the applicable limit, renting a low-income unit to a household composed entirely of full time students, leasing on a transient basis, or a variety of other compliance related problems. These noncompliance items are generally reported to the IRS by the state allocating agency on Form 8823.

Exceptions and Remedies: The simple answer to avoid recapture due to noncompliance is to keep all units in compliance. Setting up management systems to review the files of new households for completion and for qualification is a major part of avoiding recapture due to noncompliance. The problem with this approach is that no system is perfect. Even the most sophisticated, experienced and diligent management companies will make mistakes. There is some refuge for managers who are diligent and committed to ensuring that households are qualified and files are complete. According to the Joint Committee Report on the LIHTC and General Explanation Report on the LIHTC: "Owners and operators of low-income housing projects on which a credit has been claimed must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any noncompliance is corrected within a reasonable period, there is no recapture." When mistakes happen, noncompliance should be corrected as soon as possible to avoid a recapture penalty.

Casualty Loss

Trigger: A decrease in eligible basis typically occurs due to a casualty loss of some kind. A fire, flood, hurricane or other damage to some or all of the units in a building can cause a reduction of the basis of the building and can cause recapture of tax credits associated with the reduction of the basis.

Exceptions and remedies: Casualty losses do not automatically trigger recapture —that would be unfair. An owner who is unfortunate enough to have his property destroyed has an opportunity to restore the property without the penalty of recapture. No recapture will occur if the damage is repaired within a reasonable time period not to exceed two years from the close of the year that the casualty loss occurred. If the loss is not restored by the end of the

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taxable year in which it occurred, then the owner should not claim credits for that year, but there is no recapture of credits previously claimed. Special rules apply to federally declared disaster areas. In these circumstances, the property must still be repaired within a reasonable time period not to exceed two years from the close of the year that the casualty loss occurred, but credits can continue to be claimed even if the repairs are not completed by the end of the year of loss.

How Much Will It Cost?

Every year of the compliance period has a different potential recapture amount. In years one through 10, two-thirds of the total credit amount claimed have been earned and one-third of the total credit amount claimed has the potential for recapture. In years 11 through 15, the potential for recapture decreases by one-fifth of the total accelerated credit amount claimed until, at the end of year 15, the potential for recapture is zero.

Interest accumulates on recapture amounts from the due date of the tax return on which the credits were claimed. The interest rates charged by the IRS vary depending on the type of taxpayer claiming the credits.

On page 4 is an example of a building with a total credit allocation of $10 million ($1 million annually). In this example, an interest rate of 8 percent is used to calculate the total potential recapture with interest for each year. For each year, it is assumed that the recapture event would occur in the following year and payment of recapture and penalties would be made one year from the date of the last tax filing due date with credits claimed.

As you can see in the example on page 4, the interest associated with recapture can be significant. If this building were to be impacted by a full credit recapture during year 11, $5,215,162 would be payable to the IRS. More than 35 percent of that amount is associated with interest. The reason for this significant impact is that the recapture represents underpaid taxes from many years prior and interest on these amounts accumulates over time.

Note that recapture caused by a decrease in applicable fraction recaptures only the portion of credit associated with the change in applicable fraction. If the building had a change in applicable fraction from 100 percent to 50 percent, only half of the total potential cumulative recapture with interest would apply.

Although recapture is daunting and scary, there are many ways to avoid it. Through solid planning and review, no property should be forced to face these steep penalties.

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Year	Credits Taken	Credits Earned	Cumulative Credits Taken	Cumulative Credits Earned	Potential Cumulative Recapture	Potential Cumulative Interest on Recapture	Potential Cumulative Recapture With Interest
1	$1,000,000	$666,667	$1,000,000	$666,667	$333,333	$26,667	$360,000
2	$1,000,000	$666,667	$2,000,000	$1,333,333	$666,667	$82,133	$748,800
3	$1,000,000	$666,667	$3,000,000	$2,000,000	$1,000,000	$168,704	$1,168,704
4	$1,000,000	$666,667	$4,000,000	$2,666,667	$1,333,333	$288,867	$1,622,200
5	$1,000,000	$666,667	$5,000,000	$3,333,333	$1,666,667	$445,310	$2,111,976
6	$1,000,000	$666,667	$6,000,000	$4,000,000	$2,000,000	$640,934	$2,640,934
7	$1,000,000	$666,667	$7,000,000	$4,666,667	$2,333,333	$878,876	$3,212,209
8	$1,000,000	$666,667	$8,000,000	$5,333,333	$2,666,667	$1,162,519	$3,829,186
9	$1,000,000	$666,667	$9,000,000	$6,000,000	$3,000,000	$1,495,521	$4,495,521
10	$1,000,000	$666,667	$10,000,000	$6,666,667	$3,333,333	$1,881,829	$5,215,162
11	$-	$666,667	$10,000,000	$7,333,333	$2,666,667	$1,839,234	$4,505,900
12	$-	$666,667	$10,000,000	$8,000,000	$2,000,000	$1,379,425	$3,379,425
13	$-	$666,667	$10,000,000	$8,666,667	$1,333,333	$919,617	$2,252,950
14	$-	$666,667	$10,000,000	$9,333,333	$666,667	$459,808	$1,126,475
15	$-	$666,667	$10,000,000	$10,000,000	$-	$-	$-
Total	$10,000,000	$10,000,000					

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