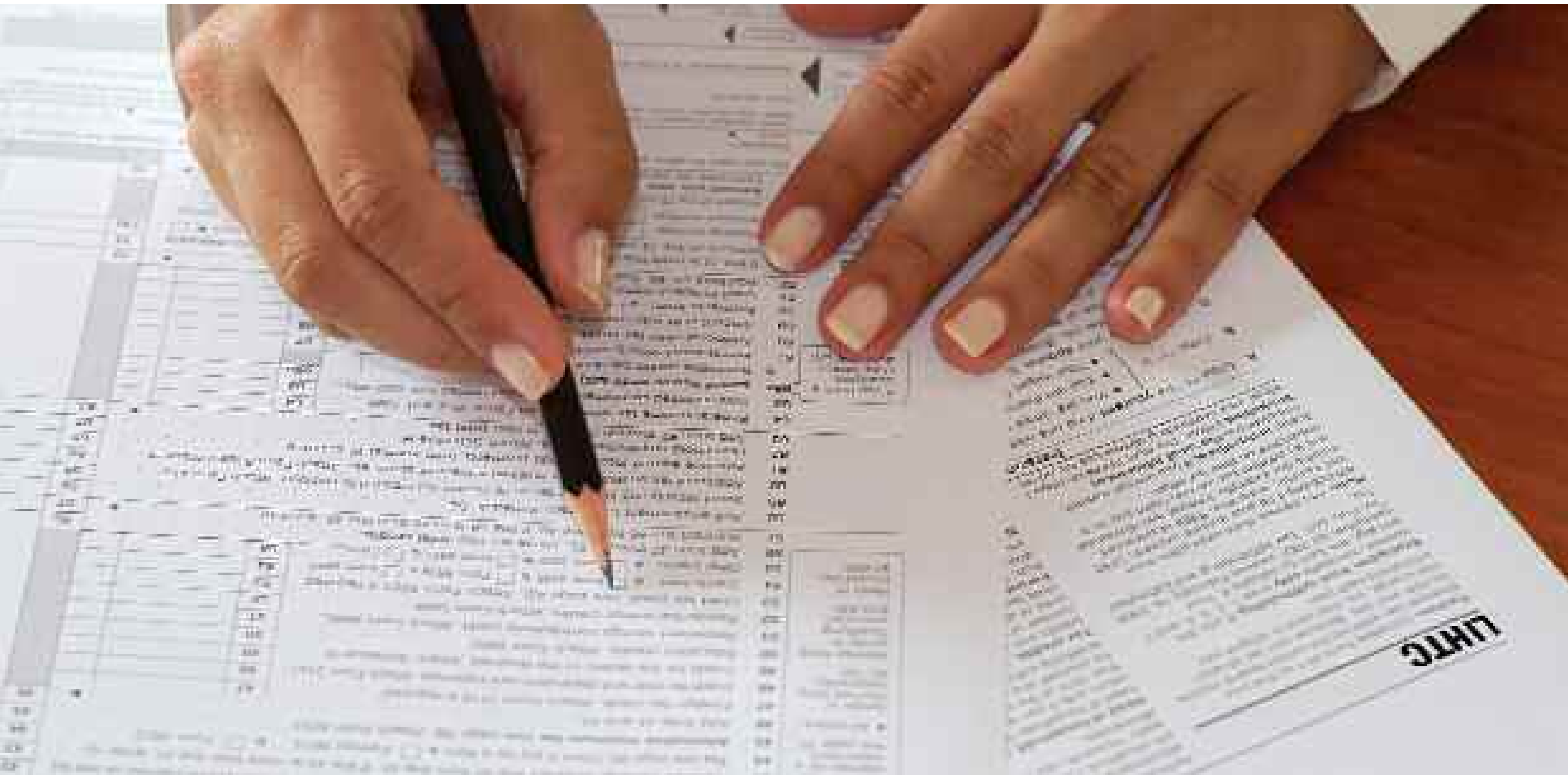
A Way to Protect Low-Income Housing Tax Credits

Insurance can be an innovative, optional endorsement that covers loss of tax credits as part of the loss of income.

BY BILL HALL



Since it began in 1986, the Low-Income Housing Tax Credit (LIHTC) program has allocated more than $7.5 billion in federal tax credits for low-income housing. These tax credits have been applied to more than 1.76 million apartment homes.

"Tax credits are extremely important to the ongoing growth of affordable housing in America. Without this mechanism, much of our housing would not be successful or affordable for our low/middle class and elderly," says Randy Phelps, Partner at HNI Risk Services.

Real estate developers apply for LIHTCs by preparing an application that is responsive to the state's Qualified Allocation Plan (QAP) for the tax credit program. The QAP will describe the types of projects eligible for credits.

Each state is given a pool of federal tax credits based on its population. The distribution of these tax credits is administered by a state housing credit agency. If the state agency approves the developer's application, they will reserve that amount of tax credits from their annual federal allocation.

Developers of low-income housing typically sell the tax credits to syndicators, who in turn find investors who have tax liability they wish to offset. In these transactions, the tax credits are guaranteed by the developer. Therefore, if a tax credit is reduced or eliminated, the developer is liable for making good to the investor on the loss.

For example, consider if a low-income housing project is receiving tax credits. As a result of a large fire, many of the apartments become uninhabitable and therefore out of service.

These units are not eligible for the tax credit for the tax year in which they went out of service. The amount of lost tax credits would obviously be significant.

"The demand for low-income housing has sky-rocketed and demand far exceeds the supply of available units, says Glenn Ricciardelli, CPA, Senior Partner at Matson Driscoll & Damico LLP.

As the IRS continues to offer tax credits for low- and moderate-income housing, there have been a significant number of cases involving the loss of tax credits or recapture as a result of property damage.

"Currently, most developers are not providing any type of insurance coverage for the owners who have the exposure to loss of the tax credits should they sustain a loss that puts the property out of service," Phelps says.

What If There's a Fire?

The "basis" for the calculation of tax credits is the value of the building and improvements.

If something happens to the property that reduces the basis—i.e., one or more units are damaged and rendered uninhabitable—the tax credits are proportionally reduced by the IRS, says John Potvin, President, Equity Management, a property management firm.

"The syndicator would lose a portion of the tax credit," Potvin says.

Insurance agent Alan Schulman of Waldor & Schulman sold an apartment policy covering a 40-unit apartment building in New Jersey. It includes coverage for loss of tax credits.

"If there was a fire that destroyed a unit, the owner would not get the tax credit," Schulman says. "Tax credits are the reason most of these builders go into these deals."

Developers who sell tax credits to syndicators and other buyers have a huge liability.

It's imperative that the developer or property manager maintain and service the property so that the tax credits remain in place.

Normally, loss of tax credits is not covered by insurance under the standard definition of business income.

Now, an innovative optional endorsement covers loss of tax credits as part of the loss of income.

This endorsement is available to property managers and owners who can find themselves caught in the middle when tax credits are lost because of a covered cause of loss such as a fire.

"Very few developers know that the coverage is out there," Phelps says.

Questions to Ask

For comprehensive protection, in consultation with the company's accountant or attorney, ask insurance carriers or agents whether the insurance policy protects you against loss of tax credits.

If not, consider adding an endorsement that will cover the loss of those tax credits.

"Without this option, upon a catastrophic claim, not only does the owner suffer the loss," Phelps says. "The developer and property manager do as well, if the property fails because of the lack of financial backing to cover the loss of the tax credit.

Seeing that the tax credit is such a critical piece of the financial pie, it only makes sense that it is insured, just like the bricks, mortar and rental income."

Questions to ask when considering such coverage as a stand-alone policy would be about the minimum premium charge and the minimum deductible requirements.

Costs can range from a small percentage of the commercial residential insurance policy premium or it can be significant in the case of a stand-alone policy.

Lastly, always ask about coverage, claims, company financial stability and any notable exclusions.

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