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The Credential

Understanding Tax Credit Adjusters

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Buried within each partnership agreement for an LIHTC development are three or four pages that embody the heart of the transaction — the sections defining credit adjusters. A tax credit investor commits to its capital contribution on the condition that the property deliver tax credits at the times and in the amounts anticipated. When the investor does not receive the benefit of its bargain, it wants to be made whole. Tax credit adjuster provisions fulfill this purpose. This article provides a basic summary of the credit adjuster provisions that are commonplace in partnership agreements for LIHTC developments.

At the initial closing of a tax credit transaction, the investor and developer establish a schedule of projected tax credits to be received by the investor during the 10-year credit period. Based on this anticipated schedule, the investor establishes a price it is willing to pay for each dollar of tax credits it expects to receive. When the credits delivered are not consistent with the projections, one of three adjusters may be applied: initial basis adjusters, timing adjusters or lost credit adjusters.

Initial Basis Adjusters

Upon completion, a cost certification is prepared to establish the total eligible basis incurred for the development. This results in the issuance of Form 8609s, verifying the amount of annual tax credits for which the property is qualified in each of the 10 years of the credit period. This amount may not equal the amount projected at the initial closing. To the extent it differs from the projection, a credit adjuster may be applied.

If the actual annual credit amount is less than the projected credit amount, the tax credit price is typically used to calculate the credit adjuster. For instance, if the investor paid $0.90 for each $1.00 of credit expected to be received, then the capital contribution will be reduced by $0.90 for each $1.00 of annual tax credits that is not supported by the Forms 8609, multiplied by the ten years in the credit period to reflect the total reduction in tax credits that will be provided to the investor. This is often known as a “downward adjuster.”

If the actual annual credit amount is more than projected, the same method is typically used for the increase, and the resulting “upward adjuster” is applied to increase the capital contribution only if the investor is projected to actually receive the additional tax credits. Because the 9% tax credit program is subject to the state housing credit ceiling that limits the amount of credits available annually, the housing agency may not be able to increase an owner’s tax credit award, even if the owner qualifies for additional tax credits. When 4% tax credits are combined with tax-exempt bonds, there is no state housing credit ceiling. The owner may be able to receive additional tax credits, and an upward adjuster may be applicable. Often, investors limit their exposure to upward adjusters by capping the amount of additional capital they will agree to contribute in the partnership agreement.

Downward and upward adjusters are typically applied to the investor's capital contribution obligation before the investor makes its final capital contribution payment. The forecasted tax credit delivery schedule for the credit period is adjusted accordingly. Because the final capital contribution often is used to pay the developer fee, a downward adjuster can be particularly devastating for the developer. Further, if the amount of the downward adjuster is actually greater than the amount of the final capital contribution payment, the developer/guarantor may be required to pay the difference directly to the investor.

Timing Adjusters

The anticipated schedule for completion of construction and leasing of the buildings in the development may result in the delivery of only a partial amount of the annual tax credit in the first year of the credit period. Any portion of the annual amount not delivered in the first year is deferred and delivered in the 11th year. In this scenario, failure to complete construction or lease the development as anticipated will reduce the amount of partial-year credit available to the investor. The credit adjuster typically applied is a present value calculation. The investor determines the difference between the first-year credit that was projected and the first-year credit that is actually delivered. Knowing that the difference will be deferred to the 11th year, the investor applies a discount factor over 10 years to reflect the present value of the loss. Ten percent is a common discount factor. The result is deducted from the final installment of the capital contribution or, if no capital contribution remains, paid directly by the developer/guarantor to the investor, and is often called a “downward timing adjuster.”

It is important for a developer to be conservative in its initial construction and leasing projections to avoid the impact of this credit adjuster. Senior developments with notoriously slow leasing schedules can be particularly vulnerable to optimistic projections from equally optimistic developers. It's far better to exceed expectations, generating an “upward timing adjuster” that is calculated in the same way with a discount factor and resulting in an additional capital contribution to the partnership.

Lost Credit Adjusters

The final category of credit adjusters occurs after the initial basis and tax credit delivery are established. If, in any year, the development fails to qualify for the full amount of tax credits projected for that year, or tax credits that were previously awarded are recaptured, an adjuster may be applied. This may occur due to a failure of compliance or a casualty that makes all or some portion of the development unavailable for occupancy. The adjustment most often occurs after the capital contribution has been fully paid, so the developer/guarantor must pay the adjuster amount to the investor from its own funds. The adjustment is usually calculated at face value — each dollar of tax credit lost by the investor must be repaid, regardless of the tax credit price. Sometimes, a premium is applied. For instance, the adjuster may be 110% of the lost credits. Additionally, the adjuster will include any penalties, interest or other costs incurred by the investor as a result of the loss or recapture.

Conclusion

Credit adjusters can have a material impact on a developer/guarantor. The risk can be mitigated by ensuring adequate expenditures to support eligible basis, utilizing conservative construction and leasing schedules, and maintaining proper compliance. Experienced developers will work with construction companies and property managers that they believe will best support them in their efforts to complete and operate the property in a manner that avoids the negative consequences of adjusters.

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