Introduction to the LIHTC Program

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Part One

Introduction to the LIHTC Program

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LIHTC Program

- The low income housing tax credit (LIHTC) program was created through the Tax Reform Act of 1986
- Its purpose is to draw private investment towards the construction or rehabilitation of rental housing affordable to low income persons
- To date, the program is responsible for the creation of more than 2.5 million affordable units

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What is an LIHTC?

- A tax credit is a dollar for dollar reduction in the federal income tax liability of an owner, reducing the amount of federal income tax an owner must pay over a 10 year credit period
- An investor applies their tax credit dollar for dollar against their federal income tax bill

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Example

- An owner receives a credit allocation with a tax credit equal to $1,000,000 for each year of the 10 year credit period
- The owner's tax liability is $3,000,000 for year 1 of the credit period
- After applying their $1,000,000 tax credit, the owner owes $2,000,000 in federal income taxes

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Use of Credits

- A developer uses the credits to attract investment to a property
- Investors purchase a share in its ownership and benefit from that share of the its LIHTC
- With the ability to attract investors, the developer is able to create the project but borrow less money and so can operate it with lower rents

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Eligible Activities

- For the acquisition of a property, so long as the project qualifies for rehabilitation credits
- For the rehabilitation of a property, regardless if it qualifies for acquisition credits
- For the construction of new, residential rental housing

Competitive Allocation Process!!!

- State agencies must issue Qualified Allocation Plan (QAP) annually
  - The QAP is the description of the process the allocating agency will use that year to score the applications for credits received from developers
  - Most agencies receive 3 times the applications they can fund in a year

Non Profit Set Aside

- 10% of the credits an HFA awards annually must go to properties with nonprofit sponsors
- The nonprofit must materially participate in both the development and operation of the property
- An HFA may allocate more than 10% of their credits to projects with nonprofit sponsors

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Preservation

- States may set aside credits to preserve existing affordable housing:
  - Section 236 and Section 221(d)(3)
  - Section 202
  - Project based Section 8
  - RD communities
  - Older LIHTC properties in need of recapitilization

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Incentive to Maximize Low Income Occupancy

- Only units occupied by eligible low income residents generate tax credits
- A developer maximizes the value of the credits by renting the number of units covered by the allocation to eligible tenants by end of 1st year
- The portion of a building occupied by LIHTC residents is officially calculated at the end of the first year of the credit period

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The Credit Period

- Lasts 10 years
- Begins the same year as the buildings placed in service date
- An owner may elect to begin credit period the year following the PIS date

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Compliance Period

- The initial compliance period lasts 15 years
- An owner must meet the requirements of the LIHTC program per the IRS and the HFA for 15 years
- The credits can be jeopardized by what an owner or does not do during the 15 years

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Extended Use Period

- The extended use period (EUP) continues after the compliance period for a minimum of 15 additional years
- An owner must commit to operating the project as an affordable property for the EUP
- Compliance requirements after year 15 may be looser than during the compliance period

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Part Two

Determining Eligible Basis and Qualified Basis

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Eligible Basis

- Those costs that are eligible to generate tax credits for an owner of a building
- Includes both hard and sot costs
- Must be a depreciable cost to be included in eligible basis

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Calculating Eligible Basis

- Calculated at the end of the 1st year of the credit period
- May include costs the owner incurs after the building's placed in service (PIS) date but before the end of the 1st year of credit period

The Developer's Fee

- Developer paid for conceiving of the property and managing it to completion
- Should be considered reasonable for the market place
- Many allocating agencies limit the developer's fee; e.g., 15% of the total development costs

The Developer's Fee cont'd

- Partnership agreement describes developer's duties in exchange for fee
- Generally final cost paid for the project
- Services developer performs must be tied to items included in basis for the fee itself to be included in basis

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Costs Excluded from Eligible Basis

- Cost of the land
- Costs capitalized as part of the land
- For acquisition credits, developer should structure sales contract to separate cost of the land from the cost of the buildings being acquired

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Federal Grants

- An owner must reduce a building's eligible basis by the amount of a federally funded grant received prior to the start of the building's compliance period
- A grant received during the compliance period that enables the owner to rent to low-income residents, and that does not add to the building's eligible basis, need not be subtracted from eligible basis

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The Minimum Set Aside

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The Minimum Set Aside

- The owner commits to renting a minimum percentage of units *at the project* to LIHTC eligible residents
- Federal tax code outlines options for minimum set aside
- HFA may require owner to commit to more a restrictive set aside

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Minimum Set Aside Options

- **<u>20% @ 50%</u>** - The owner commits to renting 20% of the units at the project to households with income no greater than 50% of the AMI
- **<u>40% @ 60%</u>** - The owner commits to renting 40% of the units at the project to households with income no greater than 60% of the AMI

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Minimum Set Aside cont'd

- An owner must meet the requirements of the minimum set aside to participate in the program and earn the minimum possible tax credit
- Must comply with the minimum set aside by the end of the 1st year of the credit period and continue to comply throughout the compliance period

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The Credit Allocation and the Applicable Fraction

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Credit Allocation

- Developer negotiates with HFA on how many units covered by allocation and the maximum possible LIHTC each building and the project may produce
- May have committed to do 100% tax credit or a mixed income property
- Most developers plan for more low income units than required by the minimum set aside

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Example

Single Building Property w/ 100 units

Owner commits to 20% @ 50% set aside

Owner received an allocation for 70 units

Owner needs 20 LIHTC units to claim credits

Owner wants to claim credits on 70 units

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Applicable Fraction

- That portion of a tax credit **building** occupied by tax credit eligible families
- Applicable fraction (A/F) is the *lesser of:*
  - The Unit Fraction – Percentage of units in a building occupied by eligible tenants; or
  - The Square Footage Fraction – Percentage of square feet in a building occupied by eligible residents

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Applicable Fraction cont'd

- Owner's goal is to meet a targeted A/F to garner maximum possible credits
- To maximize the credits, owner must meet the targeted A/F by the end of the 1st year of the credit period and maintain the target throughout the compliance period

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Example

Owner receives 70% credit allocation
Owner needs 70% of the units &
70% of the floor space rented to
low income tenants to maximize the
value of the credit allocation

Example cont'd

If the building's 100 units cover 80,000 square feet, the owner needs 70 tax credit units covering 56,000 square feet (80,000 x 70%) rented to eligible residents by 12/31 of the 1st year of the credit period to maximize the value of the building's credit allocation

Applicable Fraction cont'd

- 1st Year Applicable Fraction – The applicable fraction calculated on 12/31 of the 1st year of the credit period

The Qualified Basis

Qualified Basis

- Qualified Basis = Eligible basis x A/F
- Represents the costs for that portion of a building occupied by qualified tenants
- Qualified basis for the 1st year of the credit period establishes the potential value of the credits for the credit period

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Example

Eligible Basis = $1,000,000

1st Year A/F = 60%

Qualified Basis = $1,000,000 x 60%

1st Year Qualified Basis = $600,000

$600,000 in costs are qualified to produce LIHTC

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Part Three

The Credit Percentage
and Equity Contributions

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The Credit Percentage

- Two types of tax credits
  - 9% credits
  - 4% credits
- Applicable credit % published monthly by Treasury in the *Federal Register*
- Credit % established by building

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Establishing the Credit %

- Credit % for a building is the % published for the month the building is PIS
- Owner may elect to use the credit % the month they received a binding commitment from the HFA for a future credit allocation
- Owner must know what constitutes a binding agreement per the HFA's allocation procedures

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9 Percent Credits

- Compensates the owner for 70% of the present value of the qualified basis over the life of the credit period
- Provides additional return to compensate owner for restricted rent levels
- "Competitive credits"
  - For new construction
  - For substantial rehabilitation

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Rehabilitation Credits

- To qualify for rehabilitation credits, owner must spend the *greater of*
  - $6,500 per low income unit; or
  - 20% of the adjusted basis of a building
- Owner selects period of time no longer than 24 months to accumulate costs
- Test applied on a building basis at the end of the 1st year of the credit period

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9% Credits cont'd

- To qualify for 9% credits, financing for the construction must not be federally subsidized
- The only financing that is now considered to be federally subsidized is tax-exempt, private activity bonds
- Other federal loans, e.g., HOME, etc… no longer considered to be a federal subsidy under HERA 2008

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4% Credits

- For acquisition credits
- For new construction or rehabilitation financed with tax-exempt bonds
- Compensates the owner for 30% of the present value of the qualified basis over the life of the credit period
- Provides extra return necessary due to restricted rents of the program

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Calculating the Credits and Investor Contributions

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Calculating Year 1 Credits

- The owner multiplies the qualified basis for a building at the end of the 1st year of the credit period by the applicable credit percentage to calculate the tax credits for the 1st year of the credit period

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Example

Qualified Basis Yr 1 = $1,000,000

Tax Credit Percentage = 9%

Tax Credits for Year 1 = $90,000

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Total Tax Credits

- An owner multiplies the tax credits for the 1st year of the credit period by 10 years to determine the total tax credits projected to be generated by a building

Example

1st Year Tax Credits = $90,000

X 10 years

Total Tax Credits = $900,000

Investor Participation

- Typically investors have 99.99% ownership so they benefit from 99.99% of the credits
- Developer multiplies the total tax credits by the portion of the property owned by the investors to determine the portion of the credits benefiting the investors
- Developer multiplies investor’s tax credits by the amount investors are paying per credit dollar to determine equity raised through the sale of the credits

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Example

Total Tax Credits = $900,000

Investors own 99.99% of Property

Investors Paying 90 cents per credit $

$900,000 x 99.99% x .90

Equity Raised through Syndication = $809,919

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Averaging the First Year Applicable Fraction

Averaging the 1st Year A/F

- Must calculate a building's A/F at the end of each full month after PIS
- Include in the month-end A/F any unit leased to eligible family by month end
- Calculate 1st year credit using 1st year A/F calculated on 12/31
- Calculate the average A/F for the 1st yr using month end A/Fs following PIS

Division of the 1st Year Credit

- Owner may take credits on the 1st year tax return representing that portion of the 1st year the units were actually rented to low income tenants
- Owner takes the remaining portion of the tax credit for the 1st year of the credit period on the tax return for the 11th year of the compliance period

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Division of the 1st Year Credit

- Determine the 1st year A/F and QB and calculate the tax credit for the 1st year
- Determine the average A/F for the 1st year and determine how much of the tax credit for the first year may be taken on the 1st year's tax return

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Division of 1st Year Credit cont'd

- Subtract credit taken on the first year's tax return from the total tax credit for the first year of the credit period to determine that portion of the 1st year credit the owner may take on the return for the 11th year of the compliance period

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Example

100 unit 100% tax credit building PIS on 8/1
$6,000 credit/low income unit rented year 1

A/F on 8/31 = 40%
A/F on 9/30 = 60%
A/F on 10/31 = 80%
A/F on 11/30 = 100%
A/F on 12/31 = 100%
First Year A/F = 100%
Yr 1 Credit = $6,000 x 100 units = $600,000

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Example cont'd

Average Year 1 A/F =
(40% + 60% + 80% + 100% + 100%)/12 mos
380%/12 mos = 31.67%

$600,000 x 31.67% = $190,020
Portion of Yr 1 Credit Taken on Yr 1 Return

$600,000 - $190,020 = $409,980
Portion of Yr 1 Credit Taken on Yr 11 Return

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Averaging Convention cont'd

- Further impacts how much equity investors willing to pay per credit $
  - Earlier in the year the credits are PIS and the units are occupied by eligible households, the more investors will pay per credit $
  - Later in the year the credits are PIS and the units are occupied by eligible households, the less investors will pay per credit $

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Syndication and Ownership Structure

Syndication

- Process of raising investor equity and selling ownership in an affordable property is called syndication
- Developer contributes knowledge and skills necessary to bring planned property to fruition
- Developer typically contributes little $

Ownership of LIHTC Properties

- Most properties owned by partnerships consisting of one GP (the developer) & one or more LPs (investors)
- Some properties owned by limited liability companies consisting of a manager (the developer) and one or more members (investors)
- Consult council to determine preferred ownership structure

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Negotiations

- Developer negotiates amount and schedule for investor contributions
- Developer wants investors to contribute as much as possible as quickly as possible

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Negotiations cont'd

- The smaller and slower the investment, the more the developer will need to borrow, the more likely will need to defer developer's fee
- The investors want to minimize their investment and make payments as slow as possible to maximize their rate of return

Investor Contributions Schedule

- Market dictates size and timing of investor contributions
- Typically make three to four payments

Sample Contributions Schedule

- 30% at end of construction
- 30% after leasing units to qualified tenants
- 20% at the closing on the permanent loan
- 20% following meeting operational goals including generating positive cash flow, funding required reserves and obtaining a specified debt service coverage

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Investor Rate of Return

- Each investor decides on rate of return required for investing in LIHTC property
- Expect to receive majority of return through the tax credits
- May expect additional return through cash flow, other tax advantages and through the increase in property value

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Developer's Fee

- Paid out of final capital contribution
- Size of final payment impacted by
  - Operating reserve to prevent foreclosure
  - Operating deficit guarantee to prevent foreclosure
  - Developer making basis and delivering the credits promised
  - Developer leasing LIHTC units during Yr 1
  - Speed at which units were leased during Yr 1

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Partnership Agreement

- May require developer solicit an audit of the low income units and provide a report that all units were properly leased during Yr 1 before final payment
- Provides for credit adjustors allowing investors to make smaller and slower equity contributions if the developer does not deliver credits as planned

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Part Four

Project Underwriting and Submitting the Cost Certification

Underwriting a LIHTC Property

- An HFA conducts a financial analysis of a proposed LIHTC property at 3 stages in the allocation process
  - When the developer applies for credits
  - When the agency allocates the credits
  - When the owner places the credits in service

At Placed in Service

- At the end of the construction process, the developer submits the information the agency needs to conduct the 3rd underwriting and establish the actual credit allocation or authority
- The credit authority may be less than previously stated if the agency determines the property will be financially viable with a smaller allocation

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The Cost Certification

- The developer submits a cost certification, documenting the actual construction costs and other costs associated with the tax credit property
- Numbers must be certified as true by a CPA
- Agency may require signature of a tax attorney

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Underwriting cont'd

- HFA wants to avoid
  - Allocating credits for a property unlikely to succeed
  - Allowing the developer to earn fees in excess of that allowed
  - Allocating more credits than necessary to support a financially viable property

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Net Operating Income

- A developer calculates the NOI by subtracting the projected vacancy loss and operating expenses from the expected rental income
- The NOI is the amount of money available to meet the debt service requirements

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NOI cont'd

- Agency wants sufficient NOI to meet debt service requirements should rental income be lower or vacancy loss and operating expenses higher than projected in the pro forma
- Agency does not want to approve excessively high NOI allowing an owner to generate excessive cash flow from an affordable property

Debt Service Coverage

- Debt service coverage is the relationship between the NOI and the debt service requirements for a property
- In their underwriting guidelines, HFA establishes a standard for what is an acceptable debt service coverage for a tax credit property

Example

Net Operating Income = $530,000

Debt Service Requirements = $480,000

DSC = $530,000/$480,000 = 1.10

The NOI is 10% greater than the debt service requirement for the property

If the state requires a DSC between 1.15 & 1.20, would not allocate credits for property as planned

Example

Net Operating Income = $530,000

Debt Service Requirements = $380,000

DSC = $530,000/$380,000 = 1.39

The NOI is 39% greater than the debt service requirement for the property

If the state requires a DSC between 1.15 & 1.20, would not allocate credits for property as planned. The project can support more debt under the state's guidelines

Underwriting at PIS cont'd

- HFA establishes the actual credit authority
- If the developer requires a lower credit authority than quoted earlier in the allocation process to create a viable property, the HFA lowers the credit percentage, particularly for the 4% credits
- HFA may also limit eligible basis to reduce the tax credit a building will produce

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End of Allocation Process

- Developer signs the regulatory and extended use agreements and provides evidence of recordation HFA issues Form 8609
- Investor must submit 8609 to IRS to claim first year's tax credits
- Developer should have a realistic estimate of how long between the time s/he submits the cost certification and when the HFA provides the Form 8609

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Questions

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