

**UTILIZING THE LOW INCOME
HOUSING TAX CREDIT FOR RURAL
RENTAL PROJECTS:**

**A GUIDE FOR NONPROFIT
DEVELOPERS**

HOUSING ASSISTANCE COUNCIL

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RURAL RENTAL PROJECTS:**

A GUIDE FOR NONPROFIT DEVELOPERS

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HAC, founded in 1971, is a nonprofit corporation which supports the development of rural low-income housing nationwide. HAC provides technical housing services, seed money loans from a revolving loan fund, housing program and policy assistance, research and demonstration projects, and training and information services.

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INTRODUCTION

This guide will provide rural nonprofit developers with a starting point for exploring the Low Income Housing Tax Credit as a possible financing instrument for their affordable multifamily housing projects. The guide will review key facets of the tax credit and, more importantly, point out possible pitfalls for rural nonprofits at each point concerning use of the tax credits, from evaluating whether tax credits are useful for a given project to monitoring issues over the life of the project.

There are significant reasons why rural nonprofits should step carefully when approaching use of the tax credit. Not least of these is the potential for high-volume, long-term financial liability as an owner and/or potential manager of a tax credit project. Nonprofits also must consider carefully how to manage a relationship with for-profit partners and investors if they are going to use the tax credit successfully. Finally, rural developers must consider a cost-benefit analysis for small projects (projects with 32 units or less) -- does the tax credit provide enough capital to compensate for the relatively high levels of due diligence, monitoring, and liability for a project with comparatively few units? Are the maximum rents allowable under the tax credit program actually marketable within an economically depressed rural area, or would residents be just as likely to rent a trailer for \$250 as a tax credit unit for \$300?

This document is intended as a complement to existing training and reference materials. This guide will alert nonprofits to special considerations they should take into account in the beginning of their quest for financing small rural projects with the tax credit. However, any individual or organization should consult with technical manuals and technical assistance providers when pondering the actual use of the tax credit. Readers are also encouraged to use this guide as reference material; in addition to a basic introduction to the tax credit, this guide provides textual resources, contact numbers, and other reference materials which will be of some assistance to the rural nonprofit housing developer throughout the development process. In particular, there are extensive footnotes and cross-references to Joseph Guggenheim's *Tax Credits for Low Income Housing*.¹ While Guggenheim's text is intended for the general audience learning about tax credits (not rural entities, or nonprofits in particular), it is a comprehensive and in-depth explanation of the tax credit; HAC strongly encourages developers to read Guggenheim and keep it close by at all times. A glossary will clarify definitions of "terms of art" particular to the tax credit industry for readers unfamiliar with some language (terms which are defined later in the glossary appear in italics in the text). Finally, an extensive index has been included to facilitate continued use of this guide as additional questions develop for a rural nonprofit engaged in providing affordable multifamily housing.

¹Guggenheim, Joseph, *Tax Credits for Low Income Housing: Opportunities for Developers, Non-Profits, and Common Communities Under Permanent Tax Act Provisions (9th Edition)* (Glen Echo, Maryland: Simon Publications, 1996).

HISTORY OF THE TAX CREDIT

Nonprofits seeking to utilize tax credits for their developments for the first time should understand some of the politics and history of the program. Within the nonprofit sector, the program has been regarded by some as somewhat controversial, largely because its costs to both the federal government and the project can outstrip the costs of some direct subsidized loans such as Section 515 Rural Rental Housing. Tax credits do, however, provide a lucrative incentive to private industry to invest in affordable multifamily housing. Also, the long-term structure of tax credits helps ensure that low-income units remain low-income and occupied for at least fifteen years; should the low-income percentage of units drop within the first fifteen years, the number of tax credits available to the investor is reduced. This introduces what some have labeled “market” discipline perceived to be lacking in some programs.

The 1986 Tax Reform Act established the Low Income Housing Tax Credit in Section 42 of the Internal Revenue Code.² Originally, the program was enacted for a three-year period ending December 1, 1989, but it received extensions in 1990, 1991, and 1992. In 1993, Congress permanently authorized the tax credit program.³

In 1995, the tax credit program came under fire in Congress for alleged abuses -- primarily focused on developer fees and noncompliance -- and a “sunset” of the program was proposed. The program survived, but the U.S. General Accounting Office (GAO) was asked to determine the characteristics of tax credit projects and their residents and to evaluate the efficacy of IRS and state monitoring agency controls over program operations. Released in March of 1997, the report found that the tax credit program actually surpasses its legislated goals in some respects. The tax credit is targeted to projects with very low-income and low-income residents. In fact, approximately three-quarters of households residing in tax credit projects had very low-incomes in 1996, and the average income of residents was about \$13,000. However, GAO did conclude that state agencies need to increase their efforts to evaluate the accuracy and reasonableness of projected development costs in tax credit applications. GAO also recommended that state agencies improve their compliance monitoring efforts, and stressed that the viability of tax credit projects over the long term of the compliance period has not yet been tested, since the program is still only 11 years old. (Compliance periods run at least 15 years, generally 30 years. Many state tax credit agencies have also indicated preferences for projects with commitments to low-income use beyond the statute’s baseline of 15 years.)

Although GAO’s report and the popularity of the tax credit with private industry have probably alleviated the threat of an end to the tax credit program, Congress will be examining GAO’s recommendations for reform and prevention of abuse with an eye toward potentially extensive regulatory reform, the cost of which would most likely be passed on to applicants and owners of tax credit projects. However, it is also possible that GAO’s relatively optimistic report will support a drive to increase the *state allocating cap* on tax credits.⁴

²See Appendix A for a copy of Section 42 of the Code.

³Each extension and the permanent authorization were followed by both minor and substantial alterations in the Section 42 regulations. Projects financed with tax credits from each year continue to operate under the regulations that were in place at the time of the tax credit reservations.

⁴As explained below under *Tax Credit Basics*, each state is entitled to award annually tax credits in an amount equal to \$1.25 per capita. Most projects seeking tax credits must compete for tax credits from this pool of funds. (Projects which have been awarded tax-exempt bond financing are automatically eligible to receive 4 percent tax credits without competing against other projects, and the amount of tax credits reserved for these projects does not count against the state’s annual allocation cap.) In recent

Information from the Low Income Housing Tax Credit Database

Recently, the U.S. Department of Housing and Urban Development (HUD) provided for creation of a database capturing characteristics of tax credit projects placed in service from 1990 through 1994.⁵ HUD has also published a report detailing major findings of characteristics of projects for which most information was available, namely projects placed in service from 1992 through 1994. The report indicates several trends which are noteworthy to tax credit developers generally and nonprofit rural developers specifically. Among its findings:

- ⊞ Average project size for the three analyzed years was 42.2 units; about three-quarters of the projects consisted of 50 units or less. However, the average project size increased over the three years from about 37 units to about 45 units. The number of projects with 10 or fewer units decreased from 30 to 16 percent of all projects over the three years.
- ⊞ The vast majority of projects consist of 100 percent or nearly 100 percent low-income units. (Under tax credit regulations, not every unit in the project must serve low income households, though each project must meet minimum thresholds of low-income occupancy. Tax credits are only awarded based on the percentage of units which do qualify as low-income. See *the 20/50 rule* and *the 40/60 rule* and *minimum set-aside* in the glossary.)
- ⊞ Nearly 80 percent of the units produced over the three years were one- and two-bedroom units.
- ⊞ Nonprofit sponsorship rose from 18 percent in 1992 to 27 percent in 1994.
- ⊞ About two-thirds of projects across the three analyzed years were new construction only; about one-third were rehabilitation. Less than one percent of the projects entailed both rehabilitation and new construction.

years, however, the demand for tax credits has rapidly increased, while the number of tax credits available has not. Many tax credit advocates seek an increase in the state allocating cap.

⁵The database is available for download via the Internet at <http://www.huduser.org/lihtc>.

- ⊞ For the years 1992 through 1994, almost 35 percent of projects (consisting of about 25 percent of all units) were financed by tax credits in conjunction with RHS Section 515 Rural Rental Housing loans.⁶
- ⊞ While about 98 percent of units in nonprofit projects and Section 515-financed projects were qualifying low-income units, the *qualifying ratio* in bond-financed projects was much lower, about 64 percent of units.
- ⊞ Only about 19 percent of tax credit units were located in nonmetro areas, compared with 54 percent in central cities and 26 percent in non-central city metro areas.
- ⊞ The average size of projects located in nonmetro areas was 28 units, compared with 54 units in suburban areas and 48 units in central cities.
- ⊞ About 30 percent of tax credit projects in central cities and suburbs were sponsored by nonprofits, compared with only about 8 percent of tax credit projects in nonmetro areas.
- ⊞ Only about 60 percent of units receiving initial reservations for tax credits are actually placed in service and receive tax credit awards. Data was not available to discern why the other 40 percent dropped from the program.

The results of the database analysis raise some interesting points for nonprofit developers. Nonprofit sponsorship is clearly increasing in the program, perhaps as a result of the 10 percent nonprofit set-aside and states' increasing efforts to give preferences to nonprofit-sponsored projects. However, the results of the database analysis regarding project characteristics in nonmetro areas point out some issues which will be discussed throughout this guide. Nonmetro projects seem smaller than metro projects; however, project size across geographical areas has increased over the short span of time analyzed in the database. Also, RHS Section 515 loans were the primary financing source for tax-credit projects in nonmetro areas, providing an average qualifying ratio of 98 percent low-income units per project. Now that Section 515 has been virtually defunded, how should nonmetro (rural) developers proceed to finance their tax credit projects? The data indicate that tax-exempt bonds, while not likely to disappear in the next couple of years as did Section 515, do not seem to offer the same opportunity to focus on lower-income households throughout a project. (The report captured statistics on the use of Section 515 and tax-exempt bonds in conjunction with tax credits, but did not include data on HOME funds. Many rural housing developers are now using HOME funds to finance tax credit projects.) Finally, about 40 percent of units which receive a tax credit reservation do not seem to be placed in service using the reservation. While the researchers were unable to determine why the success rate was apparently so low, it does raise the specter of problems between the time of reservation and the projected close of construction. How can nonprofits (or developers in general) ensure that their projects have a good success rate from the time they are reserved tax credits to the time in which the units should be placed in service?

These questions will arise throughout this guide, although no concrete, fool-proof answers are available. This guide will answer obvious questions and point out areas in which many projects have experienced trouble.

Other Forms of Tax Credits (SHPO, State Tax Credits)

⁶Beginning in 1995, Section 515 has suffered drastic funding cuts. Parallel analysis of tax credit projects placed in service since 1995 would probably reveal a severely different funding trend.

There are other forms of tax credits not to be confused with the Low Income Housing Tax Credit. Historic Preservation credits and state tax credits (California and Washington, for example, have excellent state-financed affordable housing tax credits) provide different rates of credit for different purposes. Historic Preservation Credits are allocated via State Housing Preservation Offices (SHPO) and the National Park Service for the rehabilitation and preservation of buildings which are historically significant to their surrounding neighborhoods or which were constructed before 1936. Some states have also established tax credits for affordable housing, though each program may vary in terms of percentage credit offered and eligible uses. In California, for example, tax credits are available primarily for farmworker housing.

While the incentives, formulas, and targeted populations of these other tax credit programs may be similar to those of the Low Income Housing Tax Credit, HAC cannot emphasize enough that there are important differences between the LIHTC and these other programs; as with any affordable housing subsidy, those seeking assistance with other forms of tax credits should research those programs directly and carefully.

For purposes of brevity, this guide will use the term “tax credit” to refer to the federal Low Income Housing Tax Credit specifically, unless otherwise noted.

TAX CREDIT BASICS

What is the Low Income Housing Tax Credit?

Unlike a tax deduction, which reduces the amount of income against which taxes are levied, a tax credit is a credit against the actual amount of taxes due to the government by a for-profit entity.

The Low Income Housing Tax Credit in particular is a credit against the federal tax liability of a for-profit entity which invests capital toward the development or rehabilitation of an affordable multifamily housing project. Unlike many federal affordable housing programs/incentives, the tax credit is part of the United States Internal Revenue Code (tax law); it was established in Section 42 of the Code by the Tax Reform Act of 1986. The Act greatly altered and reduced the avenues by which for-profit entities and individuals could benefit from investing in affordable housing, instead narrowing the field of incentives for investment through the creation of the tax credit.

Essentially, the tax credit offers affordable multifamily housing developers an avenue through which to obtain additional capital for development through for-profit investment in the project. The tax credits awarded to a project and claimed by the for-profit investor/owner in the project are claimed by the owner over a period of ten years. In return, the project must set aside a certain portion of its units to households with low incomes for at least fifteen years and usually 30 years.⁷ (Extended Use Agreements with state tax credit allocating agencies may increase the period of low-income use to as much as 30 or 50 years, and other subsidized financing may entail their own low-income use stipulations.)

Each state, through its tax credit allocating agency (usually the Housing Finance Agency), is permitted to reserve annually a total of \$1.25 in tax credits for each person in its population. The agency accepts applications from developers and reserves tax credits for projects on a competitive basis. Projects which are issued tax-exempt bond financing for 50 percent or more of the total development costs do not have to compete for tax credits. They are automatically qualified to receive as many tax credits as necessary to ensure the feasibility of the project, and the amount of these tax credits is not counted against the state's allocation cap. *Each year, each state must set aside 10 percent of its allocable tax credits for nonprofit developers.*

Projects have until the end of the second calendar year after their tax credit reservation has been awarded to complete construction if they obtain a *carryover allocation* from the agency. To qualify for the carryover, applicants must certify and document that the project is 10 percent complete by the end of the reservation year. If the project is not completed by the end of its deadline, the applicant must return its reservation. The agency may then reallocate the credits within two years to another project. If the project is completed, then the allocating agency notifies the project and the IRS of its final award of tax credits on Form 8609 for each building of the project.⁸

⁷Section 42 initially required projects to serve low-income households for 15 years. In 1989, an amendment to the Code extended the mandatory low-income use period to 30 years except in some cases where the property may be sold and converted to market-rate units. If this occurs, low-income tenants remain protected from eviction for an additional three years. Tax credit allocating agencies are required by the statute, however, to give preference to those projects which commit to serving lowest-income residents for the longest period of time.

⁸It is important to note that tax credits are awarded to a project, but are tied to it on a building-by-building basis. Compliance with regulations is therefore judged on a building-by-building basis as well.

The amount of tax credits awarded to a project is based upon the amount of development costs and the number of low-income units in the project, as well as the type of construction financing. Tax credits are calculated as a percentage of the *qualified basis*⁹ of total development costs of the project. This percentage rate is set by the Department of the Treasury, which calculates a *tax credit rate* which will produce a *present value*¹⁰ of tax credits equal to either 30 or 70 percent of the total eligible development costs over the ten years of tax credits to be received by the investor. (See Guggenheim, page 49, for the actual formula used to calculate the tax credit rate.) The exact rates are established monthly based on current interest rates, but hover around 4 and 9 percent.

Whether or not a project uses the 4 or 9 percent credit depends on the type of project being developed and the source of financing. New construction and substantial rehabilitation projects can use the 9 percent credit to the extent that they use financing which is not considered to be federally subsidized. (State funds and bank loans are not considered federally subsidized, and neither are HOME or CDBG funds if certain requirements are met. For more details see “Other Financing Elements” below.) New construction and substantial rehabilitation projects which utilize federally subsidized financing can utilize the 4 percent credit. In rehabilitation projects, the 4 percent credit is applied to the acquisition costs of the site (not including land) regardless of the presence of federal subsidy.

Construction Type	Tax Credit Rate	Present Value
New Construction or Substantial Rehabilitation/no federal subsidy	9%	70 percent of total eligible development costs
New Construction or Substantial Rehabilitation/with federal subsidy	4%	30 percent of total eligible development costs
Acquisition of site (not including land) for Substantial Rehabilitation Project	4%	30 percent of total eligible development costs

Investors pay an agreed-upon percentage of the tax credit amount (*tax credit “price”*) into a project in the form of capital contributions. This percentage varies widely according to the particular terms of a tax credit deal, but investors may pay anywhere from 60 to about 75 cents on the tax credit dollar. The process of “selling” tax credits to an investor is called *syndication*. Like the tax credit price itself, the timing of the capital contributions is an issue to be negotiated between the general partners and the investor(s). In some projects, all of the contribution may be made prior to the start of construction. In others, the contribution may be paid over several years. (See “The Tax Credit ‘Price’ and the Pay-in Schedule” below.) An investor claims the total tax credit amount allocated each year for ten years, barring tax credit reductions or recapture, as explained below.

There may be additional costs associated with tax credit deals, including professional fees for accountants, legal counsel, state monitoring costs, and guarantees. If an intermediary, or

⁹Qualified basis is the amount of eligible development costs multiplied by the percentage of units which will be reserved for low-income households.

¹⁰Present value is defined as the current value of a cash stream received over time. High interest rates and long time periods lower the present value; low interest rates and short time periods raise the present value. For an illustration of how the actual tax credit rate is calculated each month, see Guggenheim, page 49.

syndicator, maintains investment funds for investors and handles the syndication deal with the project sponsors/general partners, additional costs will be incurred for the syndicator's work in marketing and managing the investment funds. These costs will decrease the amount of capital which eventually reaches the project. Therefore, while tax credits bring another source of financing to a development, they also increase the amount of work and "soft" costs associated with the project for accountants and attorneys' fees, as well as arranging any extra reserves of cash demanded by the limited partner to safeguard their investment. As much as 20 or 30 percent of the equity may be consumed by these costs unless the project sponsors are able to set limits on the spending.¹¹

Tax credits were never intended to provide all of the necessary financing for an affordable housing development. Tax credits can provide from 40 to 60 percent of the financing in the form of equity investment. Developers must rely on other financing for a portion of construction and permanent financing at the very least; additionally, a *bridge loan* may be necessary to meet the gap between the amount of the permanent mortgage and the costs of paying off construction-period financing until the full amount of capital contributions is received. Whether the balance of the financing is provided by government agencies or banks, the terms of the additional financing are major determinants of project feasibility. (Again, see "Other Financing Elements" below.)

The Project

For a project to be eligible for tax credits, at least 40 percent of its units must be set aside for households with incomes of less than 60 percent of the area median or at least 20 percent of its units must be set aside for households with incomes of less than 50 percent of area median. These two thresholds are denoted as *the 20/50 rule* and *the 40/60 rule*. At the time of application for tax credits, the applicant must elect under which rule the project will be eligible; this decision governs the minimum set-aside of the project for the life of the compliance period. The election also sets the standard for tenant income eligibility and rent maximums. *Area median incomes* (AMI) for each county are determined annually by the Department of Housing and Urban Development; projects must use HUD's figures for 50 and 60 percent of AMI to determine *income eligibility* of tenants and rent maximums for low-income units.¹²

Rent maximums are set by unit size rather than actual family size or family income, according to certain assumptions about how many people will live in a given unit and the maximum eligible income for a family of that size.¹³ Efficiencies are presumed to house only one person; for units with one or more bedrooms, the maximum rent calculation imputes 1.5 people per bedroom. In a two-bedroom unit, for example, the maximum rent would be based upon 30 percent of the maximum eligible income for a household of three people. This maximum rent also must cover

¹¹The GAO's sample of 423 projects experienced a range of syndication costs from 10 to 27 percent of the equity raised with the tax credits. U.S. General Accounting Office, *Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program* (Washington, DC: U.S. General Accounting Office, March 1997), p. 82.

¹²Note that HUD's calculations for 50 percent of area median income include adjustments in geographical areas which HUD determines to have unusually high or low housing costs relative to the income levels in the area. It is therefore important to use HUD-calculated figures for 50 percent of area median income, rather than simply multiplying area median income by 50, when estimating rental income for the project. By law, the maximum incomes and rents for rural or nonmetro counties are based on the greater of: a) the median family income for that county; or b) the median family income for the entire statewide nonmetro population.

¹³ However, if HOME financing is used, then rents must be calculated in accordance with HOME regulations. See Appendix E.

utility costs, so an amount for estimated monthly utility costs for that size unit is further subtracted to arrive finally at the actual maximum rent chargeable on a given size unit. The fact that rent maximums are based on maximum eligible income adjusted for the *imputed* household size of the unit (not an actual family) means that a household with a very low income may pay the same rent as a low-income family in the same size unit.

Maximum Rents and Imputed Household Size				
Size of Unit	Use maximum income level at 50 or 60 percent of area median income established by HUD for a family of:	Divide by 12 to establish maximum monthly income for the imputed household size.	Multiply by .30 to establish maximum monthly gross rent for that unit size.	Subtract utility allowance to arrive at maximum rent chargeable for that unit size.
Efficiency	One Person			
One Bedroom	1.5 Persons			
Two Bedrooms	3 Persons			
Three Bedrooms	4.5 Persons			
Four Bedrooms	6 Persons			
Five Bedrooms	7.5 Persons			
Six or More Bedrooms	1.5 Persons Per Bedroom			

Rent maximums are an important factor in determining feasibility of tax credit use for a project; if development costs plus the costs of utilizing tax credits mean that monthly rent will exceed a maximum rent for a given unit, then the project cannot use tax credits without somehow reducing monthly rent (through lower debt service for subsidized loans, or use of Section 8 certificates or state rental assistance, for example).¹⁴ This is especially important to note in economically depressed rural areas, where area median incomes are quite low, and eligible incomes and maximum rents are similarly low. There may be no problem finding income-eligible households to live in the project; but will the project be able to survive on monthly rents that are actually affordable to these residents? Tax credits do provide another source of financing for projects, but they do not really lower rents to the extent that a direct subsidized loan would. Without ongoing subsidies or reserves, this is a difficult prospect for many tax credit projects in rural areas.

Tax credits may be allocated for four different purposes: new construction, substantial rehabilitation, acquisition, and federally subsidized new construction or rehabilitation. For non-federally subsidized new construction or rehabilitation, the 9 percent tax rate applies. For both acquisition and federally subsidized projects, the 4 percent rate applies. Where tax credits are concerned, “federally subsidized financing” indicates a loan or obligation of federal funds with an interest rate lower than prevailing Treasury interest rates, as measured by the *Applicable Federal Rate (AFR)*. (Some federally subsidized financing is allowable in conjunction with the 9 percent credit; these programs are discussed specifically later under “Other Financing Elements.”)

There are also restrictions on the types of facilities for which tax credits may be utilized. All units must be “suitable for occupancy” and comply with local building codes. Unless the project is single-room occupancy housing or transitional housing for the homeless, the project must use

¹⁴Section 8 and other rental assistance payments can be used at a project without fear of reducing the project’s basis (and therefore its ability to claim full tax credits for a given year). However, it could lead to difficulty with the IRS if the combined benefits of Section 8 and tax credits are more than needed to make the project feasible.

at least six-month lease periods. In some cases and within restrictions, special needs housing, group housing, small owner-occupied rental buildings, and single-family buildings operated on a rental basis may qualify for tax credits. (For more information on this subject, see Guggenheim, *Eligibility: Types of Housing and Facilities*, pages 31 through 37.)

Location also plays a certain role in the tax credit allocation process: projects in HUD-designated low-income census tracts or difficult development areas can earn higher amounts of tax credits in recognition that project feasibility is especially hard to achieve in these areas. The eligible basis used to calculate tax credits awards in these cases is increased by 30 percent on new construction or rehabilitation expenditures (but not acquisition costs). The additional tax credits will only be awarded if the project is not feasible without them. For more information, see Guggenheim, pages 39 through 41.

To be eligible for the rehabilitation credit, total rehabilitation and related expenditures over a 24-month period must be at least equal to the greater of:

- ⊞ \$3,000 per low income unit, or
- ⊞ 10 percent of the project's unadjusted basis.

Only those rehabilitation expenditures which benefit low-income units (including common areas) count toward the threshold. However, once the threshold is met, tax credits are calculated on the total rehabilitation costs (including those for non-eligible units) multiplied by the percentage of the building that is set aside for low-income households multiplied by the tax credit rate. (See "Calculating the Tax Credit" below for an example.)

To be eligible for the acquisition credit, a project must fulfill one of the following conditions:

- ⊞ qualify for the rehabilitation credit, or
- ⊞ for buildings acquired from a government unit, meet a threshold of an average of \$3,000 of rehab costs for each low-income unit in the building (no 10 percent threshold caveat).
- ⊞ for projects which have received an IRS waiver to avoid mortgage prepayment and loss of units from the low-income housing stock (not a waiver to avoid foreclosure and loss of federal mortgage funds), meet a \$2,000 expenditure threshold for each low-income unit in the building (again, no 10 percent threshold condition).

Since acquisition is treated separately from rehabilitation costs, it is possible to use federal subsidies to acquire a building at a 4 percent tax credit rate while using non-federally subsidized financing for rehabilitation costs at a 9 percent tax credit rate.

If the project is located in a *Difficult Development Area* or a *Designated Low Income Census Tract*, the tax credit amount is calculated based on 130 percent of the qualified basis. (See Guggenheim, pages 39-41.)

The Partnership

Ownership of a project developed with tax credits is a complex issue. Generally, tax credit projects are owned by a *limited partnership*¹⁵ which consists of at least two entities: a general partner (for-profit or nonprofit) which retains approximately 1 percent ownership and approximately 99 percent responsibility for ensuring the project's continuing existence and compliance with tax regulations; and a limited partner (for-profit, to take advantage of the benefits of the tax credits) which, in return for its *capital contributions* to the development of the project, retains approximately 99 percent ownership of the project. Essentially, a limited partnership provides a construct through which various aspects of ownership (cash, equity, liability, and responsibility) may be distributed to different partners as agreed in a *partnership agreement*. The general partner is responsible for ensuring a project's successful development and rent-up, continuing operation and management, as well as compliance with tax regulations. The limited partner is responsible for making capital contributions in the amount and according to the schedule specified in the partnership agreement. The 99 percent share of ownership, along with 99 percent of the tax credits and tax losses, accrues to the limited partner(s), while 1 percent of ownership, along with 1 percent of the tax credits and losses (meaningless to a nonprofit general partner), accrue to the general partner(s). Limited partners are liable only to the extent of their investment (capital or equity) in the tax credits, although in practice they will require some protections on their investment and compensation from the general partner should the project not yield as many tax credits as projected. These protections may exist in the form of Guarantee Funds or other arrangements between the limited and general partners in the partnership agreement. Any such arrangements should be discussed and reviewed vigorously to ensure that the arrangements are equitable to both (or all) partners. General partners are liable for the entire property and partnership.

The limited partnership may include more than one general partner. If so, different responsibilities may be divided among them. General partner responsibilities entail:

- ⊠ Arranging for day-to-day management of the project (managing general partner)
- ⊠ Ensuring compliance with Section 42 regulations and any state monitoring requirements of the project (managing general partner)
- ⊠ Arranging for annual audits and tax form preparations on behalf of the limited partnership (tax matters partner)
- ⊠ Managing or arranging for management of accounts established on behalf of the partnership and the project (managing general partner)

A general partner may be a for-profit or nonprofit entity or an individual.

Limited partner responsibilities entail:

- ⊠ Providing its investment capital in the form of *capital contributions*, usually paid in several installments over the first several years of the project's life

A limited partner must be a for-profit entity in order to take advantage of the tax credit. An individual, corporation, or partnership may be the limited partner. However, passive-loss restrictions on tax credit income limit the extent to which an individual may benefit from the tax credit.

¹⁵In some states, it may be possible for a tax credit project to be owned by a *limited liability company (LLC)*. LLCs protect all partners from liability to a certain extent. However, state laws vary widely regarding LLCs, and they will not be discussed here.

The single most important document of a limited partnership is the *partnership agreement*, which governs all interaction and expectations among the partners. The partnership agreement and fee agreements establish the amount and scheduling of capital contributions, management fees, incentive management fees, payments to partnership reserves and guarantee funds, and developer fees, as well as procedures for removal of general partners should fraud or gross negligence occur. Fee agreements are separate but connected to partnership agreements. There are two basic structures of limited partnerships: one-tier and two-tier partnerships. The one-tier structure is generally used when one property is to be syndicated; the two-tier structure is utilized when several properties will be syndicated using an *equity fund*. The figures on the following page illustrate each structure.

Calculating the Tax Credit

The number of tax credits allocable to a project relates directly to the following concerns.

1. The *lesser* of the percentage of units or the percentage of floor space in low-income units which will be set aside for households with low incomes.
2. The total amount of eligible development costs (does not include the cost of the land or any non-depreciable expenditure).
3. The applicable tax credit rate, as determined by the type of project and financing, and calculated by the Treasury each month.

Considerations must be taken into account for each of these variables:

4. Should all of the units in the project be allocated to low-income use?

Most projects have 100 percent low-income units, therefore garnering the highest amount of tax credits possible for a given project. However, if the project is mixed-income, then rental income may be higher through the life of the project and therefore the project's economics may be more feasible. Also, some state tax credit agencies have elected to give preferences to mixed-income projects.

5. Only *depreciable* development costs count towards the project's eligible basis. Land acquisition costs, for example, may not be included in the basis. (See Guggenheim for a description of eligible and ineligible costs, pages 37 and 39.) Project sponsors may elect whether to include a federal grant in the basis and receive a 4 percent tax credit for federally subsidized financing or exclude the grant from the basis and retain a 9 percent tax credit, assuming all other financing is non-federally financed.
6. Since tax credit rates are calculated by the Treasury monthly based on current interest rates, projections assume 4 percent and 9 percent, depending upon the type of project and financing. It is important to use the correct tax rate in projections for the appropriate costs, and to use different types of financing strategically to be allocated the greatest amount of credits. For example, a developer using grant funds or federally subsidized financing to acquire a building and private financing for a permanent mortgage and construction financing can utilize the 9 percent credit against all construction costs, only utilizing the 4 percent credit on the building acquisition costs.

The owner chooses whether the actual tax credit rate for the 30 and 70 percent present value credits will be the rate in effect either in the month in which the allocating agency reserves tax credits for the project or the month the building is *placed in service*. Generally it is helpful to know the exact credit rate when syndicating the tax credits, so that investors can know the full value of the credits. However, if a project sponsor *absolutely* knows that interest rates will be higher at the placed in service date, than the sponsor may wish to use the tax credit rate published then, since it will be higher based on higher interest rates.

To calculate the maximum amount of tax credits for which a project is eligible, the developer first establishes the total amount of development costs, then subtracts expenses for land and other ineligible expenses to arrive at the project's *eligible basis*. This amount is then multiplied by the percentage of units (or floor space) which will be set aside for low-income households, arriving at the project's *qualified basis*. Multiplying the qualified basis by the tax credit rate produces the maximum annual tax credit for which the project is eligible.

For example, a new construction project has total development costs of \$1,200,000, land cost of \$100,000 and a federal grant for \$100,000. The project will consist of all low-income units.

Total Development Costs	\$1,200,000
Less Land Costs	\$100,000
Less Federal Grant for Qualified Development Costs	\$100,000
Less Other Non-Qualified Costs	0
Less Development Costs of Non-Qualified Units	0
Total Eligible Basis	\$1,000,000
Multiply by Applicable Fraction the <i>lesser of</i> :	
1. Percentage of total square footage for low-income units	
2. Percentage of units which are for low-income households	100%
Qualified Basis for New Construction Tax Credit	\$1,000,000
Multiply by Tax Credit Rate:	
3. 9% if no federal subsidy	.09
4. 4% if federal subsidy	.04

Maximum Annual Tax Credit Amount	Equals \$90,000 if no federal subsidy.
	Equals \$40,000 if federal subsidy.

\$90,000 Annual Tax Credit Amount multiplied by 10 years of the Credit Period equals \$900,000 in tax credits to syndicate.

\$40,000 Annual Tax Credit Amount multiplied by 10 years of the Credit Period equals \$400,000 in tax credits to syndicate.

Calculating the tax credit amount on a rehabilitation project is slightly more complex than on a new construction project, because it entails calculating tax credits on the rehabilitation expenditures separately from the acquisition expenditures. Additionally, the developer needs to keep in mind the minimum rehabilitation costs discussed above in “The Project.” The following example assumes a rehabilitation project with \$750,000 acquisition costs, \$1,000,000 rehabilitation costs, and no federal subsidy.

Acquisition Costs (land and building)	\$750,000
Less percentage of acquisition price attributed to land (assuming 10%)	75,000
Add depreciable soft costs related to acquisition	50,000
Total Eligible Basis for Acquisition Credit	\$725,000
Rehabilitation Costs	\$750,000
Add depreciable soft costs related to rehabilitation (including developer’s fee)	250,000
Total Eligible Basis for Rehabilitation Credit	\$1,000,000

Multiply Eligible Bases (Separately) by Applicable Fraction -- the *lesser of*:

1. Percentage of total square footage for low-income units
2. Percentage of units which are for low-income households 100%

Qualified Basis for Building Acquisition	\$725,000
Qualified Basis for Rehabilitation	\$1,000,000

Multiply by Tax Credit Rate:	
Acquisition Rate – 4%	.04
Rehabilitation Rate – 9% (assuming no federal subsidy; otherwise 4%)	.09

Maximum Annual Tax Credit Amount	
Acquisition	\$29,000
Rehabilitation (assuming no federal subsidy)	\$90,000

Maximum Total Annual Tax Credit Amount	\$119,000
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\$119,000 Annual Tax Credit Amount multiplied by 10 years of the Credit Period equals \$1,190,000 in tax credits to syndicate.

Because of the minimum rehabilitation costs necessary to qualify the project to receive the rehabilitation credit, an additional calculation must be performed to ensure that total rehabilitation expenditures at least equal the greater of \$3,000 per low-income unit or 10 percent of the building's unadjusted basis.

Assume there are 50 units in the project, and the project will be 100 percent occupied by low-income households. First, establish which is greater: \$3,000 per low-income unit or 10 percent of the building's adjusted basis.

Total rehabilitation expenditures must be equal to or greater than \$150,000 in this example. Since rehabilitation expenditures total \$1,000,000, this project is eligible for the rehabilitation tax credit. Generally, rehabilitation projects will not have difficulty meeting the minimum expenditure threshold.

It should be noted here that qualified basis is subject to change between the time of the tax credit reservation from the allocating agency and the time when the agency makes its actual allocation on the last day of the first year of the credit period. The initial year of the credit period is either the year in which the building is placed in service or the subsequent year, at the option of the owner. (See the discussion of construction issues below.) At that time, the tax credit calculation will be adjusted up or down if the eligible basis or the percentage of low-income units has changed. When the allocating agency files Form 8609 notifying the IRS and the owner of the tax credit award, this sets the benchmark of qualified basis to which the project is held for the rest of the compliance period. Should qualified basis change in a given year, either because of vacancies, additional low-income units, or other reasons, the amount of tax credits claimable by the partnership changes accordingly. (See the sections below on monitoring and management issues for more information on tax credit recapture and reduced qualified basis.)

EVALUATING WHETHER THE TAX CREDIT IS USEFUL FOR YOUR PROJECT

Tax credits are a tempting financing source because they are the largest federal source of affordable multifamily financing, and the state allocations include a nonprofit set-aside. However, a nonprofit should not attempt such a project unless it is demonstrably feasible, and the nonprofit is able to sustain the amount of staff time, effort, and risk that will be incurred during both project development and the compliance period. As noted in one article, “Don’t undertake a project just because there is a need for affordable housing. Good intentions will not make up for bad decisions or bad projects.”¹⁶

When attempting to determine whether a project is feasible when utilizing the tax credit, the first place to start is with a professionally performed market study or housing needs analysis (as for any housing project) to determine whether there is a need for the housing. If there is a need for affordable housing, the market study or needs analysis should also reveal at what income level there is a need, what rents exist in the area for comparable units, what size units are needed, what population needs the housing (elderly, family, etc.) and how many units are needed within each category of income level, unit size, and population.

The developer should then find the HUD-calculated Area Median Income (AMI) for the county in which the project will be located. Based on HUD’s determinations for 50 and 60 percent of area median income for the county, the maximum allowable gross rents (rent plus an allowance for utilities) on a tax credit property are 30 percent of each qualifying income level according to unit size.¹⁷ The developer should compare these rents with others in the community; are they comparable with rents on similar units? In some rural areas where incomes are excessively low, the maximum allowable rents on a tax credit property are comparable to or even higher than rents for comparable units (even if the “comparable” unit is a mobile home).

Based on the developer’s sense (or preferably knowledge) of the non-tax credit financing available for the project, he/she should be able to calculate the amount by which development costs must be reduced so that the project’s debt service will be low enough to be covered by rental income. This is the amount that will have to be covered by tax credit equity. The developer should calculate the maximum amount of tax credits available for the project as shown above and compare this amount to the gap in financing.

If the project looks marginal at this point in the planning process, the developer should consider not doing the project unless other funding sources can be secured. As one developer noted, “If a tax credit project looks marginal on paper, it will be a disaster in reality.” It may, of course, be possible to obtain HOME funds at 1 percent interest to significantly lower the amount of debt service on the project and make it feasible. Or it may be possible to rearrange other financing sources to take best advantage of tax credits available for the project.

Other Financing Elements

The tax credit program inherently drives the project sponsor to consider financing strategies in terms of federally subsidized and non-federally subsidized financing. Market-rate loans earn a higher tax credit rate (9 percent) than tax-exempt bonds or other federally subsidized financing.

¹⁶Gregory, Ramsey A., “Caveat Emptor: Joint Ventures with For-Profits Can Be Risky,” *Shelterforce: The Journal of Affordable Housing and Community Building Strategies*, Vol. XIX, Number 1, p. 17.

¹⁷It is important to note that, if HOME funds are utilized by the project, then rents must be calculated in accordance with HOME rules. See Appendix E.

which earn a 4 percent tax credit rate. In recent years many state housing agencies have contributed HOME or state-generated funds to help finance tax credit projects. These loans typically have interest rates of one percent and a term of 40 to 50 years. When combined with tax credits, the loans can make projects feasible in rural areas with low median incomes. It is important to carefully evaluate each situation.

Owners may opt to subtract federally subsidized loans from basis in order to retain the 9 percent credit on the remaining construction costs. In fact, if a federally subsidized loan is used for 57.1 percent or less of new construction or rehabilitation costs, it should be subtracted from the project's basis in order to retain the 9 percent credit on the remaining construction costs. (Nine percent of 42.9 percent of development costs is larger than 4 percent of 100 percent of development costs. See Guggenheim, page 13.)

On a rehabilitation project, the developer could also use federally subsidized financing for its site acquisition costs, since only the 4 percent credit is available for acquisition regardless of the source of financing. Since acquisition and rehabilitation costs are treated separately, the rehabilitation costs can still earn the 9 percent credit if they are financed with an unsubsidized loan.

First, developers should know which programs trigger the 4 percent rate and which do not.

Federally subsidized funding which does not trigger the 4 percent tax credit:

- ⊞ Community Development Block Grant (CDBG) Program (regardless of whether the funding source is a local or state government entity that receives the funds)
- ⊞ Federal Home Loan Bank (FHLB) Affordable Housing Program (AHP)
- ⊞ HOME Funds -- A project may utilize 1 percent HOME money and retain the 9 percent tax credit rate *if* at least 40 percent of the project is occupied by households with very low incomes, meaning that their income is at or below 50 percent of area median income. In depressed rural areas, this is an easy election to make, since tenants are likely to have very low incomes anyway. However, a project with a 1 percent HOME loan that receives the 9 percent credit is not eligible to receive the extra 30 percent of tax credits usually available to projects in designated low-income census tracts or difficult development areas.

Federally subsidized funding which does trigger the 4 percent tax credit rate:

- ⊞ Tax-Exempt Bonds -- Tax-exempt bonds are generally issued by the same agency which allocates tax credits (usually the State Housing Finance Agency). Tax-exempt bonds do trigger the 4 percent rate; however, a project with tax-exempt bonds is automatically eligible for as many tax credits as it needs to be feasible. The project does not have to compete with other projects, and its tax credit allocation does not count against the state's cap of \$1.25 in tax credits per capita. Bond issuances can be difficult to obtain and do require *credit enhancement*.
- ⊞ Rural Housing Service (RHS) Section 515 Rural Rental Housing -- Section 515 funds were previously the major source of long-term multifamily low-income housing funds in rural areas, including tax credit projects. However, since 1995, Section 515 has been drastically reduced. Therefore, Section 515 is no longer a viable financing source for new construction, with or without tax credits. However, RHS has taken considerable care to ensure that what funding it does have will go to improving its somewhat beleaguered portfolio of existing projects. For those projects over 10 years old, therefore, tax credits in combination with additional loans under Section 515 may be a viable option for substantial rehabilitation.

Developers should also be aware of two additional clauses in the tax credit statute which can increase the tax credit yield on a project. If the project is located in a *Difficult Development Area* or a *Designated Low Income Census Tract*, the tax credit amount is calculated based on 130 percent of the qualified basis. (See Guggenheim, pages 39-41.) In other words, rather than multiplying the qualified basis by either 4 or 9 percent (depending on which tax credit rate), the developer will multiply the qualified basis by 1.3 to arrive at 130 percent of qualified basis, then multiply this amount by either 4 or 9 percent and the percentage of units (or floor space) which will be occupied by low-income households to arrive at the maximum amount of tax credits for which the project is eligible. The additional tax credits thereby available are intended to compensate for extremely high housing development costs and/or extreme poverty in areas which have been designated Difficult Development Areas or Designated Low Income Census Tracts.

SPECIAL ISSUES FOR TAX CREDIT PROJECTS IN RURAL AREAS

Project Development and Long-Term Feasibility

While tax credits make for a complex development process in any geography, some special issues arise when using tax credits for affordable housing in rural areas. Issues specifically related to project development include:

1. The difficulties of using tax credits for small projects (32 units or fewer).
2. Financing problems arising from lack of private financing alternatives in rural areas.
3. Increasing competition for tax credits as other sources of financing have evaporated over the past two years (particularly Section 515 in rural areas). Inexperienced nonprofits may have difficulties meeting even basic requirements set by tax credit allocating agencies, and may therefore have to find ways to partner with a more experienced and/or wealthier for-profit or nonprofit to meet experience requirements and put up money for housing needs assessments, market studies, etc.

Other issues relate to the long-term feasibility of the project. While these are issues that may arise later in the project's life or throughout the operating and compliance periods, they will often need to be addressed when negotiating with investors/syndicators for tax credit equity. They include:

4. Ensuring that the rents established by the tax credit regulations are within rent levels affordable for economically depressed rural areas. This will impact the long-term physical maintenance of the project as well as long-term vacancy rates, which in turn make tax credit recapture more or less likely.
5. Keeping long-term property tax burdens low on the project in order to maintain its financial health for at least 15 years. In some economically depressed rural counties, this is a difficult task because the project may be the best-looking source of tax revenue from the perspective of local tax assessors.

Project size is a significant factor in determining whether the tax credit will be useful for a project. The process of applying for and syndicating tax credits is time-consuming and costly, regardless of the number of units in a project. In suburban or urban areas, developers can sanguinely opt to use tax credits, knowing that the cost of syndication is spread over a large number of units, in return for a large number of credits. In other words, large projects achieve economies of scale that make the cost of syndication less burdensome on both the project and individual units.

Developing a 24-unit project is obviously not as costly as developing a 100-unit project. However, based on development cost, the number of tax credits allocated to a 24-unit project will be significantly lower than those allocated to a 100-unit project. Meanwhile, the costs of syndicating a small project will be approximately equal to the costs involved in syndicating a larger project. The same accounting and tax law professionals will be utilized for approximately the same amount of time, and the burdens of collecting due diligence documentation are also similar.¹⁸ Some housing providers are successfully developing small tax credits projects using HOME or state-sponsored funds and avoiding the use of a *syndicator*, an intermediary between

¹⁸*Due diligence* is the process of gathering and reviewing all documents relating to the sponsors, the project and the partnership in order to establish the soundness of the sponsors, the project, the partnership, and the syndication deal. A similar, less involved process may be used when closing a loan with a lender. See Appendix C.

the project sponsor/general partner(s) and the investor(s). Some developers have interested a bank in both providing financing and investing in the tax credits available from a project without dealing through an intermediary. Some nonprofits have also worked directly with local or regional limited partner investors and equity funds. In these ways, it is possible to reduce both the primary development costs and the cost of syndication enough to attain project feasibility.

Project sponsors should recognize when estimating the project's potential yield of equity from tax credits that:

- ⊞ Investors will pay anywhere from 60 to about 75 cents on the tax credit dollar, but this amount may not be realized by the project immediately, or in one lump sum. The tax credit "price" and the scheduling of equity payments (or *capital contributions*) is negotiable between the sponsor(s) and investor(s). The final agreements will depend largely on the circumstances of the individual project, as well as the tax credit market in general at the time. (See "The Internal rate of Return" below.)
- ⊞ The costs of syndication will consume anywhere from 10 to 30 percent of investors' equity. Syndication costs include tax counsel fees, legal fees, and syndicator's fees if one is involved. Costs will also include the sponsor's staff time involved in collecting and copying all *due diligence materials*, an extensive list of documents which will be needed to close the syndication deal. See Appendix D for an example of a list of due diligence materials requested by an investor/syndicator.

It is important that utilizing tax credits does not increase a project's per-unit cost beyond either of two rent thresholds: 1) the highest permissible rent for each type of unit, based on 30 percent of the maximum area median income for the number of bedrooms; and 2) the highest rent the low-income market will bear for units of the applicable size.

Using HOME loans is one way to keep debt service low on a project. Another is to avoid a syndicator and approach a local bank to finance construction and the permanent mortgage while also investing in the tax credits and gaining credit toward meeting its CRA requirements. A bank may be willing to pay a good equity amount or provide good loan terms in recognition of the fact that it will profit from both the lending and investing aspects of the deal. Nonprofits should also be willing to approach directly other for-profit corporations that are not lending institutions as potential investors. (This route of syndication also avoids syndication fees to an intermediary, thereby increasing the amount of equity yielded from syndication.)

An often overlooked lifetime expense of a project is the property tax. If local taxes are computed based on income, a developer may not have to worry about prohibitive property taxes. However, in some areas, taxes are computed based on the appraised value of the property. In an economically depressed rural area, new multifamily housing may be an attractive revenue source in the eyes of the local tax assessor. It is imperative that a developer know the method of taxation in the county. If moderate or high taxes will destroy a project's operating finances, the developer should seek ways to mitigate or eliminate the property tax burden. Tax exemptions and tax abatements do not affect the property's eligible basis, but do improve its chances of long-term viability. Some communities allow a property tax exemption for nonprofit-sponsored projects, but the developer should make sure this applies for a limited partnership with a for-profit investor. Communities may have other exemptions, including affordable housing, elderly housing, or some other clause for which the project might qualify. Failing all these possibilities, the project may still request and obtain a tax abatement from local government (assuming local government is supportive of the project). Property tax issues should be settled as early as possible in the development process.

Some Notes on Joint Ventures between Nonprofits and For-Profits

Other issues for nonprofits arise when the nonprofit is approached by a for-profit developer to sponsor its project and compete for the nonprofit tax credit set-aside, or the nonprofit seeks the assistance of a for-profit in developing a tax credit project. This may occur where a nonprofit cannot demonstrate enough experience to win a tax credit competition, or where the nonprofit does not have enough up-front money to perform necessary steps like a market study or housing needs analysis. In some sense, any nonprofit-sponsored tax credit project is a joint venture, since the investor is necessarily for-profit. However, there are additional concerns where a nonprofit and for-profit work together to develop a tax credit project.

Joint ventures between nonprofits and for-profits are a delicate subject because there have been many examples of such ventures “gone wrong” in one way or another, often because of misunderstandings or under-appreciation of each entity’s motive in development. As a result of increasing tax credit competition, lack of resources, or inexperience, however, a joint venture may be the best approach for a given tax credit development.

Possible nonprofit contributions to a tax credit project:

- ⊠ Access to the nonprofit set-aside for tax credits, HOME, and other funding sources;
- ⊠ Good relationships with community and/or local government that may facilitate “soft” cost funding; and
- ⊠ Willingness to take on the role of general partner in the partnership (and therefore those responsibilities), allowing a for-profit developer to exit the deal once development is complete.

Possible for-profit contributions:

- ⊞ Expertise in real estate development and tax credit projects.
- ⊞ Expertise in managing multifamily and tax credit projects.
- ⊞ Good relationships with private lenders and/or investors.
- ⊞ Up-front money for market studies, etc.
- ⊞ Overall financial strength (good financial statement).

Two major problems exist for nonprofits getting involved in a joint venture: not accommodating the need that for-profits must make a profit from a deal, and not recognizing their own need to control and profit from a deal.¹⁹ The two worst case scenarios resulting from these issues are: 1) failing to partner with an effective, expert for-profit and creating a bad project and a bad deal; and 2) successfully completing construction and syndication, but ruining the nonprofit's operating budget in the process, while the for-profit takes all of the developer fee and no long-term liability.

Section 42 mandates that nonprofits competing for the tax credit set-aside must own an interest in the project and not be controlled by a for-profit firm. Some states allocating agencies have taken further steps to insure that nonprofits are not involved in joint ventures which are not equitable by:

1. Not allowing joint ventures to compete for the nonprofit set-aside, or
2. Allowing joint ventures to compete for the nonprofit set-aside, but requiring that the nonprofit:
 1. Remain the sole general partner with 1 percent ownership in the property and/or
 2. Receive a minimum portion of the developer fee.

Nonprofits may take a number of steps to insure that they are full partners in the development process and are appropriately compensated for their contributions.

First, the nonprofit should be aware that its tax-exempt status provides access to funding set-asides, property tax exemptions, and other financial bonuses for a project. If a for-profit has approached a nonprofit about a project, this is the primary reason. Some for-profits also feel that their best work is development, while nonprofits are better suited to long-term project operations, especially where social services are concerned. Nonprofits should take these assets into account when negotiating a deal with a for-profit.

The nonprofit and for-profit should be willing to negotiate their portions of the developer fee based on their roles and contributions to the development and ownership of the project. As already mentioned, some state allocating agencies now require that a nonprofit receive a minimum percentage of the developer fee. It should also be remembered that, while developer fees are intended to compensate for work, staff time, and entrepreneurial effort in developing and syndicating a project, they are also intended to compensate partially for the amount of liability incurred for paying down loans and monitoring compliance on the project over the long-term. According to one technical assistance provider, a nonprofit should be able to receive about 40 percent of the developer fee if it contributes a housing needs analysis, secures a site, and obtains political support and grant money for a project. If the for-profit does all the work, the

¹⁹ While nonprofits are not designed to “profit” per se in the same way as a for-profit, nonprofits must cover their expenses at least; at best, they can receive a developer's fee (for example) which covers their overhead and perhaps can be re-invested into the mission of the nonprofit on other projects.

nonprofit will only obtain about 5 percent of the developer fee (and risks not being “materially involved” in the project.) The shares of the developer fee will also be apportioned according to which party provides up-front money (and therefore bears up-front risk) and which party accepts the long-term risk of sponsorship/ownership. Given these generalities, however, a nonprofit will find that the portion of fees (and cash flow) that one for-profit wants for its services will vary greatly from what another for-profit wants. If political and other considerations allow, the nonprofit should always talk to more than one potential partner. Who has the most experience and offers the best deal?

Second, nonprofits should carefully review, evaluate and approve all project documents, from the *pro forma* to construction bids to the partnership agreement and fee agreements. Additionally, a qualified tax counsel and accountant experienced in both tax credits and limited partnerships should review each document and assess whether the deal is sound from the nonprofit’s perspective. The counsel and accountant should be able to explain the nonprofit’s risks, liabilities, and compensations over both the short and long term as indicated by these documents. The nonprofit should also ask advice from a technical assistance provider or other third-party observers (such as the Housing Finance Authority, Participating Jurisdiction, etc.); these parties may also have some knowledge or experience with the proposed for-profit partner.

The nonprofit should insist that all project documents and communications pass through its office as development proceeds, even if the for-profit takes the lead on development. Relinquishing control over documents and communications often means releasing the right to know that the project is going to succeed. This is termed “effective management control” in the HOME program; it is just as relevant to the tax credit process. Remaining within the communication loop will keep the nonprofit involved in the development process and aware of potential problems; it will also provide valuable experience for future projects.

The for-profit should be open to effective channels of communication with the nonprofit, and should not be averse to training the nonprofit on aspects of the development process as they relate to that project. If the for-profit is not communicative, this should be taken as a signal by the nonprofit that it should partner with a different developer.

The for-profit should also be willing to disclose all associations with consultants, contractors, and property management firms. Certain aspects of the construction should be bid out, not simply awarded to an associate of either the nonprofit or for-profit. As a practical matter, the for-profit partner often will have its own construction company and require that it be used. This is fine as long as the project is well built according to plans and specifications approved by the nonprofit and within budget, and that the contractor will be around later to make warranted repairs. It is important that the architect that does the contact administration during construction not have a business tie to the contractor. Ideally, the design architect should also be completely independent of the contractor. The for-profit should also be willing to offer current financial statements performed by an independent auditor (with an original signature), resumes of personnel involved in the project, list of references, and list of projects completed.

The for-profit developer/consultant should design the project with an exit strategy in mind for the nonprofit. Section 42 gives tenants and/or sponsors the right of first refusal to purchase the project at a discount at the end of the 15-year compliance period. The *Extended Use Agreement*, however, mandates continuing low-income use of the project for (at least) 15 years beyond the end of the compliance period, unless the project is sold and no purchaser can be found to continue the low-income units. Will the nonprofit purchase the property at the end of 15 years? Will the tenants? How will the price be settled? The consultant/developer should insure that the partnership agreement includes answers to these questions.

It will behoove the nonprofit to learn from the for-profit's attention to the "bottom line" throughout the dealmaking process, because it will enhance the nonprofit's ability to create a feasible deal, as well as approach for-profit lenders and investors with the right tools. This will be discussed in more depth under "Elements of the Deal."

Choosing Professionals

Ideally, a developer would establish relationships with tax counsel and an accountant early in the development and syndication process. Lawyers and accountants experienced with tax credit projects and with limited partnerships can assist the developer in all phases of development and syndication. However, developers in remote areas are likely to experience difficulty finding appropriate tax counsel and accounting assistance locally. It is important to emphasize, however, that a nonprofit sponsor of a tax credit project risks the project, the partnership, and its own tax-exempt status by *not* employing appropriate counsel and accountant(s). The state housing tax credit agency, another nonprofit, or a regional or national technical assistance provider should be able to suggest competent and experienced attorneys and accountants.

Tax counsel and an accountant should review every document and agreement into which the nonprofit enters on its own behalf or on behalf of the partnership. Tax counsel and an experienced accountant can evaluate the terms of the syndication deal and ensure that all documents are appropriately executed. They can assist the developer in designing the most attractive possible package for syndication. They can also alert the sponsor to possible problems with program compliance, partnership law, or other aspects of the tax code before a significant problem arises. Developers should also consider whether their choice of counsel has already established relationships with the local and state housing officials who will have input on the project, is willing to provide legal opinions to government agencies, lenders, or investors when securing financing.

ELEMENTS OF THE TAX CREDIT DEAL

When attempting to create a tax credit deal with a syndicator or directly with an investor, it is important to remember that many factors affect the true value of the equity offered for tax credits.

The Tax Credit “Price” and the Pay-in Schedule

The first element of the deal is the tax credit “price,” or amount an investor is willing to pay for each tax credit awarded to the project and claimable each year for the ten years of the credit period. Investors once paid as little as 45 cents on the tax credit dollar, but increased competition in the syndication market has raised typical tax credit prices today to as much as 75 cents or more on the dollar. Some price differences are dependent upon the type of investor: a sole corporate investor may be able to offer a higher equity rate than that offered by a syndicator managing a pool of funds. Some price differences relate to the project itself: investors may pay a higher price for projects which offer tax losses (deductions) as well as tax credits, although investors will not pay or pay well for a project with high risk. (Essentially, a project with consistent, low losses for the investor is valuable, but a project at risk of foreclosure is not.)

Second, the schedule of capital contributions to the project affects the *present value* of the equity. In the past, investors have provided equity in several infusions over the course of as many as seven years of the credit period, thereby softening the impact of the capital contributions by making them in the period in which tax credits are claimable. More recently, the period of capital contributions has shortened considerably. Investors may make as few as three capital contributions starting with the close of the syndication deal and ending with the first year of the credit period. Capital contributions may be scheduled to coincide with certain milestones affecting receipt of the tax credits, such as construction completion, the placed-in-service dates of each building or the project, or the end of the first year of the credit period. This arrangement provides incentive to the developer to meet benchmarks which affect the amount of the tax credit awardable to the investor(s).

From the developer’s perspective, partnership agreements which schedule early completion of capital contributions are preferable. A capital contribution at the time of syndication closing will decrease the amount of principal on the construction loan; a second contribution at the time of project completion/occupancy will decrease or eliminate completely the need for a *bridge loan*, a short-term loan meant to cover the difference between construction costs and non-tax credit financing while waiting for the full amount of tax credit equity to arrive. Bridge loans increase overall development costs incurred by transactional costs and additional interest expenditure. This is an important point of negotiation between investors/limited partners and developers/general partners. If an investor is unwilling to shorten the period of capital contributions, the parties may agree to a higher tax credit price.

For example, a developer has two syndication bids: one investor offers 65 cents on the tax credit dollar over two installments (close of syndication and construction completion); another offers 70 cents per tax credit over three installments (close of syndication, construction completion, and end of first year of the credit period). Which offer is better? The best way to determine the better offer is to run a *discounted cash flow* to determine the present value of the equity offered over time in each case. (Any computer spreadsheet program should have formulas and instructions to run a discounted cash flow, although if you do not understand the process, an accountant can assist you in running the discounted cash flow and explaining the implications of the results.) It may turn out that the lower tax credit price actually provides more equity to the project in terms of present value. Of course, the developer may still decide to take the less

lucrative offer if it provides more money up front and this is particularly necessary to the feasibility of the deal.

The Internal Rate of Return

Investors depend upon their calculation of Internal Rate of Return (IRR) to determine whether a project is worth their investment. (Computer spreadsheet programs also include formulas and instructions to calculate IRR, although an accountant should also be helpful in this case.) IRR can be complicated because it incorporates several factors of interest to the investor. It is therefore important that the project sponsor understand the IRR and the factors feeding into it. These include:

- ⊞ the length of time between capital contributions and the start of the tax credit stream;
- ⊞ the amount of the tax credits;
- ⊞ the amount of tax savings through losses generated after consideration of the depreciation of the housing (tax losses, however, are not as significant to investors as tax credits because they are difficult to predict and do not affect the investors' tax liability on a dollar-for-dollar basis as the tax credits do; and
- ⊞ net sales proceeds at the close of the compliance period.²⁰

Investors may require as little as 11 percent to as much as 20 percent for their IRR. In a rural project, 20 percent is an unlikely IRR, and is more likely to signal poorly designed projections and high risk. Project developers who are able to manipulate the factors feeding into the IRR calculation will be in a better position to give the investor the desired rate of return.

Of course, many projects do not produce a return that lives up to expectations. Often, reduced returns in the short term relate to problems in completing construction, leasing up the low-income units quickly, higher-than-projected vacancy rates, or noncompliance with Section 42 regulations, all resulting in lower tax credit awards and/or tax credit recapture.

Investors are typically protected by clauses in the partnership agreement which set benchmarks for payment of capital contributions; operating deficit reserves; guarantees and/or guarantee reserves to compensate the investor in cases of tax credit recapture; and credit adjusters which reduce the amount of equity to be contributed to the project if the initial tax credit award is reduced or nullified.

Another, less tangible selling point to investors is the fact that they are helping to meet the needs of a community for affordable housing. Depending on the investor, this intangible benefit may be more or less compelling. Fannie Mae, for example, is required by its status as a *Government-Sponsored Entity (GSE)* to meet certain standards of community service. Fannie Mae has also made highly publicized commitment to invest billions of dollars in affordable multifamily housing. Banks may count investment in tax credit projects toward their Community Reinvestment Act requirements, especially if they have also financed the construction and/or permanent loans to the project. Other corporations, while not legally mandated to contribute to community reinvestment, may be sensitive to opportunities for good publicity and reputation-building within a service area.

²⁰ The investors' expected proceeds from the sale of the project are constrained by the tax credit statute's requirement that a nonprofit general sponsor be given the right of first refusal to purchase the project at a discounted price. See *Right of First Refusal* below and in the glossary.

Other Key Elements of the Partnership Agreement for the Developer

The developer also benefits from the deal, as governed by the partnership agreement and its appended fee agreements:

- ⊠ Developer Fee -- if there is more than one general partner, or if a consultant helped develop/package the deal, the developer fee will be apportioned to each party as negotiated.
- ⊠ Property management fee – if applicable, compensation to the managing general partner which arranges for and oversees day-to-day operations of the project.
- ⊠ Partnership management fee -- compensation to the managing general partner for handling partnership operations, including limited partnership registration and franchise taxes, tax and audit functions, and partnership accounts.
- ⊠ Incentive management fee -- normally paid as a percentage of cash flow from the project in return for handling the management of the project successfully.
- ⊠ Right of first refusal -- Section 42 provides to the nonprofit sponsor (or the project tenants) the right to first refusal to purchase the project from the partnership at the close of compliance period. The terms of this purchase should be arranged in advance and included in the partnership agreement.²¹

Proponents of the tax credit, syndicators, for-profits in search of a nonprofit project sponsor, and tax credit seminar leaders will often enthusiastically list the aforementioned benefits to a nonprofit in sponsoring, owning, and managing a tax credit project. However, inexperienced nonprofits should be wary of undiluted enthusiasm where the tax credit is concerned. It is true that a nonprofit can gain income, experience, and reputation through development and management of a tax credit project. However, it is *also* true that tax credit deals are complex and extremely risky, particularly for the general partner in the partnership. At a minimum, tax credit projects entail a 15-year (but probably 30-year) commitment by the general partner. Should the market change considerably in the project's area, or noncompliance occur at any point during the compliance period, both the project and the partnership are at risk of tax credit recapture, default, and/or foreclosure. Should events occur during construction or the first year of the credit period that reduce or postpone the annual tax benefits to the investor, the syndication deal may be soured or destroyed. In any of these scenarios, the nonprofit general partner is finally responsible for loss of tax credits and loss of the project. The actual harm to the nonprofit in this case is determined by the conditions of the agreement. The harm to the project depends upon the amount of lost income to the project, but obviously mean foreclosure in the worst case scenario. Nonprofits must carefully and realistically assess their ability to sustain such liability before signing a partnership agreement. This assessment should include review of all project and partnership documents by nonprofit staff, board of directors, accountants, lawyers, and third-party advisers.

²¹ The pre-determined price cannot be less than the amount of outstanding debt remaining on the property (excluding debt added in the 5 years prior to the sale), plus federal, state and local taxes due as a result of the sale. To be eligible for this right, the nonprofit must be tax-exempt, include in its mission the fostering of low-income housing, and must not be affiliated with or controlled by a for-profit entity. Because purchase of the property by the nonprofit (or tenants) occurs according to a bargain price arrangement, the limited partners are able to claim a charitable deduction on their taxes for the difference between the purchase price and the appraised value of the property. If the project is composed of single-family homes, and a tenant purchases a house at the end of 15 years, the extended use provisions requiring notice, availability for outside purchase, and three years of protection from eviction of low-income residents may no longer apply. Credit agencies must approve any changes in the Extended Use Agreement.

Ways to Mitigate Risk for Both the Nonprofit Sponsor and the Investors

1. Make sure both staff and the nonprofit board understand and commit to the proposed partnership agreement. Have an accountant and tax counsel experienced with both limited partnerships and tax credits evaluate the agreement and all associated fee agreements. Everyone should understand the types and amounts of liability involved.
2. Obtain written letters of commitment from syndicators/investors. Although this does not completely protect against evaporation of the deal, it does prevent the syndicator/investor from altering its offered price or abruptly deciding to abandon the deal. If a syndicator with a pool of funds is involved, have the syndicator verify in writing that the funds are already sold to investors.
3. Make sure that all projections, including sources and uses of funds, projected income and expenses, cash flow, etc., have a strong basis in fact and contain reasonable assumptions for vacancy rates (no lower than 5-10 percent), rental increases over 15 years (no higher than 3-4 percent each year), expense increases, interest rates, time to achieve full occupancy, and marketability of the units.
4. Make sure that the nature and extent of *due diligence materials* necessary to close the syndication are understood and agreed upon well in advance of the date for closing. The nonprofit should make sure that it has all necessary documentation (nothing is missing or invalid; everything is recorded in the name of the partnership or whichever entity is the appropriate name).
5. Make sure that the partnership agreement includes clauses which deal with risk to the tax credits, the partnership, and the property at length, and that the nonprofit can sustain the implications of these clauses. The nonprofit should be as diligent as the investor in minimizing its exposure to liability. Risk clauses should address title insurance, fire and casualty insurance, contractor bonding, vacancy limits, guarantees, etc.
6. A final word regarding tax credits and vacancies: the limited partner is entitled to 99 percent of the tax credits by virtue of its 99 percent share of ownership. The syndication projections should not assume that 100 percent of the tax credits can be sold to the limited partner, or that all of the credits to which the limited partner is entitled will be available as scheduled in each and every year. The partnership agreement may stipulate that the limited partner will not require compensation for loss in any given year of 5 percent or less of the annual available tax credits. The general partner is thus protected from small fluctuations in the tax credit benefits due to small vacancy issues throughout the compliance period. The limited partner remains protected by its right to receive compensation in amounts over 5 percent of the tax credit benefits in a given year, and retains its right to remove general partner in cases of fraud or gross negligence.

APPLYING FOR A TAX CREDIT ALLOCATION

Each tax credit allocating agency must publish the criteria by which applications for tax credits will be evaluated in a Qualified Allocation Plan (QAP). Projects are generally allocated tax credits according to criteria-based rankings scored competitively with other projects for the allocation year.²² Undoubtedly, there will be some subjectivity in the scoring, and most states allow themselves a limited amount of discretion to bypass or over-ride the results of the scoring process.

Section 42 intends that QAPs target projects which meet priority housing needs in the state, are “appropriate to local housing conditions,” and serve the lowest-income tenants for the longest periods. States are free to interpret these clauses as they wish, and to add their own restrictions, preferences, thresholds, and set-asides in their plans. In evaluating projects and scoring them, states must consider at least:

- ⊞ the reasonableness of projected development costs;
- ⊞ the size of the gap between total development costs and the amount of the non-tax credit financing that can be raised; and
- ⊞ the amount of equity which will be obtained from syndication of the project’s tax credit allocation.

Assuming that a project competes successfully in the scoring process, the state may still use its discretion not to fund that project based on any of a number of “desirables” such as geographic diversity of projects, diversity of types of projects, etc. Also, projects which obtain allocations will only receive as many tax credits as necessary to make the project feasible, up to the maximum awardable level set by the tax credit calculation.

States evaluate the reasonableness of the sources and uses of development financing according to (depending on the state) HUD cost standards,²³ state-promulgated cost standards, or staff expert opinion. Developer competition also contributes; those projects which contain costs or achieve a measure of cost-efficiency may receive higher ranking than those which do not. States require cost certifications of varying stringency, from an independent auditor’s opinion that the financial information is reliable to a public accountant’s review of statements.

²²As previously noted, projects with at least 50 percent tax-exempt bond financing are automatically eligible to receive tax credits in an amount sufficient to make the project feasible. They do not have to compete for the state’s allocation tax credits.

²³HUD has published standards to be used by credit agencies or HUD field offices to review projects which receive both tax credits and HUD financing. The National Council of State Housing Agencies also published guidelines for appropriate costs on tax credit projects. See Guggenheim, pages 66-67.

Section 42 requires that at least these seven criteria contribute to the awards for tax credits:

- ⊞ project location
- ⊞ housing needs characteristics
- ⊞ project characteristics
- ⊞ sponsor characteristics
- ⊞ participation of local tax-exempt organizations
- ⊞ tenant populations with special needs
- ⊞ public housing waiting lists

Allocating agencies may give preferences to projects which will sign Extended Use Agreements for low-income use well beyond the Section 42-mandated 30 years, and/or for projects which waive the right to seek conversion to market-rate apartments until some point beyond the fifteenth year. Other required information, or criteria for which the agency will give preference, may include support from local officials, letters of commitment from financing sources, market studies, property appraisals, etc. (See Appendix C for a sample list of tax credit application required documents.)

States may utilize criteria in one of two ways: requiring that all competing projects meet a certain threshold or set-aside (for example, 20 percent of units must be set aside for tenants with special needs); and/or scoring how well a project measures up to a set of criteria (for example, a project may earn 20 of 20 possible points on special needs criteria by setting aside units for households with disabled persons, but receive only 1 of 30 possible points for targeting the lowest income tenants).

Once a project has successfully completed the application process, the allocating agency issues a binding commitment to reserve tax credits for its use. The actual tax credit award is made upon the *placed-in-service* date, when the agency issues Form 8609 notifying the IRS and the owner of the amount of tax credits claimable by the partnership *on each building*. The tax credits are tied to the partnership on a building-by-building basis, and all standards for compliance (minimum set-asides, qualified basis, etc.) are also measured on each building.

If construction has not been completed by the end of the year in which the reservation is made, the owners can obtain a *carryover allocation* by certifying (and providing documentation proving) that the project is 10 percent complete. This is known as the 10 percent threshold. All depreciable costs are considered in calculating whether 10 percent of the project's costs have been incurred. (See Guggenheim, pp. 56 through 58 for specific information on costs eligible for consideration in the 10 percent threshold.) All considered costs must be incurred in the name of the owner (i.e., the limited partnership) receiving the carryover allocation.

If the project is not ready for occupancy by the end of the second year after the reservation has been made, the project returns the tax credits to the agency for reallocation in the next application round.

Tax credit projects in presidentially designated disaster areas have six additional months in which to meet the 10 percent completion test. These projects also receive an extra year to meet the placed-in-service deadline after a carryover allocation has been received. (See Guggenheim, page 58.)

It is important to note that many projects do not compete successfully in the allocation process because their applications are incomplete or otherwise unacceptable. The demand for tax credits in many states far exceeds the supply. It is up to the developer to obtain the scoring criteria from

the agency and communicate with someone from that agency to estimate how well their project will compete. Most agencies are willing to meet with and/or discuss a project over the phone prior to the application process. Additionally, some states now make application software available to applicants which eases the process and may give the developer “dry runs” of the project score according to application criteria.

CONSTRUCTION COMPLETION AND THE AWARD OF TAX CREDITS

Once construction is complete and a building is placed in service, the owner must decide whether to begin claiming the tax credits for that year or the following year. The initial year in which an owner claims credits is the initial year of the credit period and the 15-year compliance period.

At the end of the first year of the credit period, the qualified basis for which the project may receive its full regular amount of tax credits annually is determined. Eligible and qualified basis and, finally, the tax credit award, are calculated as they were during the allocation process, except that the figures now used are “actual,” not projected:

- ⊞ Eligible basis is now derived from the actual development costs, including costs incurred through the end of the first year of the credit period (even if the building was placed in service the previous year).
- ⊞ The tax credit rate is the rate published by the IRS and effective for either the month in which the building was placed in service or the month in which the allocating agency made its reservation for tax credits, at the owner’s option. If the owner elects the latter option, a written agreement must be signed with the allocating agency deeming the rate by the fifth day of the month following the reservation. Otherwise the tax credit rate is that effective for the month in which the building is placed in service. (Electing to wait until the building is placed in service is only advisable if the owner is *certain* that interest rates will rise by the placed-in-service date. Otherwise, it is more beneficial to know the exact rate earlier for purposes of negotiating the syndication.)
- ⊞ Qualified basis is calculated by multiplying the eligible basis by the percentage of units occupied by low-income (or very low-income, depending on the test) households on December 31 of the first year of the credit period.

The allocating agency uses these numbers to determine the amount of tax credits awarded to the project for the first year of the credit period; this is the standard to which the project will be held throughout the compliance period. Qualified basis can change over the compliance period according to changes in the number of low-income units; in these cases, the project/partnership may garner a higher tax credit award or face tax credit recapture. (See “Management” and “Monitoring.”)

If the project’s low-income units are rented rapidly, the owner may decide to begin claiming credits for that year. However, only a partial year’s credit will be earned on each building, prorated by the number of months of low-income occupancy. The prorated credits are carried forward into the eleventh year of the credit period. If rent-up occurs slowly, it will be advantageous for the owner to wait until the following year to start the credit period, since the first year of the credit period determines the full regular amount of tax credits the owner may claim in each year of the credit period. (The project sponsor should make sure that the partnership agreement allows for this option.)

MANAGEMENT

Who Should Manage the Property?

Managing a tax credit property is complex and full of risk for the owners of the project, particularly for the general partner. Some nonprofit sponsors seek to manage as well as own the project in order to maintain close ties with the residents, offer services at the project, and/or obtain monthly management fees.²⁴ However, Section 42 introduces enough complications into multifamily management issues that *only* an organization with experience and familiarity with both basic management issues and Section 42 compliance should be permitted to manage the property. Noncompliance invites tax credit recapture, and noncompliance can occur in any area, from tenant files and documentation to income eligibility certification to inattention to details such as the *next available unit rule*, for examples. The consequences of a reduced tax credit award or tax credit recapture are diminished equity at best and loss of the project at worst.

Some nonprofit sponsors hire a professional management company or a nonprofit experienced with Section 42 compliance and retain an oversight role to double-check program compliance. Others retain the services of a developer or consultant (who also must be experienced with tax credit compliance) to oversee the property manager. The consultant may receive fees from the partnership and perform its oversight role either as consultant or special limited partner, depending on the wishes of the general and limited partners.

Management fees should be no higher than 5 to 7 percent of rental income. Since vacancy rates impact not only income but also tax credits, the management agreement should include a fee adjustment based on the percentage of low-income units (or their floor space, whichever is less) that are vacant, rather than simply the fluctuation of dollars from income. If the project is in any way dependent for its income on Section 8 vouchers and certificates, the management agreement may also include a fee adjustment or bonus based on management's ability to rent units to households with certificates or vouchers.

Program Compliance

However the project is managed, safeguarding program compliance at the property is key to the success of both the project and the continuing stream of tax credits to the partnership.

The major areas of compliance to be handled by management include vacancies, rents, and certifications of income eligibility, as well as maintaining comprehensive documentation and reporting to both the managing general partner (or other oversight entity on behalf of the partnership) and to the state tax credit allocating and monitoring agency.

Changes in Qualified Basis

Vacancies, as already mentioned, affect both rental income and tax credits. The number of vacancies (or the amount of vacant floor space) in low-income units must be kept at or below the levels determined at the end of the first year of the credit period in order to maintain the basis on which the credits were calculated.

²⁴In this context, monthly management fees mean the compensation awarded to the property manager for day-to-day operations at the project; these fees are taken out of monthly rental income as a project expense. This is separate from the partnership agreement's Management Fee for arranging for management of the project and overseeing its operations, which is a partnership expense.

Additional credits for additional low-income units may be earned (at a discount) if the qualified basis actually rises from the previous year. However, the penalty for a reduced basis or for noncompliance with program regulations (from reduction in qualified basis to improper certification to poor reporting to the state tax credit allocating/monitoring agency) is far more extreme.

Should the project’s qualified basis decrease from the prior year or some other form of noncompliance emerge, tax credit recapture will result. Recapture occurs on the “accelerated portion” of the credits, plus interest, for all prior years in which the credit was claimed. The “accelerated portion” of the tax credit is the difference between the actual amount of credits claimable for that year and the amount of credits that would have been available for that year if the total amount of credits were payable evenly over the entire 15-year compliance period. The accelerated portion depends upon the year in which tax credits are recaptured. (See Guggenheim, pages 71 through 79.)

Year of Recapture	Portion Recaptured
1 through 11	5/15 of all credit taken over all years to date
12	4/15
13	3/15
14	2/15
15	1/15
After Year 15	0/15

If the project fails to meet its elected minimum set-aside of either 20 percent or 40 percent low-income units, then recapture of the accelerated portion of credits applies to *all* credits. If the recapture occurs because of reduced qualified basis without failing to meet the minimum set-aside, then recapture applies only to units that are no longer in compliance. The IRS may waive recapture in cases where reduction in qualified basis was minimal or occurred because of a small error. (Again, see Guggenheim, page 72.) Recapture will not occur if noncompliance is corrected within a reasonable period after the error is discovered or *should have been* discovered. Projects which experience reduced basis caused by casualty losses in a major disaster are not at risk of recapture if the building is restored within a reasonable period of time, as determined by the monitoring agency but no longer than two years from the end of the year in which the disaster is designated by the President.

Should a building actually increase its applicable fraction, that is, the percentage of units which are rented to low-income households, after the first year of credits, it receives a “two-thirds” tax credit for the additional percentage of units. The credit received on these units is based on two-thirds of the original credit rate and the portion of the year in which the units were occupied by low-income households. These two-thirds credits are received for the balance of the credit period.

It should be noted that the penalty for reducing qualified basis or other form of noncompliance and the award for increasing qualified basis act to discourage developers/owners from either severely under-projecting or over-projecting the percentage of each building which will be occupied by low-income households. Essentially, the penalty for reduced basis is too great, and the reward for increasing qualified basis is too limited for developers/owners to strategically

over- or under-represent the projected qualified basis. The amount of tax credits awarded, and therefore the amount of equity raised, depends too greatly upon an accurate projection.

Other Compliance Issues

Project managers must carefully review tenant applications and verify tenant income eligibility. Tenant files must include extensive documentation of the income verification process as well as the manager's certification of tenant eligibility. Documentation should include W-2 forms, bank documents, social security documents, unemployment compensation documentation, etc. All tenants must be recertified annually. Tenants who qualify initially for residency continue to do so unless their income rises above 140 percent of the maximum income level. Should this occur, the tenant is not evicted, but the next available unit in that building of comparable or smaller size must be rented to an income-eligible resident or credit is lost. This is known as the *next available unit rule*.

Maximum rents must be altered annually to correspond to changes in HUD's determination of AMI and changes in utility allowances. Projects are protected from decreases in maximum rents below the initial level set at the end of the first year of the credit period.

Nonprofits who seek to manage their own projects should think carefully about the depth of risk involved in noncompliant management on a tax credit project before going ahead with their plans. The brief explanation of management issues here and compliance monitoring in the next section only scratches the surface of compliance requirements and the consequences of noncompliance, but should be enough to discourage the inexperienced nonprofit from managing its own tax credit project. Hiring expert on-site management can help contain the risk of noncompliance; involving the future management agency in the project as early as possible can help the developer avoid small problems during construction, lease-up or syndication agreement design which evolve into major issues with tax credit noncompliance later.

COMPLIANCE MONITORING ISSUES

State tax credit agencies are primarily responsible for monitoring project compliance with tax credit program requirements. Monitoring begins with the process of certifying development costs at the end of construction or the first year of the credit period, but the real work of monitoring occurs over the 15-year period of compliance mandated by Section 42.

State monitoring varies procedurally from state to state, but the overall goal remains consistent: verify that projects are consistently serving the same number of households with appropriately low incomes. Compliance officers are primarily concerned with three basic income eligibility issues:

- ⊞ Has the project continued to meet its minimum set-aside of low-income units (either 40 percent of the units set aside for low-income households, or 20 percent of units set aside for very low-income households, as elected by the developer)?
- ⊞ Has the project maintained enough of its units for low-income households to continue to qualify for all of its allocated tax credits? (Projects must meet their minimum set-aside to qualify for *any* of their allocated tax credits; once they have met that threshold, they must maintain the exact number of units to maintain *qualified basis* and claim the full amount of tax credits for that year.)
- ⊞ Has management appropriated verified tenant incomes and documented the certifications comprehensively?

Compliance officers will also examine whether rent levels on low-income units comply with rent maximums for each size unit.

Should a project fail to meet program requirements in any way (change in basis, non-reporting, etc.) recapture of tax credits is possible (and, depending on the form and extent of noncompliance, inevitable).

Depending on the state, management must report to the monitoring agency monthly, quarterly, or annually. Reports may entail statement of income and expenses plus all certifications for new residents. All tenants must be recertified annually.

States perform audits of their tax credit projects periodically, usually on a schedule such as one-third of their tax credit portfolios every year. Audits may or may not include on-site inspections. Although there is some variance among monitoring agencies' compliance procedures, owners should be aware that states in general are only going to get more careful about compliance monitoring.

The only way to ensure that a project is in compliance is to:

- ⊞ know the Section 42 and state agency regulations;
- ⊞ annually refresh one's knowledge of program regulations as a seminar for tax credit management issues;
- ⊞ hire on-site project management that is well experienced with program regulations and has experience managing a tax credit property;
- ⊞ conduct careful oversight of management activities on a monthly basis to ensure that management understands its role and carrying it out effectively (monthly reports to the managing general partner or other partnership oversight entity should include income and expense statements, vacancy reporting, certification copies, and all other data reflecting tax credit compliance);
- ⊞ ensure that the on-site management contract includes clauses which tie management fees to compliance issues.

The managing general partner bears final responsibility for compliance issues. Should tax credit recapture occur, the limited partners/investors will seek compensation as described in the partnership agreement. Limited partners also retain authority to remove general partners in cases of fraud or gross negligence. Managing responsibility should not be taken lightly.

TAXES AND AUDITS

The tax matters partner (a general partner designated in the partnership agreement to handle tax issues for the partnership and partners) is responsible for arranging a project/partnership audit annually. This audit must include reviews of project income, expenses, cash flow, reserves, and accounts, as well as partnership capital contributions, expenses, cash flow, reserves and guarantees.

Nonprofits in remote areas may have difficulty finding an accountant with experience in limited partnerships and tax credit projects, but this is *absolutely necessary* to effective auditing on the project and the partnership. An experienced auditor can alert partners to possible issues of noncompliance and ensure that funding of equity, reserves, and guarantees occurs in a timely and appropriate manner. An auditor inexperienced in tax credit projects or limited partnerships may not understand the flow of equity, cash, or liability through the construct of the limited partnership or alert the partners to issues of noncompliance. When either state monitoring agencies or the IRS itself audits the project for compliance or begins testing whether the general partner's nonprofit status is valid, an effective auditor can prevent great damage occurring to the project, the partnership, and the partners.

The tax matters partner is also responsible for arranging for preparation, filing, and distribution of tax forms based on the results of the partnership audit. Partnership forms which must be prepared and filed include: Schedule K – Partners' (plural) Shares of Income; Form 1065 - U.S. Partnership Return of Income; and Form 8609 - Low Income Housing Tax Credit Allocation Certification for *each building*. (This Form 8609 is the same form used by the allocating agency to notify the IRS and the owners of the original tax credit award; a copy is subsequently filed with the partnership's tax return and the partners' tax returns certifying that the partners/partnership are claiming the appropriate amount of tax credits.) The tax matters partner also provides to investors Schedule K-1 – Partner's (singular) Share of Income, Credit, Deductions, etc., with copies of Forms 1065 and 8609. The tax matters partner must also file any state franchise or other tax forms on behalf of the partnership.

Should a project (or building within a project) be determined to be noncompliant by the monitoring agency, the agency will file Form 8823, notification of noncompliance, with the IRS. When the building returns to compliance, the monitoring agency will use the same form to notify the IRS that the building is no longer noncompliant.

Nonprofit tax matters partners may not be aware of the full extent of filing necessary on behalf of the partnership simply because they are unaccustomed to the tax regulations affecting limited partnerships. An effective accountant and tax counsel experienced in these matters may help a nonprofit maintain its responsibilities of filing partnership taxes, registration and fees with the state and the federal government, as well as protect the nonprofit's tax-exempt status.

TEXT RESOURCES FOR THE BEGINNING TAX CREDIT DEVELOPER

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Gregory, Ramsey A., *Shelterforce: The Journal of Affordable Housing and Community Building Strategies*, "Caveat Emptor: Joint Ventures with For-Profits Can Be Risky" (Vol. XIX, Number 1: National Housing Institute, January/February, 1997).

Ramsey practical list of "Dos and Don'ts" for Nonprofits working with for-profits in joint ventures.

Moreland, Elizabeth L., *The Compliance Monitor*, "Initial Steps in Managing a Tax Credit Development" (Vol. 1, Issue 2: Elizabeth Moreland Consulting, Inc., July 22, 1996).

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Enterprise Foundation, *Partnerships That Perform: The Low Income Housing Tax Credit* (Washington, DC: The Enterprise Foundation, January, 1996).

This is the Enterprise Foundation's effective brochure for the tax credit program and for Enterprise's achievements using the tax credit. It contains a very understandable, basic explanation of the credit, its annual production, and its societal value.

The Low Income Housing Tax Credit Advisor, Dworbell, Inc. and the National Housing & Rehabilitation Association.

Sponsored by the National Housing & Rehabilitation Association, *Tax Credit Advisor* is a newsletter for tax credit users that offers substantive reporting on current issues such as rule changes and financing schemes.

Hunt, Chet, and Horace Barker, *Rural Voices*, "Tax Credits, Rural Banks and Nonprofits: Productive Partners" (Vol. 2, No. 1: Housing Assistance Council, Fall 1996).

The Housing Assistance Council's own Horace Barker provided technical assistance in arranging a tax credit project in Tennessee between a local lender and nonprofit. This article describes the financing and business relationships involved in this particular joint venture, an excellent example of a well-managed project and development process.

Affordable Housing Finance, Business Communication Services.

This is a for-profit-oriented journal, but full of tax credit financing information.

CPD, HUD, *Notice CPD-94-24* (U.S. Dept. of Housing and Urban Development, August 5, 1994).

HUD produced this "Layering Guidance for HOME Participating Jurisdictions When Combining HOME Funds With other Governmental Subsidies" which may be helpful to developers as well as HUD staff. It includes some notes on using HOME with the tax credit.

National Council of State Housing Agencies, *Housing Agencies, Tax Credit Subsidy Layering Manual* (Washington, DC: NCSHA, February 13, 1995).

This is an informative, but dry, explanation of HUD's subsidy layering guidelines triggered by use of tax credits with 221(d)(3), 221(d)(4), and 223(f) mortgage insurance, loan management set-aside assistance (LMSA), flexible subsidy, project-based Section 8, and others.

Hecht, Bennett L., *Developing Affordable Housing: A Practical Guide for Nonprofit Organizations* (New York: John Wiley & Sons, Inc., 1994).

An excellent text for beginning nonprofit housing organizations, this guide covers everything from choosing the development team to management issues, as well as every development step in between.

Sherman, Lawrence F., Bradley Smith, *Real Estate Issues*, "Building and Financing a Low-Income Housing Project" (Vol. 21 No. 1, p. 38-40: , April 1996).

This article contains a basic explanation of the low income housing tax credit; very lucid and understandable explanation of the four types of tax credits, eligible basis, qualified basis, rental requirements, credit computation, and compliance period in a short space.

Rosenblatt, Steven L., *Managing Properties with the Low Income Housing Tax Credit*, (Portland, ME: Spectrum Seminars, Inc., 1995.)

This reference consists of the training materials for Spectrum Seminars tax credit project management seminar. Spectrum Seminars, in the person of Steve Rosenblatt, present excellent seminars on tax credit compliance.

U.S. General Accounting Office, *Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program* (Washington, DC: U.S. General Accounting Office, March 1997).

This is the report to the Ways and Means Committee on characteristics of tax credit projects and their residents, plus an extensive evaluation of IRS and state tax credit allocating agency controls and compliance monitoring efforts for the program.

WEB SITES OF INTEREST TO THE TAX CREDIT DEVELOPER

National Housing and Rehabilitation Association

http://www.housingonline.com/html_pages/mocredit.html

The Journal of Property Management

<http://www.irem.org/cgi-bin/Public/htimage/irem/irem12.map?190,303>

Tax Credit Resource Hot Links

<http://www.novoco.com/links.htm>

Low Income Housing Tax Credit Information from the University of Texas

<http://uts.cc.utexas.edu/~txlihis/lihtcinfo.html>

Tax Credit Resource List

<http://www.taxcredit.com/Library/Resource.htm>

HUD's Low Income Housing Tax Credit Database On Line

<http://www.huduser.org/lihtc/>

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GLOSSARY OF TERMS

20/50 RULE -- see *Minimum Set Aside*.

40/60 RULE -- see *Minimum Set Aside*.

APPLICABLE FEDERAL RATE (AFR) -- monthly interest rate statistic published by the Treasury Department. Used to determine the tax credit rate as well as what loans constitute federally subsidized and non-federally subsidized.

AREA MEDIAN INCOME(S) -- HUD determines annually the area median incomes for each county (and for the entire statewide nonmetropolitan area). For purposes of the tax credit program, only households with incomes at or below either 50 percent of median income or 60 percent of area median income are eligible for housing in a tax credit project. See *Minimum Set-Aside*.

BRIDGE LOAN -- a short-term loan intended to cover the difference between construction-era financing and a permanent mortgage during the period of capital contributions to the project. As capital contributions arrive, they are used to “take out” the bridge loan.

CAPITAL CONTRIBUTION(S) -- infusions of capital invested in a tax credit project in return for receipt of tax credits. The amount of capital contributions relates to the total amount of tax credits which may be claimed; the schedule of capital contributions is agreed upon and described within the *Partnership Agreement*.

CARRYOVER ALLOCATION -- commitment by a tax credit allocating agency to allow a project to keep its reservation of tax credits for an extra year after the end of the year in which the reservation was made. Used when a project has not been completed, but at least 10 percent of the project’s depreciable costs have already been incurred in the name of the partnership which owns the project.

CREDIT ENHANCEMENT -- used when obtaining a bond issuance to finance affordable housing; security for repayment; typically provided by federal, state, or private mortgage insurance, bond insurance, bank letters of credit, or insurance company guarantees.

DESIGNATED LOW INCOME CENSUS TRACTS – census tracts which have been designated by HUD as particularly low-income areas based on 1994 income estimates. Tax credit projects located in a low-income census tract may be allocated tax credits based on 130 percent of *qualified basis*. The current list of designated low income census tracts will remain effective until the year 2000 census data becomes available.

DIFFICULT DEVELOPMENT AREAS – metropolitan areas and rural counties with high construction, land, and utility costs relative to area median income. HUD establishes annually which places qualify as difficult development areas by comparing Fair Market Rents to *Area Median Incomes*. In 1996, 247 rural counties were designated as difficult development areas. Tax credit projects in difficult development areas may be allocated tax credits based on 130 percent of *qualified basis*.

DISCOUNTED CASH FLOW -- calculation used to determine the future value of a cash stream received over time, or the present value of a cash stream received over time.

DUE DILIGENCE -- process of assembling and reviewing project and partnership documents to insure that all statements made by the developer/sponsor are true, that the land, property, and partnership documents are all in order. See Appendix D.

ELIGIBLE BASIS -- the portion of development costs that are eligible for consideration in the tax credit allocation process. Only *depreciable* development costs count towards the project's eligible basis. Land acquisition costs, for example, may not be included in the basis.

EQUITY FUND -- a pool of capital managed by a syndicator, sometimes involving more than one investor's money, which is used to invest in a number of tax credit projects.

FUTURE VALUE -- see *Discounted Cash Flow*.

GOVERNMENT-SPONSORED ENTITY -- a semi-private entity that was chartered by the federal government, but which has private shareholders. Fannie Mae and Freddie Mac are two examples.

LIMITED PARTNERSHIP -- an ownership entity consisting of at least one general partner and at least one limited partner. Though both partners share in the ownership, the general partner takes on management and liability responsibilities, while the limited partner invests capital into the partnership's purpose (in this case a tax credit project) and receives the majority of the profits from the project.

MINIMUM SET-ASIDE -- the minimum percentage of units in a project which must be occupied by low- or very low-income households in order for the project to qualify for the tax credit. The sponsor/owner elects whether the project will qualify for tax credit by setting aside at least 20 percent of the units for households with income at or below 50 percent of *Area Median Income*, or at least 40 percent of the units for households with incomes at or below 60 percent of *Area Median Income*. Also known as the 20/50 test (or rule) and the 40/60 test (or rule).

NEXT AVAILABLE UNIT RULE -- Rule established in Section 42 which mandates that, should a low-income occupant's income rise to 140 percent or more of the maximum eligible income, then the next available unit of comparable or smaller size must be rented to an income-eligible household in order to retain the building's qualified basis and remain in compliance with the tax credit code.

NONPROFIT SET-ASIDE -- 10 percent of each state's allocable tax credits must be set aside for nonprofit use annually.

PARTNERSHIP AGREEMENT -- the document governing all interaction between and responsibilities among partners in a limited partnership.

PLACED-IN-SERVICE DATE -- the date in which a tax credit building is certified as ready for occupancy.

PRESENT VALUE -- See *Discounted Cash Flow*.

PRO FORMA -- statement of sources and uses of funds on a project.

QUALIFIED BASIS -- the amount of eligible development costs (or *Eligible Basis*) multiplied by the percentage of units which will be reserved for low-income households

QUALIFYING RATIO -- the percentage of units that are occupied by low-income households (households with monthly income equal to or less than either 50 or 60 percent of *Area Median Income*, as elected by the project developer. See *Minimum Set-Aside*.)

STATE ALLOCATING CAP -- each state is entitled to award annually tax credits in an amount equal to \$1.25 per capita. Most projects seeking tax credits must compete for tax credits from this pool of funds. (Projects which have been awarded tax-exempt bond financing are automatically eligible to receive 4 percent tax credits without competing against other projects, and the amount of tax credits reserved for these projects does not count against the state's annual allocation cap.) In recent years, however, the demand for tax credits has rapidly increased, while the number of tax credits available has not. Many tax credit advocates seek an increase in the state allocating cap.

SYNDICATION -- the process of "selling" tax credits to an investor in return for capital or equity.

SYNDICATOR -- an intermediary between an investor(s) and a developer(s) which packages the syndication deal for each, passing through capital from investors to a project and tax credits from a project to the investors.

TAX CREDIT "PRICE" -- the amount of money per tax credit dollar which a syndicator or investor agrees to pay into a project in return for the right to claim the tax credits.

TAX CREDIT RATE -- the rate used to calculate tax credits on a project, approximately 4 percent for acquisition and federally subsidized new construction and rehabilitation and approximately 9 percent for non-federally subsidized new construction and rehabilitation; the rate is designed to produce a present value of either 70 percent of the eligible development costs over time or 30 percent of the eligible development costs over time (the ten years of the credit period).

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