FINANCING MULTI-FAMILY HOUSING: STRUCTURING THE LOW INCOME HOUSING TAX CREDIT AND TAX EXEMPT BONDS

Documenting Transactions for Investors and Developers

Using Low Income Housing Tax Credits (LIHTC)

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Strafford Publications, Inc.
November 21, 2017

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LIHTC PROGRAM OVERVIEW

- Established by the Tax Reform Act of 1986 to encourage private investment in affordable housing. Was made permanent in 1993
- Codified in Section 42 of the Internal Revenue Code (“Code”)
- Goal of the program is to provide financing for the construction and rehabilitation of affordable rental housing
- Program administered by state housing finance agencies
- States receive tax credits based on population, therefore the amount of available 9% credits is limited. Selection priorities and procedures vary in each state and are outlined in a Qualified Allocation Plan (“QAP”)

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LIHTC PROGRAM OVERVIEW, continued

- Dollar-for-dollar reduction of federal tax liability for the owner of the qualified project
- Amount of credit based on cost of building new affordable units or renovating existing housing developments
- Credits claimed over a 10 year period
- Tax Credit Compliance period is 15 years
- But the restrictions extend for at least 30 years

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PARTIES TO THE TRANSACTION

- Developer
- Lender
- LIHTC investor
- State Housing Finance Agency
- Residents
- Consultant, General Contractor, Architect, Engineer, Surveyor, Title Company, Locality, Attorneys, Accountants

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TYPES OF LIHTC

- 9% LIHTC are the best you can get
  - Finances new construction without additional federal subsidies
  - More equity – 70% value
  - But much more competitive because limited amount in each State
- 4% LIHTC with Tax-Exempt Bonds
  - Finances new construction that uses federal subsidies or the acquisition and renovation of existing units
  - Less equity – 30% value
  - Easier to obtain (bonds are competitive but 4% credits are automatic and not subject to the per capita limit)
  - More complex financing structure
  - Higher closing costs
- Rates change monthly as published by the IRS

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OWNERSHIP STRUCTURE IN LIHTC TRANSACTIONS

- Owner of the units is a for-profit entity (limited partnership)

- Tax credit investor is the limited partner and typically owns 99.99% of the entity (99.99% of tax credits, profits and losses)
  - Investor will invest its equity in the form of multiple capital contributions made according to negotiated benchmarks.

- General Partner typically owns 0.01% and oversees operations
  - General Partner guarantees construction completion, stabilization, operating deficits, as well as total amount of credits and timing of delivery of credits

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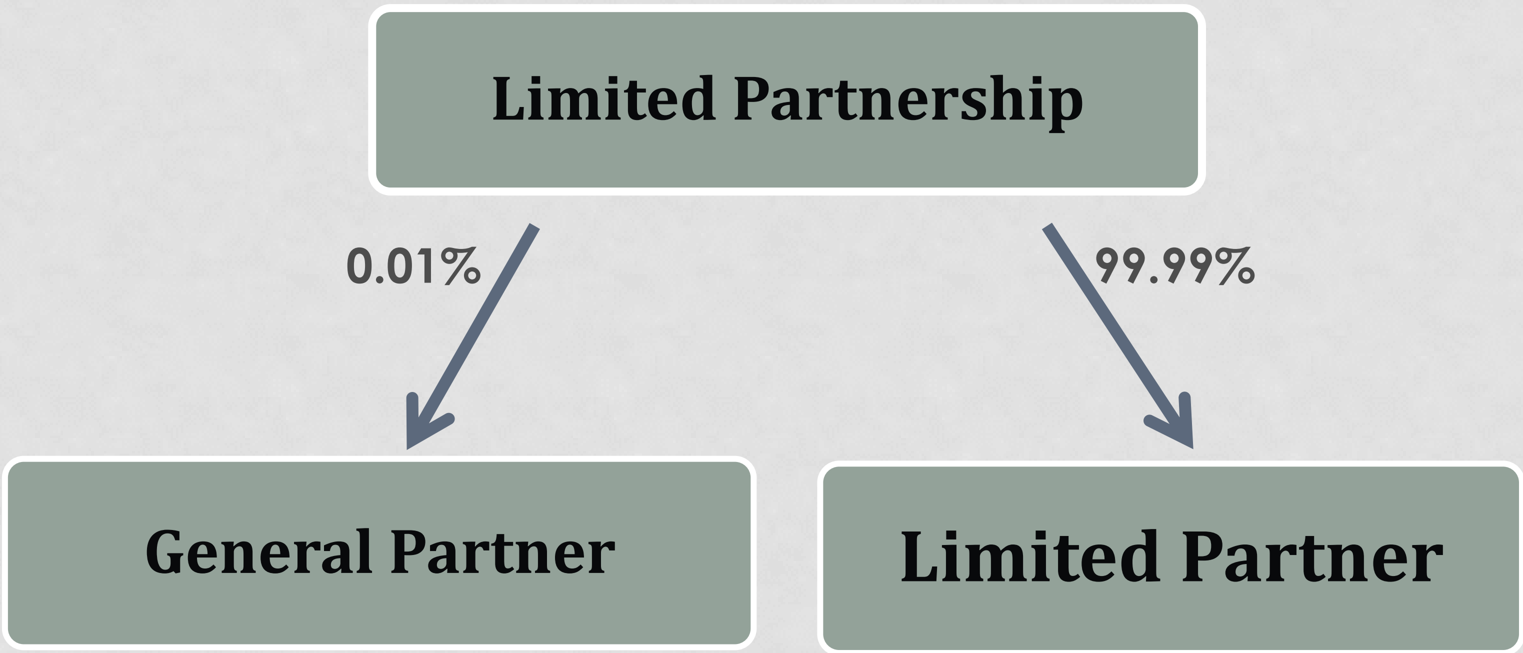
OWNERSHIP CHART for LIHTC TRANSACTION



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QUALIFIED ALLOCATION PLANS (QAP)

- State housing finance agencies must adopt QAP to allocate credits
- QAP must set forth priorities that govern allocation
- QAP must identify a procedure for notifying IRS of non-compliance
- Projects financed with tax-exempt bonds must satisfy QAP

PROJECT EVALUATION

- State agency will only allocate amount of credits necessary for the project's feasibility

- Items to be considered include:
  - Sources and uses of funds
  - Equity to be generated by tax credits
  - Reasonableness of development and operating costs
  - Market study

- Evaluation occurs at application, allocation and completion of project

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CREDIT CALCULATION

- The credit is calculated building by building
- Credit based on Eligible Basis, not total development costs. The determination of a building's Eligible Basis is the starting point for the computation of the credit
  - Most costs, minus non-depreciable items (Eligible Basis includes rehabilitation costs, reasonable developer fee, common areas)
  - Examples of non-eligible costs: land, syndication costs, financing costs, legal fees related to the acquisition of land, costs of surveys, federal grants, commercial space

CREDIT CALCULATION, continued

- Qualified basis: Eligible basis x applicable fraction
  - The qualified basis of a building is that portion of the building's Eligible Basis that is attributable to low-income tenants (number of low income units compared to total number of units, or floor space fraction)
  - Annual credit amount is available each year for 10 years, beginning with the year in which the building is placed in service (unless the taxpayer elects to defer the start of the credit period by one year)
- The credit is calculated to provide a yield over a 10 year period equal to 70 percent or 30 percent, as applicable, of the building's qualified basis
- In the first year, the credit amount is reduced to reflect qualified occupancy in that year

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CREDIT CALCULATION, continued

- Eligible basis x percent qualified units x applicable percentage x 10 years = total tax credits
- The applicable percentage is set either when the State issues a credit reservation or when the building is placed in service (for November 2017, the rate for the 9% credit is 7.53% and the rate for the 4% credit is 3.23%)
- Total tax credits x price per credit = investor total equity
- Note that most of the investor's equity will not be contributed to the owner entity until the project is completed

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CREDIT CALCULATION, continued

Example of Tax Credit Calculation

- 300 Unit Project/240 Low-Income Units
- TDC (including land) = $40M
- Land Cost= $4M
- Qualified Basis= $28.8M ($36M x 80%)

Typical Installment Structure

- Capital contributions by Investor
  - 15% at closing
  - 65% at 100 completion of project
  - 15% at project's breakeven point
  - 5% at issuance of Form

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LIHTC PROGRAM REQUIREMENTS

- Occupancy/Income Requirements
  - Either 20% of units occupied by households with incomes at or below 50% of AMI, adjusted for family size ("20/50")
  - Or 40% of units occupied by households with incomes at or below 60% of AMI, adjusted for family size ("40/60")
  - The set-aside election is made on IRS Form 8609 upon placement in service
  - The requirements of the minimum set-aside must be met no later than the close of the first year of the credit period and must continue throughout the compliance period
  - Tenant income must be reviewed and documented at least annually throughout the compliance period

LIHTC PROGRAM REQUIREMENTS, continued

- Rent Requirements
  - The gross rent (including utilities) for a LIHTC unit may not exceed 30% of the imputed income limit applicable to such unit size
  - Rent limits change annually when new area median incomes are calculated
  - Rent never decreases below original floor
  - Rent subsidies (including Section 8) are not included in calculating gross rent
- Maintain habitability standards

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TERM OF AFFORDABILITY RESTRICTIONS

- The occupancy/income and rent restrictions are in place for the 15 year tax credit compliance period
- An additional extended use period of at least 15 years applies to most developments pursuant to recorded extended use agreement

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CARRYOVER ALLOCATIONS

- 10% of Reasonably Expected Basis must be incurred within one year of the date of allocation
- Reasonably Expected Basis is the anticipated basis of the land and building at such time as the building is placed in service
- Building must be placed in service by December 31 of the second year after carryover

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RECAPTURE

- 10 year credit period / 15 year compliance period means the credits are "accelerated", i.e. claimed faster than they are earned
- Recapture percentage depends on year in which recapture event occurs. Only the accelerated portion of the credit is recaptured
- Recapture events - Recapture occurs if there is a decrease in qualified basis:
  - Nonqualified unit: for example, a unit not occupied by a qualified tenant, or a unit for which the owner charges above limit rent
  - Building disposition through sale or foreclosure unless the building is expected to continue to be operated as a low income building
  - Unit not suitable for occupancy (casualty loss or dilapidated unit)

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RECAPTURE, continued

- Opportunities to cure issues that could lead to Recapture
  - Compliance issues corrected before year end do not lead to recapture
  - Units affected by a casualty event can be repaired/placed back in service

- Recapture amount calculated based on the decrease in qualified basis / new applicable fraction, plus interest

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COMPLIANCE

- State housing finance agency monitors projects
- Record keeping requirements:
  - Total number of units and number of LIHTC units in project
  - Income certifications
  - Qualified and eligible basis amounts
  - Rent amounts
- Annual compliance certifications

CONCLUSION

- LIHTC is a critical tool to help finance affordable housing
- Tax exempt bonds in 4% transaction add value, but transaction is more complex
- Potential impact of tax reform
- Evaluate the project carefully
- Select good partners

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November 21, 2017