LEVERAGING AFFORDABLE HOUSING HUD FINANCING: RAD AND OTHER MIXED-FINANCE DEVELOPMENT PROGRAMS

Converting and Preserving Public Housing Through Public-Private Partnerships

Using Low Income Housing Tax Credits (LIHTC) with RAD

By Delphine G. Carnes
Crenshaw, Ware & Martin, P.L.C.

Strafford Publications, Inc.
June 4, 2015

ADDING LIHTC TO THE RAD PROCESS

- LIHTC is a key component if substantial rehabilitation is needed
- The property may not qualify for a large enough loan/may not be able to generate enough cash flow for debt service
- If the existing units have low contract rents/high expenses and need substantial rehab, 9% LIHTC may be the only way to finance the renovation
- Opportunity to earn a developer fee

CRENSHAW, WARE & MARTIN, PLC

LIHTC PROGRAM OVERVIEW

- Established by the Tax Reform Act of 1986 to encourage private investment in affordable 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")
- Dollar for dollar reduction of federal tax liability for the owner of the qualified project
- Credits claimed over a 10 year period
- Restrictions in place for 15 years
- Many states extend the restrictions for a longer period

TYPES OF LIHTC

- 9% LIHTC are the best you can get
  - More equity – 70% present value
  - But much more competitive because limited amount in each State
- 4% LIHTC with Tax-Exempt Bonds
  - Less equity – 30% present 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

Crenshaw, Ware & Martin, PLC

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
  - 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
- Rent Requirements
  - The gross rent for a LIHTC unit may not exceed 30% of the imputed income limit applicable to such unit size
- Maintain habitability standards
- Operate under the occupancy/income and rent restrictions for at least 15 years (30 or more years in many States pursuant to Extended Use Agreements)

CRENSHAW, WARE & MARTIN, PLC

CREDIT CALCULATION

- Credits 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)
  - Examples of non-eligible costs: land, syndication costs, financing costs, legal fees related to the acquisition of land, costs of surveys, federal grants
- Qualified basis
  - The qualified basis of a building is that portion of the building's eligible basis that is attributable to low-income tenants
- 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

CREDIT CALCULATION

- Eligible basis x percent qualified units x applicable percentage x 10 years = total tax credits
- 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

CRENSHAW, WARE & MARTIN, PLC

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)

CRENSHAW, WARE & MARTIN, PLC

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

Crenshaw, Ware & Martin, PLC

RAD AND LIHTC
THE TAX CREDIT "FAST TRACK"

- HUD Process created in 2014 for RAD conversions using 9% or 4% LIHTC with conventional/non-FHA financing
- Traditional RAD Milestones are consolidated
- Financing Plan due 60 days after LIHTC award
- Requirements listed at www.radresource.net (*see Fast Track Submission Checklist*)
  - Underwriting Documents
  - Administrative Program Requirements
- If you apply but do not receive tax credits, you have 90 days to come up with a feasible alternative financing plan or your CHAP may be revoked

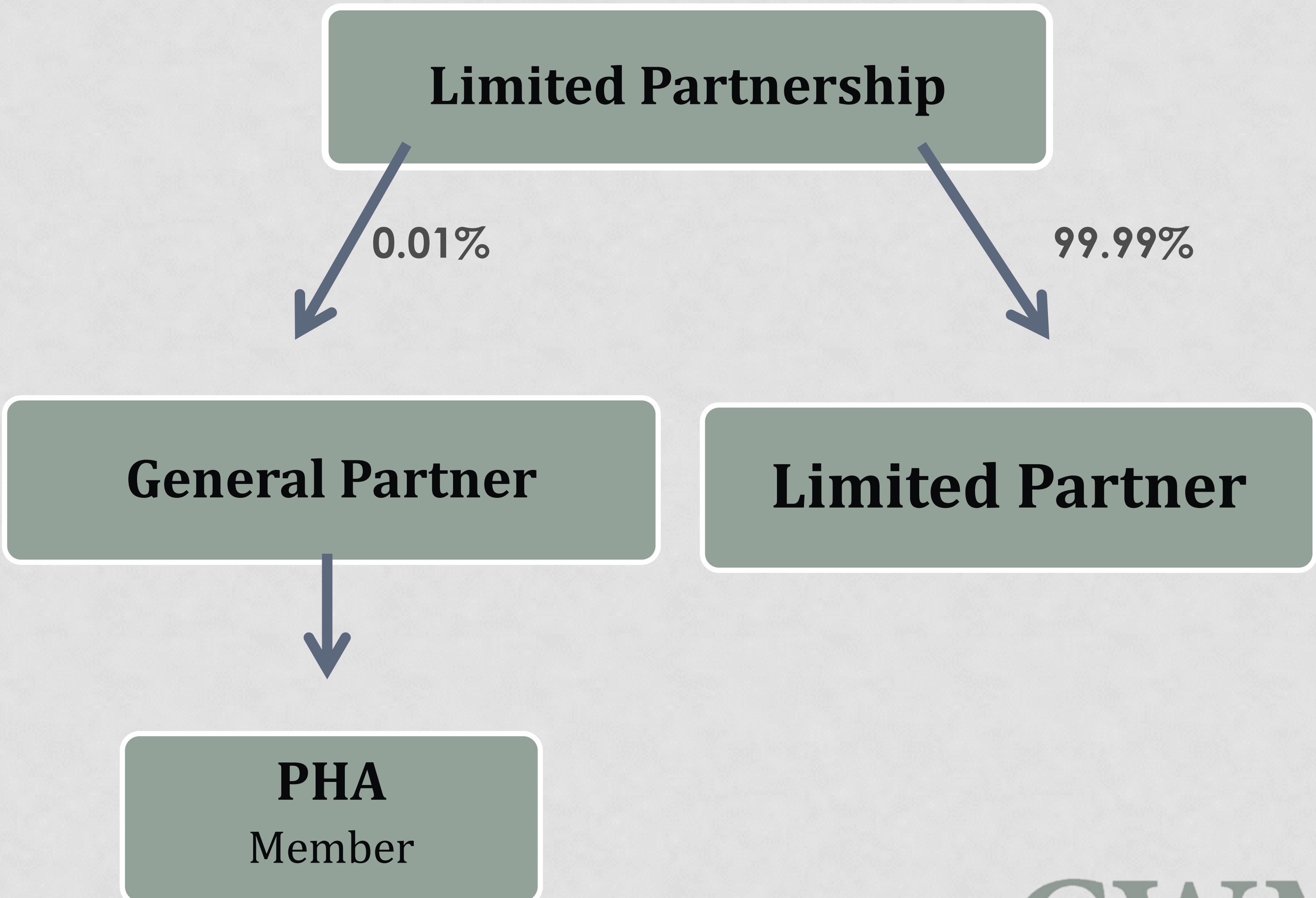
CRENSHAW, WARE & MARTIN, PLC

OWNERSHIP STRUCTURE IN LIHTC/RAD 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
- General Partner typically owns 0.01% and oversees operations
- PHA must have some control over the limited partnership

Crenshaw, Ware & Martin, PLC

OWNERSHIP CHART for LIHTC/RAD TRANSACTION



POTENTIAL ROLES FOR THE PHA

- PHA can maintain ownership of the land. Ground lease to the limited partnership
  - Ground Lease Payments
- PHA can sell the land to the limited partnership
  - Seller financing
- PHA can provide subordinate financing, secured by a lien on the units
  - Financing fees/debt service
- PHA can serve as sole developer, or co-developer
  - Opportunity to earn a developer fee

CRENSHAW, WARE & MARTIN, PLC

POTENTIAL ROLES FOR THE PHA, continued

- PHA will generally be a member (or the sole member) of the general partner entity
  - Cash flow
- PHA can serve as property manager
  - Opportunity to earn a property management fee
- Right of first refusal for sale of the property
- Fees earned by the PHA are unrestricted funds (NOT program income)

PARTIES TO THE TRANSACTION

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

CRENSHAW, WARE & MARTIN, PLC

INVESTOR CONSIDERATIONS

- Price per credit matters, but is not the only concern
- Investor familiarity with PHAs
- Guaranties (construction completion, operating deficit and recapture)
- Investors tend to require a developer with LIHTC experience
- Investors/their counsel will review all contracts and loan documents. May require Riders

CRENSHAW, WARE & MARTIN, PLC

CHOOSING A LENDER

- Experience with PHAs
- Familiarity with HUD and with RAD. Lack of familiarity with the process may result in delays and increased costs
- Underwriting, DSCR requirements and due diligence
  - Timeline
  - Costs involved (lender's legal fees, third party reports such as environmental reviews)
- Investor will want to approve the loan structure and loan documents
- Note: FHA financing can be used in conjunction with RAD (Section 223(f) for refinancing or acquisition with minor repairs; Section 221(d)(4) for substantial rehab; Section 223(f) LIHTC Pilot Program for rehab up to $40,000 per unit). This presentation does not focus on FHA financing

CRENSHAW, WARE & MARTIN, PLC

CHOOSING A CONTRACTOR

- Price matters but is not the only concern
- Low bidder may be a company that submits a plethora of change orders
- Experience with PHAs
- Experience with LIHTC process and ownership structure
- Investor will want some input on the contractor selection, construction contract and insurance coverage

CWM
Crenshaw, Ware & Martin, PLC

RESIDENT RIGHTS

- Any displacement of existing residents for more than 1 year requires compliance with the Uniform Relocation Act
- Existing residents who are temporarily relocated during construction must have the right to return
- Rehab Assistance payments provided by HUD to assist with relocation costs
- RAD does not allow screening of existing residents who have a right to return
- Investor will review and approve the form of lease
- Owner entity must sign Consolidated Owner Certification stating that residents had 30 days advance notice
- New leases for existing residents must be signed prior to the effective date of the HAP contract

CRENSHAW, WARE & MARTIN, PLC

CONCLUSION

- RAD can be a good tool, combined with LIHTC, to help finance substantial rehabilitation
- Complete re-do or "gut rehab" and new construction will necessitate higher debt
- RAD does not always work, even with LIHTC. Run the numbers carefully
- Use all funding sources available: Replacement Housing Factor (RHF) Funds, reserves, HOME, CDBG, AHP, grants, senior and subordinated debt . . .
- Select your partners carefully

Delphine G. Carnes
dcarnes@cwm-law.com

CRENSHAW, WARE & MARTIN, P.L.C.
150 W. Main Street ▪ Suite 1500 ▪ Norfolk, VA 23510
T (757) 623-3000 | F (757) 623-5735

CWM
CRENSHAW, WARE & MARTIN, PLC

www.cwm-law.com

June 4, 2015