Housing Tax Credit Essentials

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Background

- Part of 1986 Tax Reform to encourage the construction and rehabilitation of low-income rental housing
- Contained in Section 42 of the tax code
- Emphasis on private sector involvement (i.e. developing and managing properties)
- Objective: provide investor equity to lower debt service which decreases rents
- Credit is a dollar-for-dollar tax reduction
- Credit amount based on the cost of constructing or rehabilitating housing developments

Program Requirements

- Minimum percentage of units occupied by low-income tenants (20/50 or 40/60)
- Maximum income limited for households renting LIHTC units
- Maximum rents limited for LIHTC units
- Minimum 30-year affordability commitment
- Projects subject to IRS and State regulation/compliance

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State Allocation Volume Limit

- In 2008 the maximum credit per resident in the state is $2.20 ($2.00 with $.20 boost in 2008)
- Adjusted annually for inflation
- The 2008 minimum is $2,557,500 for small states ($2,325,000 + 10% in 2008)
- Similar rules apply in 2009

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Volume Limit Rules

- **Example:**
  - State with 2.5M population has $5.5M in credits in 2008
- **Amount is for 1 year of credit**
- **10% non-profit set-aside**
- **50% test: tax-exempt bonds subject to bond volume - no credit allocation needed**

Qualified Allocation Plans

- **State must adopt QAP to allocate credits**
- **QAP must set forth allocation priorities**
- **QAP must give preference to projects with:**
  - Lowest income tenants
  - Longest period of low-income use
  - Contributing to a concerted revitalization plan in a Qualified Census Tract
- **For allocations after 2008, QAP must take into account energy efficiency & historic character of the project**

Additional QAP Rules

- QAP must provide a procedure for notifying IRS of non-compliance
- Tax-Exempt bond financed projects must “Satisfy” QAP

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Project Evaluation

- **Credit cannot exceed amount the state agency determines is necessary for feasibility and long term viability**
- **Agency must consider:**
  - Sources and uses of funds
  - Amounts expected to be generated by tax benefits (Equity for credits and tax deductions)
  - Reasonableness of development and operating costs

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Project Evaluation (con't)

- **Evaluation occurs at application, allocation and completion**
- **Owner must certify as to amount of subsidies**
- **For tax-exempt bond financed projects, issuer must do similar evaluation**
- **Agency must require market study paid for by developer**

State Allocation Process

- **Carryover Allocations:**
  - 10% of Reasonably Expected Basis must be incurred within one year of the date of allocation
  - Building must be placed in service by 12/31 of 2nd year after carryover
  - Carryover basis includes cost of land and depreciable property
  - Reasonably Expected Basis is the basis of the land and building expected at the time the building is placed in service

Carryover Allocation Document

- Must be issued by the state agency by 12/31 of allocation year
- 10 Elements required in document
- Agency will later issue Forms 8609 after buildings are complete
- State may carryforward unallocated credits for one year; then credits go to the National Pool to be allocated to states that used their entire allocation

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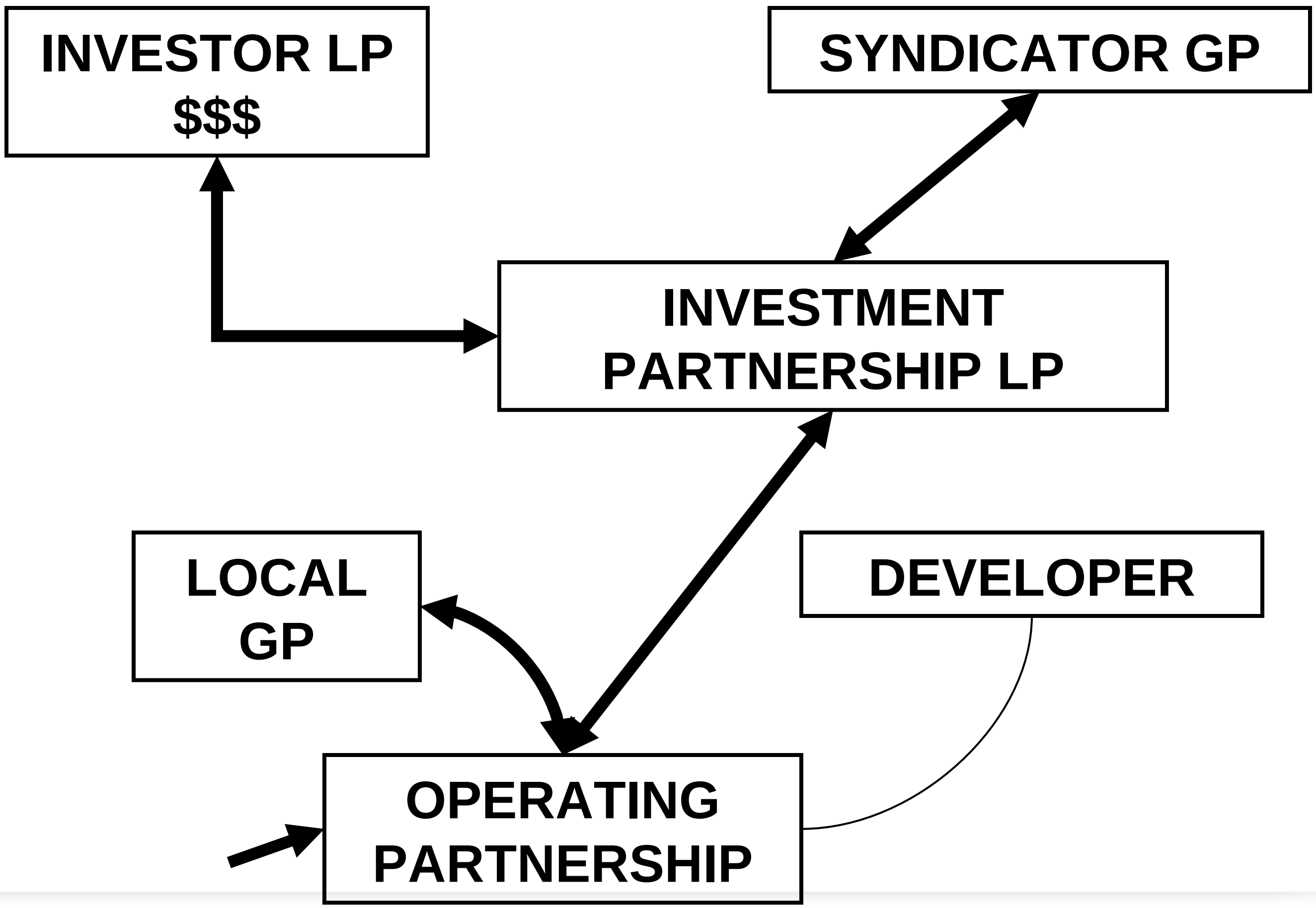
Who Can Use Credits?

- **C Corporations can use losses and credits against ordinary income and taxes**
- **Individuals are limited under passive loss rules to approximately $9,900/yr assuming a 39.6% marginal tax rate**
- **Limitations on “Closely-Held” Corporations**
- **Credit may be used to offset Alternative Minimum Tax (effective for buildings placed in service after 2007)**

Typical Structure



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Key Business Terms

- Projects generally owned by limited partnership or limited liability company
- Limited partner investor generally owns 99.99% of tax credits, losses & profits
- LP pays in capital contributions in multiple installments (generally 3 or 4), based on negotiated benchmarks
- GP guarantees completion & stabilization, amount and timing of credits and funding of deficits

Income Restrictions

- **Minimum Set Aside Election of:**
  - 20% of Units at 50% of Area Median Income or
  - 40% of Units at 60% of AMI
- **Election upon placement in service and made on Form 8609**
- **Must meet minimum by end of first year of the Credit Period**
- **HUD publishes area median income figures annually**

Rent Restrictions

- **Rent (including utilities) cannot exceed 30% of qualifying income for assumed family size, based on bedrooms per unit**
- **Assumed Family Size:**
  - One Person for studio
  - 1.5 Persons per bedroom

Additional Rent Rules

- Rent limits change annually with publication of new area median incomes
- Rent will not decrease below original floor
- Gross rent does not include Section 8 (or similar rent subsidies)
- Gross rent must include utility allowance for tenant-paid utilities (i.e., deduct from rent to owner)

Rent Calculation Example

- Median Income = $50,000
- Minimum Set Aside elected – 40/60
- Two bedroom unit so assumed family size of 3 persons (2 BR x 1.5 people)
- 3 person income limit = $27,000
- 30% of income limit = $8,100
- Monthly rent (1/12) = $675

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Length of Affordability

- **Fifteen-year tax credit compliance period**
  - Continued tenant qualification required
  - Possibility of credit recapture
- **Fifteen-year extended use period (or longer)**
  - Recorded extended use agreement
  - Early termination of minimum 30-year affordability commitment if:
    - Foreclosure (or Instrument in lieu of foreclosure)
    - Qualified Contract Process

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Qualified Contract Process

- **Available under Section 42; Many states require waiver (deferral) of right in order to receive initial credit allocation**
- **State agency to find buyer pursuant to qualified contract if requested by owner after 14th year**
- **Contract Price = outstanding debt + adjusted investor equity + other capital contributions – cash available for distribution**
- **If no buyer found within one year, owner may opt out of tax credit program (subject to 3-year rent transition period)**
- **IRS issued proposed regulations in June 2007; comments received and under review; public hearing held**

Recapture

- **Recapture on non-compliance:**
  - Accelerated portion of credit recaptured (1/3 of credit for years 1-10 and decreasing through year 15)
  - If Minimum Set-Aside fails, all accelerated credits are recaptured
  - Otherwise, unit-by-unit (extent of decrease in Qualified Basis)
- **Full recapture if transfer of project or interest therein with a diminimus (1/3 ownership change) exception**

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Avoiding Recapture: Old Rule

- **Recapture may be avoided upon the disposition of a building (or interest therein) if:**
  - Taxpayer reasonably expects the building to remain low income and in compliance with LIHTC program, and
  - Taxpayer posts a recapture bond (or pledges securities)
- **Revenue Ruling 90-60**

Avoiding Recapture: New Rule

- The Requirement that a bond be posted upon the disposition of a building (or interest therein) to avoid credit recapture is <u>repealed</u>
- Recapture bonds are replaced with an extended period for the statute of limitations – three years following taxpayer's notification to the Treasury that a recapture event has occurred
- Effective for dispositions after 7/30/08 and for dispositions before 7/30/08 if taxpayer elects the application of the new provisions
- Outstanding bonds may be retired if the taxpayer elects application of these provisions
- Revenue Procedure 2008-60

Compliance Monitoring

- **State credit agencies monitor projects**
- **Owners recordkeeping requirements:**
  - Number of low-income & total units
  - Income certifications/annual re-certifications (except for 100% LIHTC projects under the new law) & Backup Verifications
  - Qualified & eligible basis amounts
  - Rent amounts
- **Owner annual compliance certifications**
- **Check QAP for state specific rules**

Calculating Credit Amounts

- Annual credit amount is available each year for 10 years
- Credit Period begins when a building is placed in service unless the taxpayer elects to defer the start of the Credit Period to the next year
- First year credit reduced to reflect qualified occupancy during the year
- Annual credit amount = Qualified Basis X Applicable Percentage

Basis Calculations

- Start with calculation of Eligible Basis, then calculate Qualified Basis

Eligible Basis

- New Construction = Adjusted basis
- Acquisition = Acquisition cost of building
- Substantial Rehab = Capitalized rehabiliation expenditures
- Must subtract Federal grants
- 130% Increase in "QCTs" and "DDAs" as defined by HUD or state tax credit agency
- Excludes commercial space
- Includes common areas

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Qualified Basis

- **Applicable Fraction X Eligible Basis**
- **Applicable Fraction is the lower of:**
  - Number of occupied “Low-Income Units” vs. Total Units or
  - “Floor Space Fraction”
- **Calculated building by building**

Applicable Percentage

- **Two Credit Rates:**
  - 4% Credit = 3.28% for January 2009 (floating)
  - 9% Credit = "Not less than 9.00%" for buildings placed in service after 7/30/08 and before 12/31/13
- **Owner elects to set applicable percentage either: (i) when receiving a binding commitment from the state (or when tax-exempt bonds issued), or (ii) when building is placed in service**

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Example Of Tax Credit Calculation

- **100 Unit Project/70 Low-Income Units**
- **TDC (Including Land) = $5.5M**
- **Land Cost = $500K**
- **Eligible Basis = $5.0M**
- **Qualified Basis = $3.5M ($5.0M x 70%)**

Calculation (con’t)

- Applicable Percentage= 9.00%
  (not tax-exempt bond financed)
- Annual Credit= $315,000 ($3.5M x 9.00%)
- 10 Year Credits = $3,150,000

Equity Calculation

- Pricing primarily based on total credits available to investor, timing of delivery and market conditions
- Expressed as “cents per tax credit dollar”
- In above example, if investor will invest 75 cents for $1.00 of tax credit, equity equals $2,362,264 ($3,150,000 x 99.99% x .75)

4% credit vs. 9% credit

- **Qualifying for the 4% Credit**
  - Acquisition of building
  - Tax-Exempt bond-financed building

- **Qualifying for the 9% Credit**
  - New construction/rehabilitation if building is not federally subsidized (which now means financed by tax-exempt bonds)
  - New Rule: “Below Market Federal Loans” no longer disqualify building from 9% credit

4% Acquisition Credit

- Existing buildings/acquisition costs
- Purchase from unrelated party. The definition has been changed by the new law
- Ten year rule

Acquisition credit (con't)

- **Certain Placements in Service Ignored**
  - Carryover basis
  - Acquired from decedent
  - Placement in service by governmental unit or non-profit entity
  - Foreclosure
  - Projects substantially assisted, financed or operated under HUD or RHS housing programs or similar state housing programs for buildings placed in service after 7/30/08 (replaces the Treasury waiver)
  - Technical termination of partnership

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Substantial Rehabilitation Requirement

- **For credit allocations made and bonds allocated after 7/30/08, expenditures during a 24-Month period selected by the taxpayer must equal the greater of:**
  - $6,000 Per low-income unit *(to Be Adjusted for Inflation)*, or
  - 20% of adjusted basis
  - *Increased from $3,000/10%*
- **Separate new building**
- **4% (tax-exempt bond financed) or 9% credit on the expenditures**

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Federally Subsidized and Below Market Federal Loans: Old Rule

- **For buildings placed in service before 7/30/08:**
- **4% credit for federally subsidized new construction or rehabilitation expenditures**
  - Building receives tax-exempt bonds or below market federal loan
- **Below market federal loan**
  - From federally appropriated funds
  - Interest rate below AFR (in January 2009 for long-term loans compounded annually, AFR = 3.57%)
  - Not applicable for buildings placed in service after 7/30/08

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Exceptions From Federally Subsidized Definition

- **HOME Loan if 40% at 50% targeting (in each building)**
- **Community Development Block Grant (“CDBG”) Loans**
- **Affordable Housing Program (“AHP”) loans**
- **Loan or bond is subtracted from eligible basis**
- **Section 8**
- **Native American Housing Assistance and Self-Determination Act (“NAHASDA”) of 1996 if 40% at 50% targeting (in each building)**