INTRODUCTION TO FEDERAL LOW INCOME HOUSING TAX CREDITS

I. THE TAX CREDIT GENERALLY

a. Established under the Tax Reform Act of 1986. Essentially an effort to partially privatize the affordable housing industry. Program works by providing investor equity, thus reducing the amount of debt service on a project, allowing for lower rents to be charged to tenants while still producing positive cash flow. The program provides a dollar-for-dollar reduction in tax liability for owners (and the partners of the owners).

b. 4% and 9% Credit Allowed

   i. 4% for new construction w/ Federally subsidies, i.e., tax-exempt bonds;

   ii. 4% credit for acquisition of existing buildings which are substantially rehabilitated; and

   iii. 9% for new construction/rehabilitation expenditures w/out Federal subsidies.

c. Calculation of Tax Credit

   i. Basic Formula: Applicable Percentage X Qualified Basis = Annual Credit

   ii. Defining the Terms

      1. Applicable Percentage

         a. There are actually two credits – the "9%" (or 70% present value) credit and the "4%" (or 30% present value) credit. Credits are allowable over a 10 year credit period. Each month the Treasury Department recomputes (based on a statutory interest rate-bases formula) the annual applicable percentage for each credit that will yield a present value of 70% and 30% over a 10 year period.

            I. For example, in January 2008, the 70% present value credit equals 7.93%, and the 30% present value credit equals 3.40%.

         b. Owner can elect the applicable percentage in effect 1) when it receives a binding agreement from state to allocate credits (or when tax-exempt bonds are issues)

(a "lock-in election"); or 2) when building is placed in service.

2. <u>Qualified Basis</u> -- the "Applicable Fraction" times the "Eligible basis" equals "Qualified Basis".

3. <u>Applicable Fraction</u> is the lower of the number of occupied "Low Income Units" vs. total units or the floor space of occupied "Low Income Units" vs. the total floor space.

4. <u>Eligible Basis</u> of a new project is its adjusted basis, generally development cost less the cost of land; for existing projects, eligible basis for acquisition credit is acquisition cost. Eligible basis for rehabilitation credit (which is calculated separately from acquisition credit) is rehabilitation expenditures aggregated over 24 months which are chargeable to capital account and which meet minimum described above. Must subtract the amount of any federal grants. Eligible basis increased by 130% in certain very low-income census tracts (QCTs—**HUD designated areas with a poverty rate of 25% or higher**) and difficult development areas (DDAs) as determined by HUD survey. **Also, eligible basis may include costs of community service facilities which primarily serve project tenants, if located in a QCT only**.

5. <u>Low Income Units</u>

    a. Threshold of either 20% of units are "rent restricted" at 50% of area median gross income where project located or 40% of units at 60% of median ("set-aside"); receive credit for additional units over threshold. Elect either 50% or 60% standard when applying for credits and verify when project placed in service, and must generally meet targeting restrictions by close of first year of credit period. Income figures are published annually by HUD for all areas in the country.

6. <u>Rent Restricted</u>

    a. Rent, including utilities, cannot exceed 30% of qualifying income. To calculate rent, certain number of occupants assumed to occupy a unit, depending on bedroom size (no actual occupants). Assumed family size is 1 person in studio and 1.5 persons per bedroom (e.g., rent in 2 bedroom unit is 30% of 3 person qualifying income). Restriction in effect during entire compliance period. In figuring rent to owner, HUD

Section 8 or similar federal and state subsidies not taken into account.

b. Example:

Median Income = $40,000
2 Bedroom Unit
3 Person (2 BR x 1.5) Income Limit = 21,600
30% of Income Limit = $6,480
Monthly Rent (1/12) = $540

c. Rent limits change annually with changes in median income, provided rent will not decrease below original amounts (“gross rent floor”).

d. Gross rent does not include Section 8 (or similar state or federal rental subsidies) paid to owner.

e. Gross rent does include utility allowance for any tenant – paid utilities (i.e., must be subtracted from rent paid to owner). Allowance depends on type of financing on project, e.g. HUD or RHS financing. Owner or tenant may be able to obtain utility company estimate.

II. THE STUCTURE, PROCESS AND THE PLAYERS

a. The Structure

i. Owners generally are limited partnerships (or limited liability companies). Must be a partner (or member) to receive credits. Credits cannot be sold separately.

ii. Syndication transactions involve two (sometimes three) separate partnerships:

1. Local or Operating Partnership – owns the project, comprised of general partner (developer) and an investment partnership as limited partner.

2. Investment Partnership – becomes the limited partner in Local Partnership and is itself comprised of one or more investors (generally large corporations) and a sponsor entity as general partner.

iii. Direct investment transactions generally involve a direct corporate investor as limited partner and the local general partner in a single tier Local Partnership.

iv. Some Operating Partnerships will also have a "special limited partner" with certain approval and supervisory rights.

v. Limited partner will generally own between 99 and 99.99% of the tax credits, losses and profits. Cash flow and sale residuals can be negotiated.

vi. Capital contributions generally paid in four or five installments based on agreed upon benchmarks such as admission, completion, permanent loan closing, cost certification, 8609 issuance, breakeven operations.

vii. General Partner generally must guarantee completion, amount of tax credits, environmental matters, and to fund operating deficits.

b. The Players

i. State Agency – Each state has an agency that is responsible for administering the low income housing tax credit program. Among other things, State Agencies create a Qualified Allocation Plan (setting forth procedures for applying for tax credits);

ii. General Partner/Developer/Property Manager – Generally an entity or group of affiliated entities the will aplly for credits on behalf of the taxpayer (the partnership that owns the project). This group will be responsible for acquiring the land (and buildings), applying for credits, finding investors, contructing and/or rehabilitating the project, and managing the project in accordance with the program.

iii. Investor – This entity will provide the equity to the partnership.

iv. State/Federal Agencies – Projects utilizing tax-exempt bonds will have to locate a state agency willing to issue tax-exempt bonds to fund the construction of the project. In some states, this agency will be the same as the State Agency. Other Federal and State Agencies may be able to provide "soft" money to projects but be aware of the "federal subsidy" issues.

v. Other Lenders - Banks will generally need to be located to provide both Construction and Permanent Financing on a project. Occasionally, Lenders may have provisions in their loan documents that conflict with the requirement of the program or limit it (for example – recourse vs. nonrecourse debt).

c. The Process of Obtaining Credits

i. File an application with the State Agency.

1. 9% new construction and 4% acquisition credits are awarded on a competitive basis. Applications are scored by the State Agency in accordance with the Qualified Allocation Plan. 4% credits for projects using tax exempt bonds are automatically available provided the application meets the State Agency's threshhold requirements and demonstrates a financial need for the credits.

    a. Non-Profit Set Aside – 10% of the State's credit pool must be allocated to projects with a qualified nonprofit organization as the sponsor.

2. Obtain an award of Credits

    a. Binding Forward Commitment/Reservation

    b. Carryover Allocations

I. For non-bond financed projects, allocation must occur either in year project placed in service or there must be a "carryover allocation." Carryover allocation may occur for new construction or rehabilitation if 10% of reasonably expected basis incurred by **end of carryover allocation year if the allocation is made before July (or earlier if required by State) or within 6 months of the date of the credit allocation if after July 1**; and the project is placed in service by end of seconds year thereafter. Carryover allocation basis includes costs of land and depreciable property incurred by close of allocation year. Accountants' certifications as to costs incurred generally required.

II. Carryover allocation document must be issued by end of year and include 10 required elements (see Reg. Sec. 1.42-d(d)). Carryover allocation may be done on a project basis.

III. If carryover issue, state must issue IRS Forms 8609 after buildings are completed and cost certification submitted. 8609s are attached to owner's tax returns each year.

IV. State may carry forward unused or returned credit **for one year, if not used by then, credit goes into a national pool**.

V. 10% expenditures test will be discussed later

    c. 42(m) letter (for tax-exempt bond deals)

3. Obtain Form 8609

    a. Issued after project is placed in service.

b. Cannot claim credit until after Form 8609 is issued.

c. Recent Development: IRS is arguing that no credits can be claimed until the form is actually issued. Problematic for quarterly taxpayers and when form is not issued until after April 15.

III. 4% ACQUISITION CREDITS

a. For existing buildings, building acquisition costs qualify for 4% credit provided:

i. Building purchased from "unrelated" party

ii. For existing buildings, must be a period of at least 10 years between the date of acquisition by the taxpayer and the date it was last placed in service or substantially improved. Ten-year period subject to Treasury waiver for troubled federally assisted projects, for properties acquired from failed financial institutions and to avoid conversion from low-income to market rate use. In addition, certain placements in service are ignored for 10 year rule purposes: carryover basis transactions, properties transferred from a decedent, placements in service by governmental units and non-profits if no placement in prior 10 years, and foreclosures if no placement in prior 10 years and property resold within 1 year.

iii. Building must be "<u>substantially rehabilitated</u>" – at least $3,000 per low-income unit (it may be higher at the state level) or 10% of adjusted basis, whichever is greater. Note that "sub rehab" is considered a "separate new building" and the credit is calculated separately. Therefore, owner can receive either 4% or 9% credits on sub rehab costs depending on how the rehab is financed, i.e. if rehab is not "federally subsidized", the owner can get "9%" credits on rehab plus "4%" credits on acquisition.

IV. ONGOING COMPLIANCE

a. Basic "Compliance Period" for maintaining low-income use is 15 years.

b. Continued Tenant Qualification:

i. Incomes can increase up to 40% above current eligibility level and tenants still considered low income; note that this is 40% increase above the updated, current maximum income.

ii. Special rules allows income to increase to 70% above current applicable maximum if project set aside 15% of its low income units for tenants with incomes under 40% of area median and average rent

for non-low income tenants is 200% of average rent for low income tenants.

iii. Vacant units, or units occupied by originally qualified tenants who go over income, can remain qualified if next available unit of comparable or smaller size in the building is rented to a qualifying tenant and rent restriction test maintained.

iv. Recapture on Non-Compliance: The "accelerated portion" of the credit is recaptured. The accelerated portion equals one-third of credit amount during the first ten years decreasing to zero at year 15. Only if project fails to meet either the 20% or 40% test is entire credit subject to recapture. Otherwise, credit taken away to the extent of decrease in qualified basis (e.g., units do not qualify).

v. Recapture on change of more than 1/3 ownership interest unless old owner posts a satisfactory bond with the Treasury and its is expected that the new owner will keep the project in compliance fort the 15 year period. New owner steps into old owner's shoes regarding compliance period, credit basis, etc.

c. "Extended low-income housing commitment" must be in effect between credit agency and owner

i. Commitment must bind owner and successors to maintain specified low-income occupancy during "extended use period" and must be recorded and be enforceable by tenants.

ii. "Extended use period" is greater of 30 years or date specified by credit agency.

iii. Extended use period terminates upon foreclosure or if state is unable to find a buyer willing to present a "qualified contract" to buy building and maintain low-income use within a year after a request by owner which may be made any time after 14th year.

iv. a "qualified "contract" is a contract to buy low-income portion of building for amount equal to applicable fraction times the sum of outstanding debt plus "adjusted investor equity" plus other capital contributions, reduced by cash distributions.

v. "adjusted investor equity" is investor capital contributions (reflected in basis, i.e., no syndication expenses) inflated by cost-of-living adjustment, up to 5% per year.

vi. If no buyer found, property may be sold or converted, subject to 3 year vacancy decontrol provision for existing tenants, i.e., no evictions except for cause and rent restriction stays in place during that period.

d. Compliance Monitoring

   i. State credit agencies must monitor projects for compliance, **including habitability standards**.

   ii. Owners have extensive recordkeeping requirements, including:

      1. number of total and low-income units;

      2. income certifications and annual recertifications with backup documents;

      3. eligible and qualified basis;

      4. rent charged for each unit.

   iii. Owners must file annual certifications regarding compliance.