TAX CREDIT BASICS

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Lightengale Group, Inc.
Types of Tax Credits

- Federal Low-Income Housing Tax Credits
- Illinois Affordable Housing Tax Credits
- Federal Historic Tax Credits
Low-Income Housing Tax Credit (LIHTC)

- Created under Section 42 of the Internal Revenue Code in 1986
  - Intended to incentivize investment in low income housing
  - Administered by the IRS
  - True Credit against tax liability
  - Available to the Owner each year for 10 years
Income and Rent Restrictions

- **Income restricted**
  - Minimum set asides of 20% @ 50% AMI or 40% @ 60% AMI

- **Rent restricted**
  - 30% of the applicable AMI (50 % or 60%)

- **Regulated for 15 to 30 years**
  (recorded encumbrance called an “extended use agreement”)

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Extended Use Agreement Restrictions

- **Credit Period**—rents restricted for the 15 year “Credit Period” (even though the credits are paid over 10 years in most situations)

- **Compliance Period**—rents restricted for an additional 15 year period after the Credit Period, for a total of 30 years

- The EUA imposes additional restrictions
  - Cannot discriminate against Section 8 voucher holders
  - Cannot terminate leases without good cause
  - Transfers generally prohibited
Typical Users of the Credit

- LIHTC syndication funds are most common users
  - NEF, ESIC, RBC/Apollo Housing, SunAmerica
- Single investor vs multi-investor funds
  - Pooled Funds vs. Targeted Investors (eg, JPMC)
- Fannie Mae, Freddie Mac (although, not recently)
- Large C Corporations may be direct investors
  - Verizon, Nationwide, GE, Banks
- Returns vary, may be a guaranteed minimum return
Obtaining Credits

- 2 ways of obtaining LIHTC:
  - Competitive allocation process (9% credits or 4% acquisition credits)
  - Private Activity Tax exempt bonds subject to volume cap (4% Credits)
9% Credits

- Qualified Allocation Plans
  - Each State has their own QAP, but all have similar characteristics
  - Determines housing priorities and assigns scoring criteria to accomplish same
  - IHDA, City of Chicago both get allocations of credits

- “Set-asides” – Some credits are set-aside for special groups (e.g., non-profits)

- Limitations on Federal Subsidies
  - “70% credits” – Sized so that present value of total credits over ten years equals 70% of construction / rehab costs (IRS sets rate monthly)
4% Credits

- **Tax-exempt bonds** — fairly automatic allocation if > 50% of the building & land costs are financed through tax-exempt bond issuances

- **Acquisition credit** — Additional credits available to cover acquisition of development if certain criteria are met (applies whether the rest of the deal gets 9% or 4% credits)
  - “10 Year Rule”: can’t have placed project in service w/in 10 years
  - “Anti-churning Rule” limits interests of related parties

- “30% credits” — Sized so that present value of total credits over ten years equals 30% of construction / rehab costs (IRS sets rate monthly)
Unique Issues to 4% Bond Deals

- Must still satisfy the QAP, even though not competitive
- Need to obtain volume cap
- Lower credit amount = less equity
- “50% Test” vs. DSCR and LTV
- Credit Enhancement may be necessary
Determining the Amount of LIHTC

- **Credits** = (eligible basis) \( \times \) (applicable fraction) \( \times \) (applicable %)

- **Eligible Basis** = Depreciable basis minus ineligible costs.

- **Applicable Fraction** = Fraction of LIHTC units to market units (or fraction of physical area of LIHTC units to other units)

- **Applicable %** = The “9%” or “4%” credit rate set monthly by the IRS (2007 HERA legislation set the 9% credit rate at 9% minimum; set to expire shortly)

- Cannot be allocated more credits than are needed
“Boosts”

- To encourage development in certain areas, the IRS allows a 30% boost in the amount of credits in:
  - Qualified census tracts (QCT)
  - Difficult to develop areas (DDA)

(2007 HERA legislation allows agencies to also designate additional areas as DDA for this boost)
Credits are a function of the percentage of LIHTC units

- Mixed income projects have a lower “applicable fraction,” and thus, are not entitled to as many credits as a similar project that devotes all of its units to LIHTC qualified tenants

- Mixed-use projects: cost of commercial space not always includable in the calculation of development costs
Typical Ownership Structure

**Project Partnership**
- an Illinois limited partnership

**General Partner:**
- an Illinois for profit/not for profit corporation

**Investor Limited Partner:**

**Sole Member/Shareholder:**

**Corporate Investors:**

**Board of Directors**
Why Create a New Affiliate?

- Liability Protection—otherwise, owner at risk of claims unrelated to the particular project
- Investor Concerns—cross defaults, matters beyond their scope of control or review
- Tax Issues—depreciation
Demand for the Credit

What drives the pricing?

- Investor structures
  - CRA versus multi-investor (national) funds and geographic desires
- Size of investment
- Strength of sponsor (guarantees discussed next!)
- Strength of the market
Tax Credit Development Risks

- **Construction**: Completion of construction, on time, on budget, lien-free and per plans and specifications
- **Tax Credit Delivery**: Delivering to investor the committed amount of tax credits within the agreed upon timeframes
- **Rent Up/Stabilization**: Initial lease up of project and operating project on a stabilized basis
- **On-going Regulatory Compliance**: Leasing project to qualified tenants and documenting same
- **Environmental**: Indemnifying lenders and investors for known and unknown environmental hazards
OTHER ISSUES UNIQUE TO NON-METRO PROJECTS

- Capacity and Financial Strength of the Sponsor
  - Typical Financial requirements?
  - Create Reserves to address deficits, loss of subsidy, lack of liquidity
  - Require a Joint Venture with experienced developer and/or property manager
- Difference in underwriting strategy on rural deals?
- Access to Amenities