

# Housing Tax Credit Essentials

# 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**

## **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**

# 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**

# 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

## **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

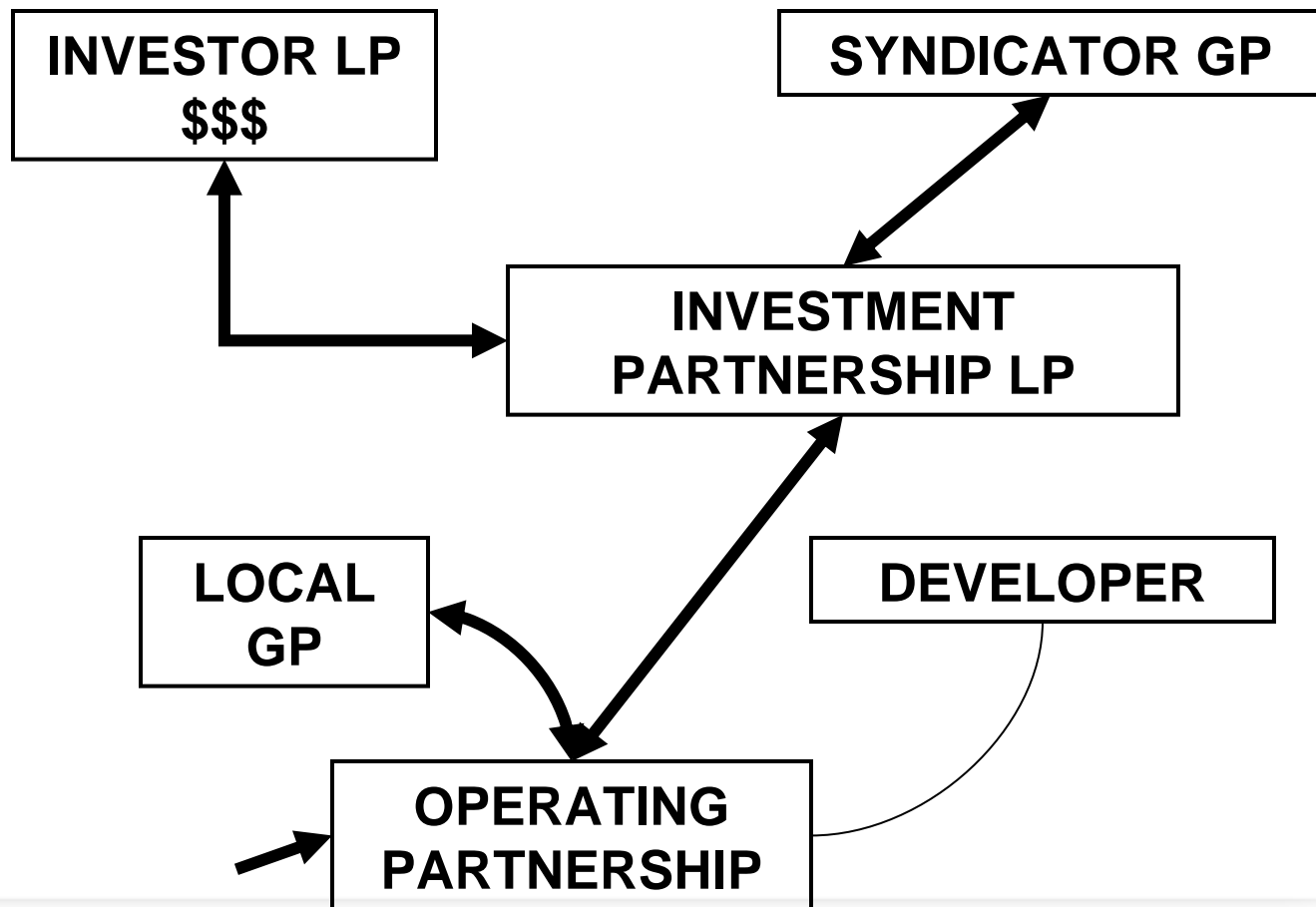
# Carryover Allocation Document

- **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**

## 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



# 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**

# 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

## 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**

## **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 repealed**
- **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 rehabilitation 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**

# 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**

# 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 ( $\$3,150,000 \times 99.99\% \times .75$ )

## 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

# 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**

# 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

# 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)**