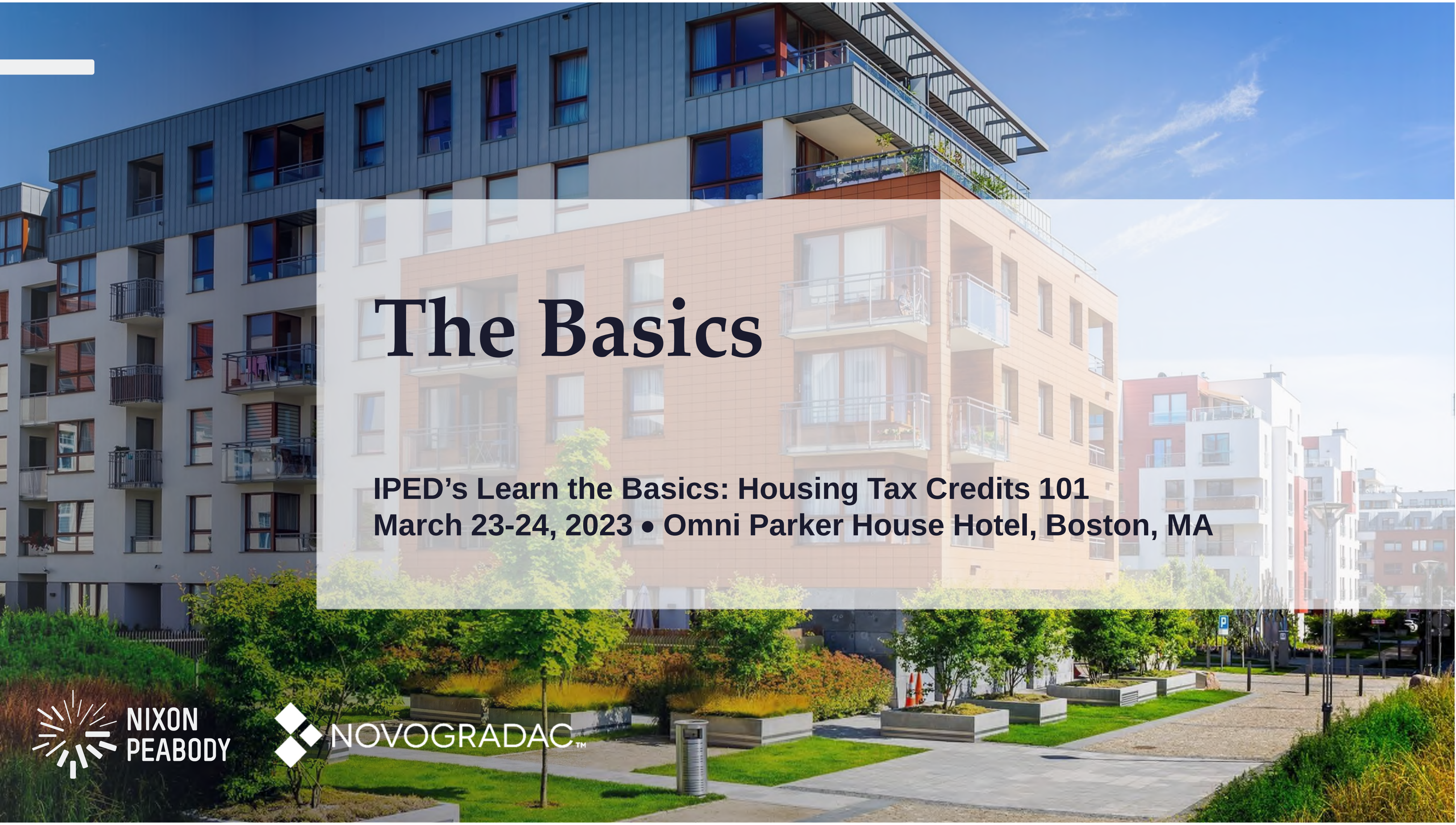

The Basics

IPED’s Learn the Basics: Housing Tax Credits 101
March 23-24, 2023 • Omni Parker House Hotel, Boston, MA

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Background

- Part of 1986 tax reform to encourage the construction and rehabilitation of affordable rental housing
- Administered by the Treasury Department and allocated by state agencies
- Contained in section 42 of the tax code
- Emphasis on private sector involvement (i.e. developing and managing properties)
- Objective: to provide investor equity to lower debt service, thereby lowering rents
- Credit is a dollar-for-dollar tax reduction
- Credit amount based on the cost of constructing or rehabilitating housing developments

Program Requirements

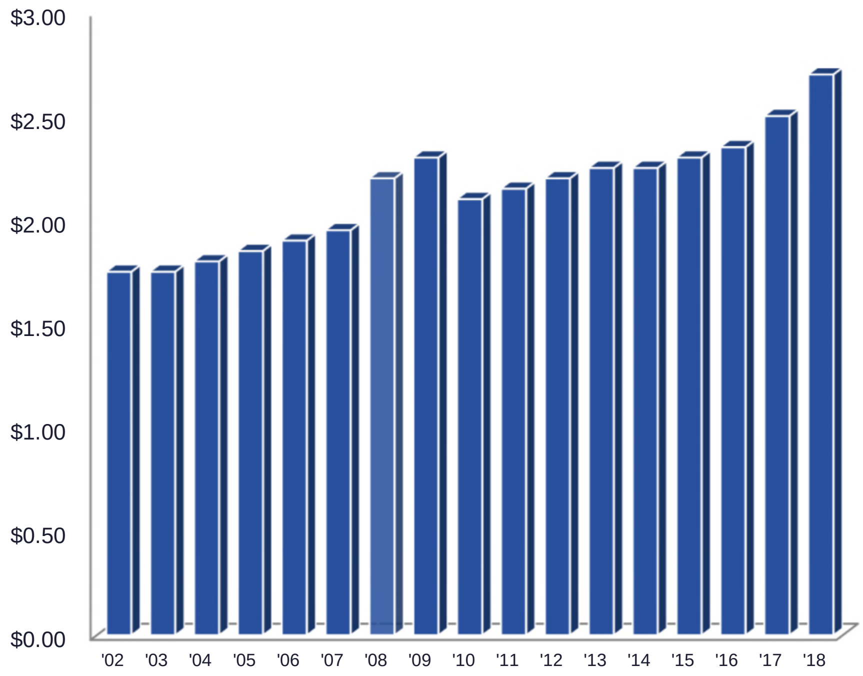
- / Minimum percentage of LIHTC units (20/50, 40/60/ 25/60 or average income*)
- / Minimum 30-year affordability commitment
- / Maximum income limited for households renting LIHTC units
- / Maximum rents limited for LIHTC units
- / Projects subject to IRS and state regulation/compliance

* The consolidated appropriations act of 2018 permanently established the average income set-aside as an additional minimum set aside (more to follow)

State Allocation Volume Limit

Credits are limited

- In 2000, Congress raised cap from $1.25 to $1.50 in 2001, $1.75 in 2002, and thereafter adjusted for inflation
- In 2008, Congress raised cap from $2.00 to $2.20 (2008/2009 only)
- The consolidated appropriations act of 2018 temporarily increased the allocation authority for the 9% credit by 12.5% for four (4) years, beginning in 2018
- $2.75 per person for 2023
- The small state minimum will jump to $3,185,000



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Volume Limit Rules

Example:

The private activity bond (PAB) multiplier will increase to $120 and the small-state minimum for PAB cap will be $358,845,000

- Allocated amount is for one year of credit
- 10% nonprofit set-aside

Qualified Allocation Plans

- State must adopt QAP to allocate credits
- Must set forth allocation priorities
- Must give preference to:
  - Lowest income tenants
  - Longest period of low-income use
  - QCT projects contributing to a concerted revitalization plan
- Must take into account energy efficiency and historic nature of projects
- Must provide procedure for notifying IRS of non-compliance
- Bond-financed projects must "satisfy" QAP

Project Evaluation

Credit may not exceed amount state agency determines is necessary for feasibility and viability

Agency must consider:

- Sources and uses
- Amounts expected to be generated by tax benefits
- Reasonableness of development and operating costs

Evaluation occurs at the time of application, allocation and placement in service

Compliance Monitoring

/ State credit agencies and investor/syndicator monitor projects

/ Check QAP for specific requirements

/ Owners' recordkeeping requirements:

- Number of low-income and total units
- Income certifications and annual re-certifications (in some cases, other than for 100% low-income) and backup verifications
- Qualified basis and eligible basis amounts
- Rent amounts

/ Owner annual compliance certifications

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Applicable Percentage

4% credit vs. 9% credit – which percentage applies?

9% credit

Applies for new construction or substantial rehabilitation of properties not financed with tax exempt bonds

4% credit

Applies to the acquisition of an existing building (acquisition credits) and all new construction/substantial rehabilitation of properties financed with tax exempt bonds

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Industry Participants

/ Congress
/ IRS/Department of Treasury
/ State Tax Credit Agencies
/ Developers/Owners
/ Property Managers
/ Syndicators/Investors
/ GSEs
/ Nonprofits
/ State/Local Governments
/ HUD
/ Tenants
/ Tax Professionals

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Tax Credit Development Timeline

April 2023	Read state QAP. Analyze prior winners, meet with staff
April 2023	April 2023 pick site, plan type of project
May 2023	Develop cash pro formas and construction budget. Investigate loan availability and interest rates; request market study
August 2023	Option land (with conditions regarding zoning, approvals)
August 2023	Apply for soft loans/grants, if necessary
October 2023	Receive soft loan commitment
January 2024	Apply for tax credits
March 2024	Receive reservation of tax credits (2024 tax credits)

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Tax Credit Development Timeline

March 2024	Work on site plan/zoning approvals; submit loan applications
June 2024	Obtain site plan and zoning approvals
June 2024	Purchase land; select equity investor and execute commitment letter for debt/equity
December 2024	Obtain carryover allocation (for 2024 credits)
January 2025	Close on equity investment and construction loan; begin construction
December 2025	*Submit cost certification of 10% of reasonably expected basis for carryover allocation* (state deadlines vary but 1 year under federal rule)

Tax Credit Development Timeline

October 2026	Place all buildings in service (required by 12/31/26)
November 2026	Finish construction; begin leasing
January 2027	Start first year of credit period; continue leasing; submit cost certification for forms 8609
April 2027	Achieve full lease-up and beginning of break-even period
August 2027	Close permanent loan, obtain IRS forms 8609 and achieve final equity contribution

Federal Placement in Service Deadline

General rule:

A project must generally be placed in service in the year that the housing tax credit is allocated by the state tax credit agency

Carryover exception:

A project that receives a valid carryover allocation may be placed in service no later than the end of the second calendar year after the year that a carryover allocation is made

To obtain such an extension, a project must receive a valid carryover allocation agreement and satisfy the “10% test” in a timely manner

Defining “Reasonably Expected Basis” for 10% Test Purposes

- “Reasonably expected basis” means the adjusted basis of land and depreciable property (whether or not it is included in eligible basis)
- Eligible costs include building/construction costs, related personal property and land costs
- Ineligible costs include permanent loan fees, reserves, syndication fees, partnership organizational costs and tax credit fees
- States may impose stricter standards as long as the terms do not violate the federal credit rules
- 10% test is a “cliff” test

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Understanding
Tax Credit Investments

Common Investment Structures

1 – **Direct Investment**
Investment directly into the project partnership which is the owner of the housing development

2 – **Propriety Investment**
Investment through a fund managed by a syndicator without other investors for a particular housing development

3 – **Multi-investor Investment**
Investment through a fund managed by a syndicator with other investors for a particular housing development

4 – **Secondary Investment**
Purchased during the 10-year credit period from original investor

5 – **Guaranteed Investment**
Certain sponsors may guarantee a specific yield and/or against specific investment risks

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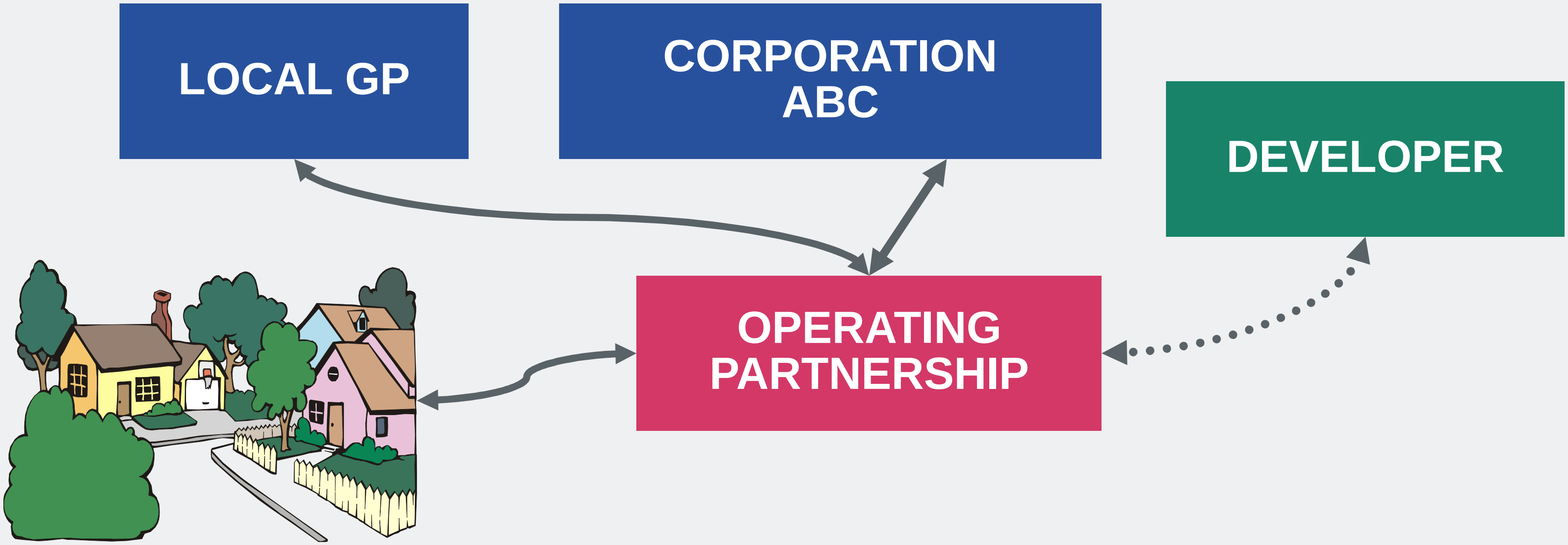
Direct Investment Structure



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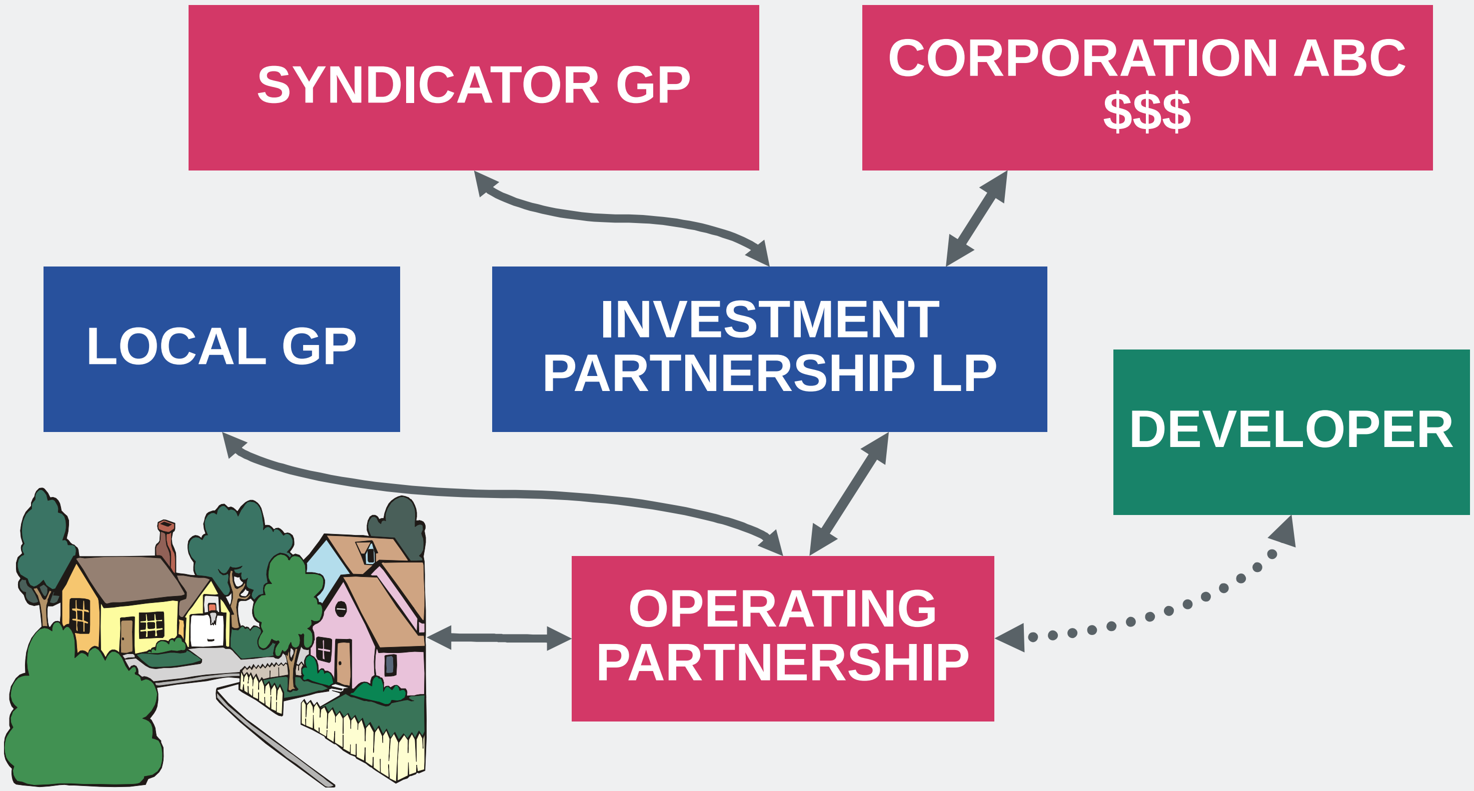
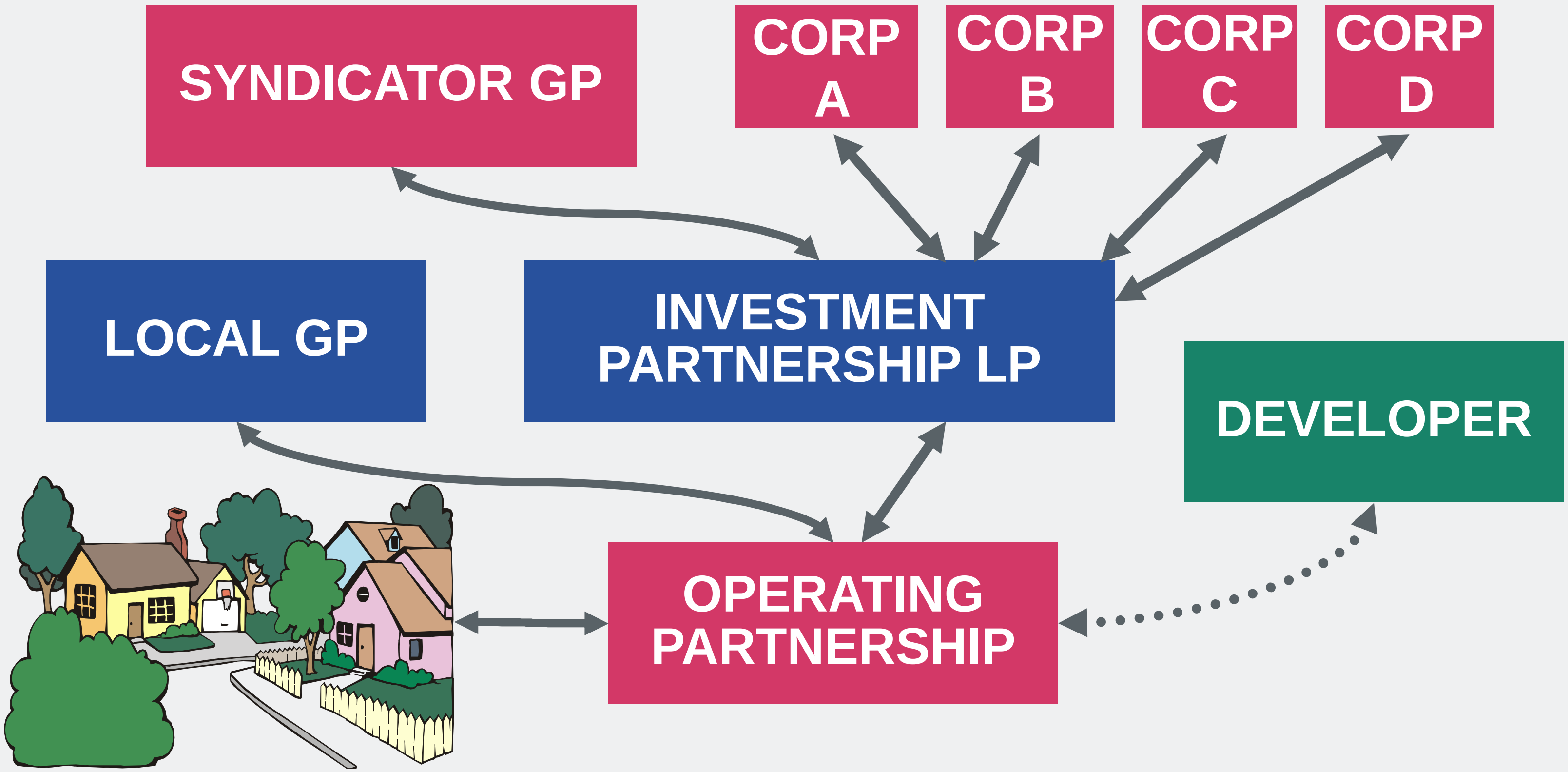
Syndication Structure



Syndication Structure – Multi-investor



Key Business Terms and Investor Risks/ Protections

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Major Investment Risks

Overview

Tax

Recapture of a portion of previously-allocated credits and future credits for projects that do not comply with income, rent and other project restrictions during the initial fifteen-year compliance period

Operational

Loss of property through foreclosure would result in similar recapture and loss of future credits

Construction & lease-up

Units must be completed and rented to qualifying tenants to receive credits

Sponsor risk

Weak or overextended sponsor

Key Business Terms

/ Projects owned by Limited Partnership or Limited Liability Company

/ Limited Partner typically receives 99.99% of tax credits, depreciation, losses and profits

/ Limited Partner makes capital contributions in multiple installments (generally 4 or 5), based on negotiated development, financing and performance benchmarks

/ General Partner guarantees completion/stabilization, amount and timing of credits, and funding of deficits

/ Investor protections (removal/repurchase/adjusters)

Structuring Tax Credit Investments

- Tax Credit Adjusters
  - Eligible Basis Adjuster
  - Timing Adjuster
  - Compliance Adjuster
- Construction Completion/Stabilization Guaranty
- Operating Deficit Funding Guaranty
- Removal of General Partner/ Admission of Additional General Partner
- Removal of Management Agent
- Reporting Requirements/ Removal of Accountants
- Repurchase of Investor Interest
- Removal of General Contractor
- Operating/Replacement Reserves
- Personal Guarantees

Calculating Credits

CALCULATING CREDITS

Who Can Use Credits?

- C corporations can use credits and losses against ordinary income and taxes
- Limitations on “closely-held” corporations
- Credit may be used to offset alternative minimum tax (effective for buildings placed in service after 2007 and rehabilitation expenditures incurred after 2007)
- One year carry back; twenty-year carry forward

Credit Overview

- Annual credit amount = applicable percentage X qualified basis
- Annual credit amount available 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 taxable year
- First year credit reduced to reflect qualified occupancy during first credit year

Understanding the 4% and 9% Credits

Qualifying for the 4% credit

/ Acquisition of building

/ Tax-exempt bond financing

Qualifying for the 9% credit

/ New construction/rehabilitation if building is not “federally subsidized” (which now means financed by tax-exempt bonds)

/ “Below market federal loans” no longer disqualify building from 9% credit

Basis Calculations

“Start with eligible basis, then qualified basis”

Eligible Basis

General rules

- New construction = adjusted basis (generally, development cost less land)
- Acquisition = acquisition cost of building
- Substantial rehabilitation = capitalized rehabilitation expenditures (24-month rule)
- Must subtract federal grants
- Excludes commercial space but includes common areas
- 130% increase in qualified census tracts (“QCTS”) and difficult development areas (“DDAS”), and areas specially designated by credit agencies

Eligible Basis

Depreciable basis of residential rental housing eligible for tax credits includes:

- Impact fees
- Onsite roads, sidewalks and parking lots
- Cost of utility hookup
- Landscaping if adjacent to building
- Final grading of building site
- Common area
- Full-time manager’s unit
- Community space (with some limitations)

Eligible Basis

Common areas

- Eligible basis includes cost of common areas and tenant facilities to the extent such facilities are made available to all residents without additional charge
- Common areas include community rooms, garages, laundry rooms and pools/playgrounds
- Common areas/tenant facilities must be used “exclusively” by tenants of the tax credit property
- Community service facility exception: cost of construction of “community service facility” may be included in eligible basis even if non-residents use the facility

Eligible Basis

Manager units

- Eligible basis includes cost of constructing units occupied by a full-time resident manager/on-site maintenance personnel
- Manager units are excluded from the applicable fraction when determining a building's qualified basis

Eligible Basis

Mixed use buildings

/ Mixed use buildings may qualify for tax credits but the eligible basis must be reduced by the cost of any non-residential rental property

/ Cost of common areas allocated between residential and non-residential use according to any "reasonable method" that properly reflects the proportional benefits to be derived by the residential/non-residential property

/ Common approach: allocating cost of common elements based on relative square footage of residential/commercial property

Understanding the 130% Basis Boost

- Qualified Census Tracts (QCT)
- Difficult Development Areas (DDA)
- A State-Designated Difficult Development Area
  - 2008 Housing Act
  - Not applicable to bond-financed properties
  - If needed to make building financially feasible
- Applies to new construction/rehabilitation expenditures
- Projects that are in a QCT and DDA at the time of their tax credit application, but are no longer in subsequent years, may still qualify

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Qualified Basis

Qualified basis = eligible basis X applicable fraction

Applicable fraction is the lower of:

- Number of occupied low-income units divided by the total number of residential units, or
- Floor space fraction

Calculated building by building

Applicable Percentage

With qualified basis defined, now define applicable percentage

Two credit rates:

- 9% credit = “not less than 9.00%”
- 4% credit
  - Bonds issued or PIS prior to 1/1/2021 – floating rate
  - Bonds issued and PIS after 12/31/2020 – “not less than 4%”
  - IRS recently issued guidance allowing deals with a portion of bonds issued prior to 2021 to qualify for the 4% fixed rate if the PIS is after 12/31/2020 and a de minimis (at least 10%) of bonds were issued in 2021

Owner elects to set applicable percentage either (i) when receiving a binding commitment from the state (or when tax-exempt bonds are issued), or (ii) when building is placed in service

Example of Tax Credit Calculation

- 100 unit project/70 low-income units
- Total development costs (including land) = $5,500,000
- Land cost = $500,000
- Eligible basis = $5,000,000
- Qualified basis = $3,500,000 ($5,000,000 X 70%)
- Applicable percentage = 9.00%
- Annual credit = $315,000 ($3,500,000 X 9.00%)
- 10-year credits = $3,150,000

Equity Calculation

- Pricing typically based on total credits available to investor (and timing of delivery) and market conditions
- Expressed as “cents per tax credit dollar”
- In above example, if investor will pay $0.98 per tax credit dollar, equity = $3,086,691 ($3,150,000 X 99.99% x 0.98)
- Equity generally paid in several installments (often 4 or 5 installments) based upon negotiated benchmarks
- If bond-financed 4% deal, equity = $1,371,863 ($5,500,000 - $500,000) X 70% X 4.00% x 10 x 99.99% x 0.98) [$1,121,498 at old 3.27% rate]

Understanding the Affordability Commitment

- 30-year affordability commitment
  - 15-year tax credit compliance period
  - 15-year extended use period
- Extended use agreements
- Early termination of 30-year affordability commitment
  - 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 credits
- State to find buyer if requested by owner after 14th year pursuant to qualified contract
- 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 transition period)
- IRS issued proposed regulations in June 2007; comments received and under review; public hearing held; final regulations not yet available

Understanding Income & Rent Restrictions

Income Restrictions

Minimum set-aside election of:

/ 20% of units at 50% of area median income ("AMI");

/ 40% of units at 60% of AMI; or

/ New alternative – "average income"

Election upon placement in service

Must meet minimum set-aside by end of first credit year

HUD publishes area income figures annually

Implementing the Average Income Set-Aside

- IRS issued guidance in late 2020 that was viewed as more restrictive than necessary: only a very small number of units leased to higher-income tenants could have threatened the tax credits for the entire development; and the regs prohibited the change in designation of the units once made
- Additional guidance came from the IRS in October of 2022
- Discarded this so-called “cliff test” and limited the impact of one unit’s noncompliance on the ability of a project to satisfy the average-income test – if at least 40% of the units collectively average 60% AMI
- Allows for unit redesignation, simplifies compliance and reporting

Rent Restrictions

/ Rent (including utilities) cannot exceed 30% of qualifying income for assumed family size; based on bedrooms per unit

/ 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 rental subsidies)

/ Gross rent must include utility allowance for tenant-paid utilities (i.e., deduct from rent to owner)

Acquisition/Rehabilitation of Existing Properties

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4% Credit for Acquisition

/ Based on the acquisition cost of an existing building

/ Purchase from an unrelated party (50% related party rule)

/ Ten-year rule

/ Certain placements in service ignored

- Carryover basis
- Acquired from decedent
- Placement in service by governmental unit or nonprofit 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)

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Substantial Rehabilitation Requirement

To be eligible for acquisition credit, must fulfill substantial rehabilitation requirement

- 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
- Separate new building
- 4% (tax-exempt bond financed) or 9% credit on the expenditures

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Recapture of Tax Credits

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Recapture

Recapture on non-compliance:

- / Accelerated portion of credit recaptured (1/3 of credit first 10 years, decreasing through year 15)
- / If minimum set-aside fails, all accelerated credits recaptured
- / Otherwise, unit-by-unit (extent of decrease in qualified basis)

Full recapture on transfer of project or interest therein

- / De minimis (1/3 ownership) exception

Calculating Recapture Cost

- Recapture tax (up to 1/3 of credits previously claimed)
- Additional interest charge
- No right to receive future tax credits

Avoiding Recapture:

- 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
- The result is that outstanding bonds may be retired if the taxpayer elects application of these provisions
- Revenue procedure 2008-60

Section 42 Provisions Relating to Qualified Nonprofit Organizations

Nonprofit Set-Aside

- Each state tax credit agency must set aside at least 10% of its annual credit ceiling each year for projects involving qualified nonprofit organizations
- Many states provide preferences for nonprofit sponsored projects by assigning “points” to projects with nonprofit involvement
- Whenever there is nonprofit involvement, need to determine whether the tax credit agency actually awarded credits from the nonprofit set-aside

- Nonprofit organization must be exempt from federal income tax under section 501(c)(3) or 501(c)(4) of the IRC
- One of the organization’s exempt purposes must include the fostering of low-income housing
- Nonprofit cannot be “affiliated with or controlled by” a for-profit organization
- Nonprofit must own an interest in the project (directly or indirectly)
- Nonprofit must materially participate in the development and operation of the project throughout the compliance period

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Right of First Refusal

- Added to IRC section 42 in 1990 to facilitate nonprofit ownership of tax credit properties at the end of the 15-year compliance period
- Eligible holders and minimum purchase price are specifically set forth in IRC section 42(i)(7)
- There have been conflicting court rulings as to whether a ROFR is triggered in certain circumstances
- Federal legislation has been proposed to change the statute to ensure a nonprofit general partner has a below-market option to purchase property rather than a ROFR

Why Invest in Affordable Housing Tax Credits?

Tax Benefits

- Predictable 10-Year Credit Stream Based on the Cost of Constructing or Rehabilitating Residential Rental Housing
- Depreciation Losses

Economic Benefits

- Cash Flow and Sale/Refinancing Sharing (But Not Generally Underwritten)
- Asset Management Fee Revenue

Social Benefits

- Community Reinvestment Act (“CRA”) Qualification
- Shareholder Relations
- Social Responsibility
- Some Projects May Qualify as Green Investments

Geographic Flexibility

- Can Provide Geographic Diversification
- Can Target for Local Priorities and Visibility

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Thank you!

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