LOW-INCOME HOUSING TAX CREDIT CLOSINGS FOR PHAs AND RAD TRANSACTIONS

June 2015

What Do Tax Credits Finance?

- New construction and rehab projects
- Acquisition in some cases
- Housing for families, special needs tenants, single room occupancy and the elderly
- Urban, rural and suburban locations
- Additional tax incentives for projects in high-cost or difficult-to-develop areas

How Do Housing Tax Credits Work?

- Rental units with tenants earning no more than 60% of area median income
- Investors earn dollar-for-dollar credits against their federal tax liability
- Investors also get tax benefits from losses
- Generally, tax credits are received over the first 10 years of operation
- Some tax credits are recaptured by the IRS if the project does not comply for 15 years

Unit Restrictions

- **Threshold Elections – Who can live there?**

  40/60 election

  20/50 election

  All tax credit units must be within election parameters

- **Rent Restricted – How much can tenants pay?**

  Rents and utilities – limited to 30% of threshold income

  Allowable rent based on size of unit

	No Tax Credit/ No Deduction	Deduction	Tax Credit
Net Income from Operations	1,000,000	1,000,000	1,000,000
Tax Deductions	none	(300,000)	none
Taxable Income	1,000,000	700,000	1,000,000
Tax Liability: **Tax at 40% tax rate**	**$ 400,000**	**280,000**	400,000
Low-Income Housing Tax Credits	none	none	**(300,000)**
Net Tax Liability	**$ 400,000**	**$ 280,000**	**$ 100,000**

Structure –
Tax Credit Syndication

Limited partnership structure

- General partner owns just 0.01%,
  but controls and operates the project

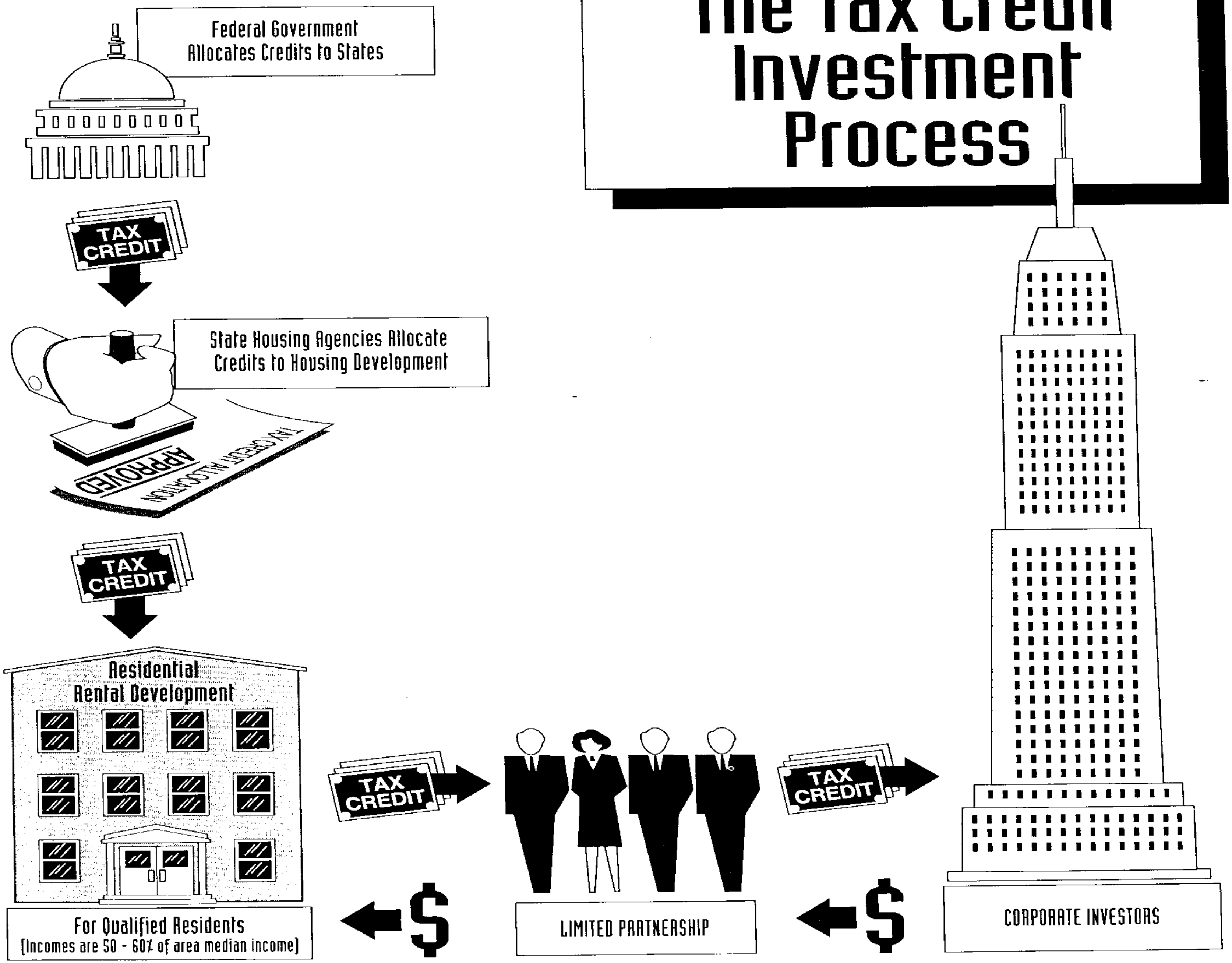
- Passive limited partner invests equity
  in return for 99.99% ownership

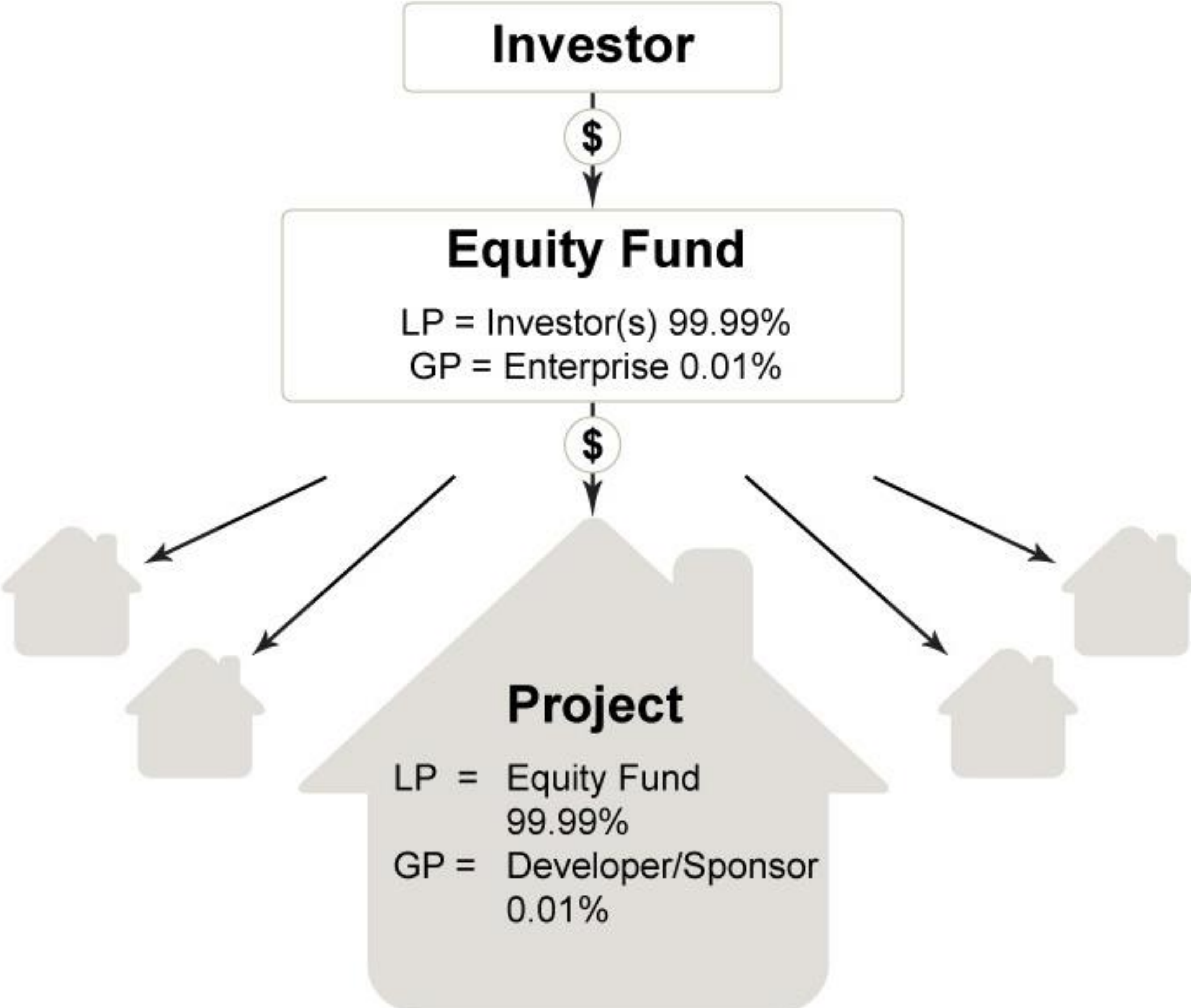
- Sale to Investor Limited Partner of most of the tax credits and tax losses maximizes investor equity

- More investor equity reduces other financing needs and helps project development

- L.P. is a passive investor, and gets its return almost exclusively from the tax credits and losses

The Tax Credit Investment Process




Investor
$
Equity Fund
LP = Investor(s) 99.99%
GP = Enterprise 0.01%
$
Project
LP = Equity Fund 99.99%
GP = Developer/Sponsor 0.01%

The Parties in a Tax Credit Syndication

- **Development Team**
  - Developer
  - General contractor
  - Architect
  - Attorney
  - Accountant
  - Property manager
  - Consultants

- **Lenders**
  - Construction lender
  - Permanent lenders
  - Lender attorneys

- **State Housing Finance Agency**

- **Syndicator**
  - Underwriter
  - Fund manager
  - Attorney

Computing Tax Credits: Basis

Eligible Basis

X

Applicable Fraction

X

Basis Boost (if applicable)

=

Qualified Basis

Computing Tax Credits: Annual Tax Credits

Qualified Basis

X

Tax Credit Rate

=

Annual Tax Credits

Computing Tax Credits: Total Tax Credits

Annual Tax Credits

X

10 (Years)

=

Total Tax Credits

Computing Tax Credit Equity

Total Tax Credits

X

Pay Price (Cents per dollar)

=

Equity

Computing Basis to Calculate Credits

- **Eligible Basis** - Depreciable basis of residential rental housing eligible for tax credits

- **Qualified Basis** - Adjust Eligible Basis for non-income qualified tenants, using "**Applicable Fraction**" (the % of units qualifying for credits)

Applicable Fraction

Lesser of:

- The number of qualifying rent-paying residential units over the total number of rent-paying residential units

  or

- The square footage of qualifying rent-paying residential units over the total square footage of rent-paying residential units

- **Basis Boost** – Increase tax credit basis by 30% if project is in
  - a "qualified census tract" (QCT)
  - a "difficult to develop area" (DDA) or
  - A state designated difficult development area
    - Does not apply to tax-exempt financed projects
    - Applies if building or project is placed in service after 07/30/08

Eligible Basis – Excludes the following:

- land and land-related costs
- building acquisition and related costs
- historic tax credits taken on residential part of project
- fees and costs related to permanent loan financing
- syndication-related costs
- tax credit fees
- reserves
- post-construction working capital
- federal grants
- non-residential costs

- Includes
  - Impact Fees
  - Onsite Roads, sidewalks and parking lots
    - Offsite if adjacent, functionally related and owner maintained
  - Cost of Utility Hookup
  - Landscaping if adjacent to building
  - Final grading of building site

- Excludes:
  - Initial grading
  - Landscaping not adjacent to building

- Includes:
  - Common area
  - Full time manager's unit
  - Community space

Computing Annual Tax Credits

• Total Development Budget	$9,632,000
• Less ineligible costs	1,062,500
• Eligible Basis	$8,569,500
• Applicable Fraction	x100%
• QCT/DDA Basis Boost	x 130%
• Qualified Basis	$11,140,350

Computing Annual Tax Credits: 9% Credit

- Qualified Basis $11,140,350
- Applicable Rate*** x 9.00%
- Annual Tax Credits $ 1,002,631

***Published rate would apply if PIS before 07/31/08 or after 2013.

Computing Total Tax Credits and the Equity Raise: 9% Credits

• Annual Tax Credits	$ 1,002,631
• 10 Years	x 10 years
• Total Tax Credits	$ 10,026,310
• Price Paid	x $0.80
• Equity	$ 8,021,048

Equity represents 83% of development costs

Computing Annual Tax Credits: 4% Credit

Qualified Basis	\$11,140,350
Applicable Rate (Nov. 2011)	3.19%
Annual Tax Credits	\$355,377

Annual Tax Credits	$	355,377
10 Years		x 10 years
Total Tax Credits	$	3,553,770
Price Paid		x $0.80
Equity	$	2,843,016

Equity represents 30% of total development costs

Structuring the Project

- Step 1: Estimate tax credit basis
- Step 2: Estimate tax credits generated
- Step 3: Estimate investor equity
- Step 4: Estimate first mortgage amount
- Step 5: Estimate the funding gap
- Step 6: Fill the gap with a combination of other funds

Sources of Funding to Fill the Gap

- HOME, CDBG funds
- AHP Funds
- ARRA Funds – TCAP and Exchange
- Other Local Funds
- Deferred Development Fee
- Cost Savings (development or acquisition)
- Modification of First Mortgage Terms
- Income or Expense Modifications

Tax Credit Timeline

- Apply for tax credits
- Get a tax credit reservation
- Receive carryover allocation
- Incur more than 10% by required date
- Complete project and place it in service
- Apply for 8609s for all buildings
- Record extended use agreement
- Rent tax credit units to qualified tenants
- Elect when to start tax credits
- Keep tax credit units in compliance

Placing a Project in Service

- Project must be "**placed in service**" by the end of the second year following the Allocation Year

Example:

- Credits allocated in 2010
- Carryover met in 2011
- All buildings in project must be placed in service by December 31, 2012

Placing a Project in Service

- New Construction
  - When first unit is ready
  - Certificate of Occupancy
- Rehabilitation – more flexibility
  - No earlier than the date when the rehab equals the greater of:
    - $6,000 per unit or
    - 20% of acquisition price
  - Lower amount of rehab required if placed in service prior to 07/31/08

Financial Structuring:
Kinds of Debt and Grants

"Hard" Debt:

- Must pay, conventional bank debt
- Generally amortizing

"Soft" Debt:

- Generally from governmental agencies
- Cash flow contingent or accruing
- Repayable

Grants: not repayable

Grants

- Grants – funds that are not repayable or cannot be repayable under reasonable assumptions
  - Outright grants
  - Forgivable loans
  - Cannot be repaid at maturity
- Tax treatment
  - Income recognition
  - Potential basis reduction if federal funds

- Development Grants – funds that are used directly or indirectly to fund development costs
  - Basis must be reduced
  - Could flow through GP as a loan
    - At the AFR, if 9% deal PIS prior to 07/31/08
    - Lower rate allowed if after 07/31/08
    - Caution – reallocation and residual test issues

- Operating Grants – funds that support the operations of the project
  - Building PIS after 07/30/08:
    - No basis reduction
    - Income must be recognized
  - Building PIS before 07/31/08:
    - Reduction of eligible basis
    - Income must be recognized
    - Exceptions for Sec. 8, Sec. 9, Shelter plus care

Special Situations

- Historic Tax Credits
  - Add value to a deal, but rigid procedures and approvals are involved.
  - Eligible basis for LIHTC reduced by the amount of the historic credit
- Energy Credits and Green Subsidies
  - Credits for energy efficient appliances, solar energy property and other environmentally beneficial enhancements to project
- Special needs deals have structuring issues related to the length and strength of subsidies

The Syndicator's Approach To Underwriting

- Quality of the Development Team
- Project Characteristics
- Evaluation of the Development Budget
- Rents/ Market/ Marketability
- Operating Costs
- Reserves
- Sponsor Guarantees

Concerns Being Evaluated

- Reputations of the developer, general contractor and other members of the team
- Design considerations of the project
- Quality of materials to be used
- Timelines for construction and lease-up
- Useful life analysis – will it continue to attract tenants as it ages?
- Market analysis – are rents supported by outside analysis?

Quality of the Development Team

- Sponsor/ general partner experience
- Architect/ engineer – design, supervision
- General contractor – size and type of construction, capacity to produce on time
- Attorney and Accountant – experience with tax credit partnership structure and issues – and Mixed Finance/RAD
- Property manager – experience with low-income tenants and management capability
- Consultants to fill in holes in experience

Evaluation of Project Characteristics

- **Need** - does it answer a real need in the community?
- **Finances** - does it meet the syndicator's financial threshold?
- **Quality** - will it continue to attract tenants?
- **Strategic Interest** - does it meet the syndicator's programmatic needs?
- **Geography** - is it located where syndicator and its investors want to invest?

Evaluation of Development Budget

- **Can the project be completed in the time and within budget**
  - What will it cost to build the project?
  - How much is needed to place it in service?
  - What are reasonable timelines?

- **What are the key risk areas to lenders and equity investors and how can the risks be ameliorated?**

Rents/Market/Marketability

- Are rents realistic for the market area?
- What is demand for proposed housing?
  - neighborhood
  - what demographics will project address
- Are tax credit rents sufficiently below area market rents – less of a concern if there is operating subsidy?
- What if subsidy is eliminated?
- Are other funding requirements factored in?

Site Assessment Criteria

- Access to employment and transportation
  - Proximity to downtown or employers
  - Transit
  - Ability to support parking
- Proximity to services and amenities
  - Retail, parks, etc.
- School district quality and proximity to neighborhood schools
- Curb appeal of immediately surrounding uses

Evaluation of Operating Costs

- Examine assumptions for proposed costs
- Are insurance, etc. costs confirmed by bid?
- Are repair and maintenance costs consistent with housing type and family size?
- If there's an elevator, are its costs included?
- Are legal, accounting and administrative costs high enough?
- Are reserves funded in a plausible way?
- Do costs need to be restructured for cash flow?

Structuring Project Reserves

- Reserves are a way to structure for the project’s risks
- Operating and lease-up reserves protect against inadequate cash flow
- Replacement reserves provide funds for capital replacement when needed
- Other reserves (for tenant services, etc.) are structured for specific needs or risks0

Sources of Funds for Reserves

- Operating reserves usually come from investor equity, but may come from cash flow
- Operating reserves are paid in over time to optimize the use of equity
- Replacement reserves usually are funded from cash flow, but may come from equity
- Some projects need replacements reserves earlier than cash flow permits, requiring equity
- Special-needs housing may not have cash flow for reserves, which may be funded from equity

Sponsor Guarantees

- Allocate costs related to specific risks to the developer and related parties
- Areas where guarantees apply may include:
  - development cost overruns
  - delays in construction completion and lease-up
  - operating deficits until stable operations
  - reduced or delayed tax benefits
  - partnership management

Due Diligence/Closing Items

- Development Team, Guarantor and Contractor Financials
- Identification of Development Team Responsibilities and Development Agreement Draft
- Operating Agreement Draft
- Tax Credit Approval
- ALTA Survey
- Environmental
  - Phase 1 and 2(if necessary)
  - Lead, Asbestos and other building testing
- Geotech and Wetlands
- Title
- Property Management Plan
- P&P Bonds

Long Lead Time Items

- Identification of Guarantors
  - Construction
  - Operating Deficit
- Bidding
- Plan and Cost Review
- Phase 2 and DEQ Approval if Contamination is Present
- Zoning
- Subdivision
- Title
- Tax Credit Approval
- Bond Commission Approval if 4%
- HUD Evidentiary Submission and Approval