

## **TAX CREDIT OVERVIEW**

- The credit is a 10 year tax incentive to encourage the development of residential rental housing at or below 60% of area median income
- Credits are awarded to a developer (general partner) based on the cost of construction. The credits are then sold or “syndicated” to an investor limited partner (typically CRA-driven banks, large corporations or an equity fund).
- The equity generated from the sale of the credits can fund approximately 70%\* of the total development costs of the project. The reduced funding gap allows the project to carry a smaller mortgage; therefore, the project can charge lower more affordable rents.
- There are 2 types of tax credits:
  - 9% credits are available to projects with conventional/taxable financing. NJ’s authority for 9% credits is based on \$2.20 per capita
  - Projects that receive tax exempt bond financing are limited to a 4% credit. The availability of 4% credits is based on the availability of bond financing from volume cap.

## **HMFA’S ROLE**

- HMFA is the housing credit agency responsible for administration of the federal Low Income Housing Tax Credit Program in NJ
- HMFA allocates over ± \$19 million in 9% credits annually, which generates over \$170 million in equity for the development of affordable housing in the State.
- With demand for 9% credits exceeding supply by approx 4:1, HMFA has instituted a competitive awards process in its Qualified Allocation Plan (QAP Application). Rounds are typically held in spring of each year.
- HMFA is also charged with monitoring the long-term compliance of these projects within Section 42 of the Internal Revenue Code. There are over 500 projects Statewide that contain over 30,000 tax credit units affordable residential in HMFA’s tax credit portfolio.

\* Based upon the present value of tax credit stream and the current value of tax credits.

## LOW INCOME HOUSING TAX CREDIT (LIHTC) BASICS

The LIHTC Program is an indirect Federal subsidy used to finance the development of affordable rental housing for low-income households. The LIHTC Program may seem complicated, but many local housing authority and community development agencies are effectively using these tax credits to increase the supply of affordable housing in their communities. This topic outline is designed to provide a basic introduction to the LIHTC Program.

### HOW DO HOUSING TAX CREDITS WORK?

The LIHTC Program, which is based on Section 42 of the Internal Revenue Code, was enacted by Congress in 1986 to provide the private market with an incentive to invest in affordable rental housing. Federal housing tax credits are awarded to developers of qualified projects. Developers then sell these credits to investors to raise capital (or equity) for their projects, which reduces the debt that the developer would otherwise have to borrow. Because the debt is lower, a tax credit property can in turn offer lower, more affordable rents.

Provided the property maintains compliance with the program requirements, investors receive dollar-for-dollar credit against their Federal tax liability each year over a period of 10 years. The amount of the annual credit is based on the amount invested in the affordable housing. Before we go on, let's take a look at the difference between tax credits and tax deductions:

<b>Credits:</b> Tax Credits are subtracted directly from one's tax liability. Credits reduce tax liability dollar-for-dollar.	<b>Deductions:</b> Tax deductions are subtracted from a taxpayer's total income to compute his or her tax base. Deductions reduce tax liability by the amount of the deductions times the tax rate.
For example: A \$1,000 credit in a 15% tax bracket reduces tax liability by \$1,000.	For example: A \$1,000 deduction in the 15% tax bracket reduces taxable income by \$1,000, thereby reducing tax liability by \$150.

## **ALLOCATING HOUSING TAX CREDITS**

Each year, the IRS allocates housing tax credits to designated state agencies – typically state housing finance agencies – which in turn award the credits to developers of qualified projects. Each state is limited to a total annual housing tax credit allocation per resident, with only the first year of the 10 years of tax credits counting against the allocation. This limit is adjusted for inflation.

States allocate housing tax credits through a competitive process. Federal law requires that the allocation plan give priority to projects that (a) serve the lowest income families; and (b) are structured to remain affordable for the longest period of time. Federal law also requires that 10 percent of each state’s annual housing tax credit allocation be set aside for projects owned by non-profit organizations. For additional information, contact your state tax credit allocating agency for a copy of its Qualified Allocation Plan (QAP).

A State has two years to award housing tax credits to projects. Tax credits not awarded in a year may be carried forward to the next year. If a state is unable to use its tax credits over a two-year period, they are returned to a national pool for re-allocation. If a state awards tax credits to a project that is not completed and the tax credits are returned, the state has an additional two years to award the tax credits to another project within that state.

## **ELIGIBILITY**

To be eligible for consideration under the LIHTC Program, a proposed project must:

- Be a residential rental property
- Commit to one of two possible low income occupancy threshold requirements
- Restrict rents, including utility charges, in low income units
- Operate under the rents and income restrictions for 30 years or longer, pursuant to written agreements with the agency issuing the tax credits

## **Residential Rental Property**

Typical rental properties that are eligible under the federal Home Investment Partnerships program (HOME) administered by HUD will also be eligible under LIHTC. However, the LIHTC Program is not as flexible as the HOME program concerning service-enriched housing, or concerning group homes and transitional housing.

The LIHTC Program requires that rehab be performed, if the developer is acquiring an existing building. Tax Credits may be earned on the acquisition of an existing development provided the owner meets the 10-year previous ownership rule. This rule states that the property to be acquired must not have changed ownership and been placed in service during a 10-year period prior to acquisition. A building that has not been used in ten or more years can claim the acquisition credit even if its ownership has changed, given that it has not been placed in service during that period. The 10 year rule does not apply to projects that are substantially assisted, financed or operated by HUD.

## OCCUPANCY THRESHOLD REQUIREMENTS

Projects eligible for housing tax credits must meet low-income occupancy threshold requirements. Project owners may elect one of the following two thresholds:

- 20-50 Rule: At least 20 percent of the units must be rent restricted and occupied by households with incomes at or below 50 percent of the HUD-determined area median income (adjusted for household size).
- 40-60 Rule: At least 40 percent of the units must be rent restricted and occupied by households with incomes at or below 60 percent of the HUD-determined area median income (adjusted for household size).

The 20-50 Rule is conceptually similar to – although not exactly the same as – a 20 percent Low HOME requirement. Similarly, the 40-60 Rule is comparable to a 40 percent High HOME requirement.

Typically, state QAPs encourage applicants to provide more than the minimum number of affordable units, and to provide greater than the minimum level of affordability. Moreover, credits are available only for the affordable units. As a result, many applications provide for 100 percent of the units to be affordable, and many applications provide for some units to be affordable well below 50 percent of Area Median Income (AMI).

### Rent Limits

The rent for each unit is established so that tenant monthly housing costs, including a utility allowance, do not exceed the applicable LIHTC rent limit. These limits are based on a percentage of AMI, as adjusted by unit size. Of course, rents cannot exceed local market rents.

It is important to note that the LIHTC program restricts only the portion of the rent paid by the tenant, not the total rent. As a result, certain rental assistance programs can be used to raise the total rent above the LIHTC rent limit. For example, project-based Section 8 contract rents can exceed the LIHTC rent limit, but tenant-based Section 8 contract rents cannot.

### Affordability Requirements

The LIHTC Program requires a minimum affordability period of 30 years (i.e., a 15-year compliance period and subsequent 15-year extended use period). Some states require a longer affordability period for all LIHTC properties, and other states may negotiate longer affordability periods on a property-specific basis. Tenant incomes are recertified annually to ensure their continued eligibility. The allocating agency is responsible for monitoring compliance with the provisions during the affordability period and must report the results of monitoring to the IRS.

## SYNDICATION

Developers may claim housing tax credits directly, but most sell the tax credits to raise equity capital for their housing project. The developer can sell the tax credits:

- Directly to an investor, or
- To a syndicator, who assembles a group of investors and acts as their representative.

Tax credits can be claimed annually over a 10-year period by the property owner. However, the developer needs the money immediately to pay for development costs, not 10 percent annually for 10 years. Accordingly, the developer typically syndicates the credits – i.e., sells the rights to future credits in exchange for up-front cash.

The credit purchaser must be part of the property ownership entity; usually, this is accomplished by creating a limited partnership (in which the credit purchaser is a 99%+ limited partner) or a limited liability company (in which the credit purchaser is a 99%+ non-managing member). The general partner is responsible for managing the project and the partnership, which the limited partners are typically limited to a passive investment role. Typically, profits and losses and housing tax credits are shared according to the partners' (members') percentage ownership interest. However, each Limited Partnership Agreement (or LLC Operating Agreement) also provides for a carefully negotiated "waterfall" that describes how any positive cash flow of the property is to be distributed. Typically, the general partner (managing member) receives a large share of any positive cash flow, often structured in the form of fees for services such as partnership management, incentive management or investor services.

Note the following:

- **Limited Partnerships** were the most common ownership structure for multi-family properties in the 1960's and continuing through much of the 1990's. A typical LIHTC limited partnership consists of the developer (or an affiliate) as the general partner, and the credit purchaser as the limited partner. The general partner has a small percentage ownership interest (often below 1 percent), but has the responsibility to manage the affairs of the partnership, arrange for management of the property, and make most of the day-to-day operating decisions. The limited partner has a larger percentage ownership interest (often well above 99 percent), has a passive role, and has liability that is limited to the amount invested. That is, if a disaster occurs, the most the limited partner can lose is the amount invested; however, the general partners can lost many times the amount invested. The rights and obligations of the partners are outlined in a Limited Partnership Agreement. Typically, the limited partners do not participate in day-to-day operating decisions but do participate in major decisions such as decisions to sell or refinance the property.

- **Limited Liability Companies (LLC)** are an increasingly common structure ownership structure for multi-family properties. A typical LIHTC LLC consists of the developer (or an affiliate) as the managing member, and the credit purchaser as an additional (non-managing) member. The managing member has a small percentage ownership interest (often below 1 percent), but has the responsibility to manage the affairs of the partnership, arrange for the management of the property, and make most of the day-to-day operating decisions. The non-managing member has a large percentage ownership interest (often well above 99 percent), and has a passive investor role. All members of an LLC have liability that is limited to the amount invested. That is, if a disaster occurs, the most they can lose is the amount invested. The rights and obligations of the partners are described in an LLC Operating Agreement. Typically, the non-managing members do not participate in day-to-day operating decisions but do participate in major decisions such as decisions to sell or refinance the property.

### **A Closer Look at Syndication**

Syndication is a complex and expensive process. By law, syndicators must offer prospectuses to potential tax credit purchasers, fully disclosing the terms and risks of the investment. Sales of tax credits to multiple investors in the general public are referred to as public placements and have the highest disclosure requirements. Private placements are sales to a few knowledgeable investors. They have lower disclosure requirements and sales costs.

Of course, developers are interested in the highest possible price paid by investors, and the lowest possible syndication costs. Similarly, investors are interested in paying the lowest possible price, at the lowest possible level of risk. Syndicators are interested in earning high fees and potentially future business with the developer and investors. To-be-developed properties are not easy to evaluate. These factors mean that the market for housing tax credits is as complicated and sophisticated as the market for stocks and bonds. It is also quite competitive.