Low Income
Housing Tax Credit Program

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Part 1: Introduction

Overview

- Title 26, United States Code, Section 42 allows one to obtain tax credits against federal income tax obligations
- Credits may be earned for “low income housing units in low income buildings in qualified low income housing projects”
- “Earned credit is taken in each of ten years equal to the appropriate percentage multiplied by the qualified basis applicable to the low income units in each qualified low income building”

Introduction (Cont.)

Created Under the Tax Reform Act of 1986 (TRA86)

- (TRA86) provides incentives for the utilization of private equity in the development of affordable housing aimed at low-income Americans
- LIHTC accounts for the majority - approximately 90 percent - of all affordable rental housing created in the United States today

Introduction (Cont.)

Created Under the Tax Reform Act of 1986 (cont.)

- Tax credits are more attractive than tax deductions as they provide a dollar-for-dollar reduction in a taxpayer's federal income tax.
- The "passive loss rules" and similar tax changes made by TRA86 greatly reduced the value of tax credits and deductions to individual taxpayers. As a result, almost all investors in LIHTC projects are corporations

Introduction (cont.)

LIHTC Characteristics

- Occupancy is tenants with low income
- Gross rent restrictions apply
- State agency sets priority for credits (VHDA)
- Internal Revenue Service certification requirement

Introduction (cont.)

Other Requirements

- Must remain qualified for fifteen years, or subject to recapture
- Restrictions can be extended for additional fifteen years
- Agreement can have an initial thirty-year term, or more

Introduction (cont.)

Tenant Mix & Income Levels

- 20 percent of the residential units must be both rent-restricted and occupied by individuals whose incomes are 50 percent of the median gross income for the area, or

- 40 percent of the residential units must be both rent-restricted and occupied by those whose incomes are 60 percent of the median gross income for the area

Introduction (cont.)

Other Characteristics

- A project may contain both qualified low income units and "market" units
- If no qualified tenant can be found, the affected unit(s) are often kept off the market (vacant)
- Restricted rent is a dollar amount charged for a unit, including a utility allowance, and
- Is dependent on the tenant's income as a percentage of the median gross area income

Introduction (cont.)

IRS Certification

- Annual requirement
- Administrative expenses are always higher than normal apartment developments
- Could be more than 60 items to verify for each low income tenant
- Significant audit requirements

Introduction (cont.)

Program Restrictions

- Recorded in the local land records, said to “run with the land”
- If sold, buyer must adhere to the program restrictions for the agreed period

Introduction (cont.)

Non-Compliance Issues

- Taxpayer subject to recapture of a portion of credit claimed (additional taxes and interest)
- If sale occurs before end of compliance period, seller may be required to post bond in a dollar amount satisfactory to, and for the period required by, the Secretary of the Treasury

Introduction (cont.)

Characteristics of LIHTC Properties

- Are market quality construction
- Legally structured for a target population
- Subsidized by government functions to close financial gaps
- Each development is unique

Introduction (cont.)

Types of Affordable Housing

- Rental
- For Sale
- Lease to Own

List of Current LIHTC Properties in Virginia

http://www.vhda.com/BusinessPartners/MFDevelopers/LIHTCProgram/Pages/TC-Property-Listings-Developer-Info.aspx

900 Development Projects   80,000 Rentable Units

Part II: Historical Perspective

Overview

- Housing Improvement Programs has existed for over 100 years
- Rooted in reform movements and public needs: i.e. food purity, health care, housing, etc.

Historical Perspective (cont.)

Reform Movements

- First laws regulating housing came from New York City (immigrant population growth issues)
- Creation of the Tenement Acts of 1901
- Progressive Movement developed housing prototypes for the urban poor.

Historical Perspective (cont.)

Housing Act of 1933

- Created Federal Housing Administration (FHA)
- Resulted from growing political support for the "deserving poor"
- Addressed poor construction in urban areas, overcrowding, and threat of disease

Historical Perspective (cont.)

New Deal Era (1933-1937)

- National Industrial Recovery Act (1933) used for job creation and helped restore annual housing production
- Housing Act of 1937 authorized local housing authorities (LHAs) to create local tax-exempt funds for public housing (Federally assisted direct capital write downs backed by tax exempt bonds floated by the LHAs)
- Federal Home Loan Bank Board (FHLBB) created to make funds available for residential mortgages & help revive housing industry

Historical Perspective (cont.)

<u>World War II Era (1941-1945)</u>

- Increase in urbanization (shipyards, industrial facilities, raw material processing)
- Strong housing demand caused by minimal residential construction
- Housing starts at depression levels

Historical Perspective (cont.)

Post-War Era (1946-1960)

- Veteran Obligation: Political force of returning veterans drove new residential construction, loan programs and subsidies
- Government Programs: Federal Housing Administration (FHA), Veterans Administration (VA)
- 1949 Housing Act Preamble: “A decent home and suitable living environment for every American family”, resulting in homeownership increase from 44% (1940) to 62% (1960)

Historical Perspective (cont.)

The 1960's Era –Age of Activism

- Civil Rights Act of 1964, addressed racial barriers
- Civil Rights Act of 1968, addressed discrimination in public accommodations and established equal opportunity in housing
- 1968 Housing Act, reaffirmed the 1949 Housing Act, reenergized goal to create affordable housing for lower income families.
- HUD given cabinet level status and given authority for housing programs, urban renewal and public housing (Great Society).

Historical Perspective (cont.)

Great Society

- Jump started housing initiatives with private firm participation, not for profit organizations and quasi-governmental groups, with government assistance.

Historical Perspective (cont.)

1970's Initiatives

- Section 235, interest reduction payments to lender by HUD (Single Family)
- Section 236, interest reduction payments to lender by HUD (Multi Family)
- Section 236 RAP, early form of Section 8 program
- Section 8, assistance for multifamily (new construction, rehabilitation, set-asides, defaults)
- Section 202, for seniors (now called Supportive Housing for Elderly)
- Section 811, for people with disabilities

Historical Perspective (cont.)

<u>Facts about Section 8 Program</u>

- Initiated because of rising inflation that threatened affordable housing viability
- Income subsidies to cover spread of tenant income and fair market rent of unit was project based or tenant based
- Supported Sec 235 and Sec 236 programs by assisting owners with escalating operating cost and spiking energy costs.
- In the end, this major entitlement program became too costly

Historical Perspective (cont.)

<u>Shift away from HUD sponsored initiatives</u>

- Why: Problems with high concentration of residents without addressing social issues, housing agencies not equipped to handle complex management issues, property maintenances, financial corruption
- Solution: Disperse development activities throughout levels of government, and place greater reliance on private firms and non-governmental participants.

Historical Perspective (cont.)

Federal LIHTC Program

- Initiated in 1987 to promote private investment in affordable housing
- Not regulated by HUD, but by IRS
- Main benefit comes from federal tax credits
- Allow investor to receive a direct deduction to income tax obligation
- Credit can be sold to write down costs of development
- Stockholders in development partnership

Historical Perspective (cont.)

State and Local Government Programs

- House finance agencies (HFA) can float tax exempt bonds for housing development
- Local administration of LIHTC projects
- Inclusionary zoning requirements (no NIMBY rule)
- If needed, forms of gap financing with second mortgages that may or may not have to be repaid

Part III: How it Works

Overview

- TRA86 adversely affected investment incentives for rental housing while leaving incentives for home ownership
- Since low-income people are more likely to live in rental housing than in owner occupied housing, this would have decreased the new supply of housing accessible to them
- The Low Income Housing Tax Credit was hastily added to TRA86 to provide some balance and encourage investment in multifamily housing for those in need of affordable rental housing options

How it Works, (cont.)

- Overview (cont.)

- Provides funding for development by allowing an investor (usually the partners of a partnership that owns the housing) to take a federal tax credit
- Development capital is raised by "syndicating" the credit to an investor or, more commonly, a group of investors.
- Developer will typically propose a project to a state agency, seek and win a competitive allocation of tax credits, complete the project, certify its cost, and rent up the project to low income tenants.
- Investors will make a "capital contribution" to the partnership or limited liability company that owns the project in exchange for being "allocated" the entity's LIHTCs over a ten year period.

How it Works, (cont.)

- Overview (cont.)

- The amount of the credit will be based on (i) the amount of credits awarded to the project in the competition, (ii) the actual cost of the project, (iii) the tax credit rate announced by the IRS, and (iv) the percentage of the project's units that are rented to low income tenants.
- Failure to comply with the applicable rules can lead to recapture of credits previously taken, as well as the inability to take future credits.
- The private investors bear the financial burden if properties are not successful.

How it Works, (cont.)

<u>Application Process</u>

- Project owner submits an competitive application to a state authority
- The application will include estimates of the expected cost of the project and a commitment to comply with "set asides"
- No limits on rents charged to tenants who are not low income

How it Works, (cont.)

Program Administration

- Administered by a state housing finance agency
- Allows each state to set its own priorities, address its specific housing goals.
- Encourages developers to offer benefits that are better than the established minimums (e.g., charging lower rents, or maintaining the low income requirements for a longer number of years, etc)
- Projects that are financed by tax-exempt bonds can also qualify for the credit.

How it Works, (cont.)

Terms & Conditions

- The project owner must maintain an agreed percentage of low income units in a "Land Use Restriction Agreement" (LURA) which is recorded.
- Under the LURA, the project is required to meet the particular requirements for a 15 year initial "compliance period" and a subsequent 15 year "extended use period"
- The credits are subject to "recapture" if the project fails to comply with the requirements of Section 42 of the Tax Code during the 15 year compliance period.

How it Works, (cont.)

Eligible Basis

- Cost of acquiring an existing building if there is one (but not the cost of the land), plus construction and other construction related costs
- Multiply by the percentage of the units that are "low income", in accordance with the conditions described above, to determine the project's "qualified basis"

How it Works, (cont.)

Syndication & Partnership

- A tax credit (equity) syndicator connects private investors seeking strong return on investments with developers seeking cash for a qualified LIHTC project.
- Developers typically "sell" the credits by entering into limited partnerships with an investor, with 99.99% of the profits, losses, depreciation, and tax credits being allocated to the investor as a partner in the partnership.
- The developer serves as the general partner/managing member, and receives a majority of the cash flow
- The funds generated through the syndication vary, although 85-95¢ for each total dollar of tax credits was common in the first several years of the 21st century

How it Works, (cont.)

Syndication & Partnership (cont)

- Depreciation on the buildings owned by the partnership is also tax deductible, and that depreciation is allocated 99.99% to the investor
- An investor will typically stay in the partnership for at least the compliance period, because a reduction in its interest can also result in recapture of the credits
- The following summarizes a typical relationship between the developer and outside investors.

How it Works, (cont.)

Typical Partnership Structure		
	Developer	**Investor**
Partner Level	General	Limited
Management of Property	Yes	No
Partnership Control	Primary	Some Veto Rights
Share of LIHTC	0.01%	99.90%
Share of Initial Equity	0.01%	99.99%

How it Works, (cont.)

Government Subsidy Programs

- Debt Capital (grants, below market loans, credit enhancements)
- Equity Capital (Low income housing tax credits)
- Operating subsidies (rent paying support, Section 8 voucher, etc.)

LIHTC Example

History of development

- Section of "Old Manchester" acquired through multiple transfers by housing authority (RRHA) between 1960's – 2000; all structures demolished by the end of 1999

- Area approved for HUD's Hope VI, Neighborhoods in Bloom block grant funding program in 1997.

- RRHA (landlord) gave 80 year Master Land Lease in 2000, to a Limited Partnership (tenant) for a total, up-front rent of $8,000.00 (the equivalent of $100.00 per year) .

LIHTC Example (cont.)

- Limited Partnership constructed housing for low income tenants under restrictions using an out-of-state developer. Construction started in 2000 & completed before the end of 2001
- Completed project = 99 Attached &/or Semi-attached Townhouse apartments with separate utility metering, designed to be subdivided into Condo-able units.

LIHTC Example (cont.)

- Developers cost (book) value of improvements = \$8,900,000; land investment = \$8,000 (lease).
- Appraised value of land (based on area sales (\$5,000/apt. + excess land value) = \$500,000 (estimated)

LIHTC Example (cont.)

Project Funding

- HUD Grant for $4,300,000 (from Hope VI Federal Block Grants) No repayment required
- RRHA non-repayment Grants for $3,000,000 + $500,000 = $3,500,000

- Note: ($8,900,000-$4,300,000-$3,500,000= $1,100,000)

- Conventional mortgage thru Low Income Housing Initiative Loan Programs for $1,100,000

LIHTC Example (cont.)

- $8000 prepaid Land Lease for 80 year option
- Total Amount expended for the project = $8,908,000 from all sources known per date

LIHTC Example (cont.)

<u>Assessments & Other Issues</u>

- Assessor's Office, unaware that this project was being privately developed, maintained its exempt statues from 2000-2004, and lost approximately $136,300 in taxes.
- RRHA had applied for Rehab partial abatements on every improved property, and became eligible for Rehab abatements.

LIHTC Example (cont.)

- In 2006, a law firm filed an appeal to the Board of Review (BOR), claiming the $7,535,000 assessed value of the completed project should be $1,600,000.
- The BOR upheld the Assessor's valuation and the owner's attorney filed suit in circuit court.
- The court case was eventually settled, the rehab credits were process, and a refund of $195,200 in taxes and interest was made.

Source Credits

Notes:

1. **Square Peg, Round Hole**, by Wayne Tennenbaum, Esq. Fair & Equitable, May 2003

2. **Valuation and Market Studies for Affordable Housing** by Richard E. Polton, MAI, CRE, AICP. Appraisal Institute, 2002

3. **Low Income Housing Tax Credit (LIHTC) Subject Guide** by the IAAO Library, Mary Odom, Librarian, 2011