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Mixed Finance Development

Agenda

- Development Process and Structuring
- Public Housing and LIHTCs
- Other Tax Incentives for Affordable Housing & Community Development:
  - Historic Tax Credits
  - Energy Investment Tax Credits
  - Issues for LIHTC Transactions

Parties

- Developer
- Lender(s)
- LIHTC Investor
- State Housing Finance Agency
- Development team (e.g. general contractor, architect, attorneys, accountants, management agent, etc.)

Developer Responsibilities:

Create and Implement the Development Vision

- Develop overall program (design, unit mix, income mix)
- Assemble/Manage Development Team
  - Architects/Engineers
  - General Contractor
  - Attorneys
  - Accountants
- Manage Closeout, Cost Certification

Developer Responsibilities

Structure the Financing

- Proforma/Underwrite Project
- Acquire Allocation of Tax Credits
- Select/Negotiate Tax Credit Investor
- Arrange First Mortgage
- Identify/Negotiate Gap Financing

Regulatory Methods of Public Housing Development:

- Conventional
  - Development owned by PHA directly and funded solely with public housing funds
  - Regulations: 24 CFR 941 subpart C
  - Development proposal
  - Review conducted by HUD Field Office
- Mixed-Finance
  - Development typically owned by a limited partnership or limited liability company
  - Regulations: 24 CFR 941 subpart F
  - Mixed-Finance proposal and evidentiary submission/approval process
  - Review conducted by HUD headquarters with involvement of HUD Field Office in certain matters (e.g. title/survey review)

Conventional vs. Mixed Finance Comparison

Conventional Development	Mixed Finance Development
PHA owns building directly	Private owner (tax credit entity) – may be related to PHA (i.e. PHA wholly owns general partner)
All PH dollars (possibly limited mixed sources)	Multiple sources of funding
All PH units (possibly limited mixed use)	Usually mixed income (PH, tax credit, market)
Management is usually PHA (can be private)	Management is usually private (but may be PHA or related entity)
PHA hires contractor directly, Field Office approves proposal	More complex, more time required to coordinate multiple parties, more intensive HUD review
Viable for stimulus funds? ✓New construction ✓Acquisition/rehab	Viable options for stimulus funds? ✓New construction ✓Acquisition/rehab

Development Models (Rentals)

PHA Level of Responsibility

Minimum ← → **Maximum**

A — PRIVATE DEVELOPER	B — DEVELOPER/ PHA JOINT VENTURE	C — PHA AS DEVELOPER
Development: Developer	Development: Developer	Development: PHA Affiliate
Ownership: Developer's Affiliate, Partnership	Ownership: PHA Affiliate, Partners (after occupancy)	Ownership: PHA Affiliate
Property Management: Developer's Agent	Property Management: PHA or private Management Agent	Property Management: PHA Affiliate (or Agent)

Developer responsible for all development services including design, construction, and construction/permanent financing

PHA in capacity-building role learning from private developer/program manager and/or its affiliate

PHA, with assistance from consultant is responsible for everything

Public Housing Sources

Traditional Public Housing Sources for PHA Development:

- Capital Funds/RHF Funds
- Capital Funds Financing Program
- HOPE VI
- Choice Neighborhood Initiative
- Operating Subsidy
- Project Based Vouchers

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Non-Public Housing Sources

- Neighborhood Stabilization Program
- Low-Income Housing Tax Credits
- CDBG Funds
- HOME Funds
- AHP Loans
- Private Debt

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Operating Proformas

- Projections of future income and expenses
- Must know whether the proposed development will cash flow—and how much
- Key for setting reserve amounts
- Key for designing unit mix
- Run for 15 years

Operating Expenses

- Estimate based on similar developments
- Assume 3% to 7% vacancy rates
- Assume reserve contributions
- Assume all PHA fees
- Remember to consider unit mix and compliance activities
- Will likely be higher than traditional public housing
- Trend at 3% to 4%

Operating Income

- Different types of subsidies have different income rules
  - LIHTC
  - Public Housing
  - Section 8
  - Home
- Also consider the market, any applicable waiting lists, and income tiers
- Should trend at 2% to 3% per year

Public Housing Unit Income

- Project Expense Level set by HUD for each project
- Operating Subsidy = PEL – Formula Rent + Add-ons
- Formula Rents based on actual tenant rents
- Subject to HUD Proration
- HUD Form 52723 to calculate subsidy
- Governed by 24 CFR Part 990

Section 8 Voucher Income

- Based on Fair Market Rents (FMR)
- Published by HUD each year
- May charge 110% of FMR in Qualified Census Tracts
- All rents charged are subject to rent reasonableness
  - Rents charged cannot exceed local market rents
  - For Tenant Based vouchers—must not exceed rents charged for unassisted units in the same building

LIHTC and HOME Unit Income

- Set based on levels of affordability
  - LIHTC—50% or 60% of AMI
  - HOME—50% or 65% of AMI
- Published by HUD and/or HFAs
- No additional subsidy, so actual rent will be dependent on what the market can support

Operating Income Tools

- Market Studies
- Market Comparables
- PEL Calculator
- Operating Subsidy Calculator
- Novogradac and Company
  - http://www.novoco.com/products/rentincome.php
- PHA Payment Standards

Public Housing and LIHTC

- HUD Approval Processes
- Affiliate and Instrumentality Issues

Mixed-Finance Development

- Use of non-public housing sources to develop public housing
- May be owned by an entity other than a PHA
- Can utilize a mix of different funding programs and structures

HUD Processes

- If using HUD funds for development or operation, must go through HUD processes and receive HUD approvals

- Types of Approvals—mixed finance, disposition, environmental, subsidy layering (for Section 8 PBV), CFFP, etc.

Mixed Finance Approvals

- Two Parts:
  - Mixed Finance Proposal—allows HUD to evaluate the financial terms of the deal and general plan
  - Evidentiary Review—HUD reviews most deal documents, includes a legal review
  - Process may be streamlined (proposed rule issued in 2006)
- Allow at least 3 months to complete review process
- Coordinate timing of LIHTC and HUD processes

Low-Income Housing Tax Credits

- Credit serves as housing subsidy for rental housing
- Created pursuant to Section 42 of Internal Revenue Code
- Administered by State housing finance agencies
- 10 year credit; 15 year compliance period

Types of Credits

- **9% New Construction/Substantial Rehab Credit**
  - Standard type of credit
  - State Credit Amount based on population
  - Competitive Award Process
  - Substantial Rehab = Greater of:
    - 20% of the adjusted basis of the building
    - $6,000 per unit

Types of Credits

- **4% New Construction/Rehab Credit**
  - Generally used with tax exempt bonds
  - Bonds are competitively awarded, credits are as of right
  - Bonds must finance 50% of construction costs (50% test)
  - Rules similar between 4% and 9% credits

Types of Credits

- **4% Acquisition credit**
  - Used to assist with the purchase of buildings that are to be substantially rehabbed
  - May be paired with other tax credits
  - Building must not have been previously transferred within the past 10 years unless federally subsidized
  - Land costs are not considered in determining the available credits

Sample Development Timeline

Approximate 2-year timeline between reservation and full lease up

- Month 1 – Receive reservation of LIHTCs
- Months 1-3 – Identify Financing Partners
- Months 3-12 – Negotiate with financing partners and apply for HUD approvals (e.g. mixed-finance, disposition)
- Months 12-24 – Construction and begin lease-up
- Months 24-26 – Complete lease-up, receive Form 8609

Key Defined Terms for LIHTC

- Qualified Low-Income Housing Project
  - Must meet gross rent and tenant income tests:
    - Gross rent test
      - 20/50 Test – 20% of the residential rental units must be occupied by individuals at 50% or less of AMGI (adjusted for family size)
      - 40/60 Test – 40% of the residential rental units must be occupied by individuals at 60% or less of AMGI (adjusted for family size)
    - Rent-restriction test
      - Gross rent must not exceed 30% of the imputed income levels set forth above (rents calculated using 1.5 persons per bedroom not actual tenants)

Key Defined Terms

- Carryover Allocation
  - 10% or more of the project's reasonably expected costs (land and depreciable property) must be incurred by one year after the date of the allocation
  - The carryover allocation may be carried forward and the project placed in service up to 2 years after the carryover allocation was made
- Placed-in-Service: Suitable for habitability under local law

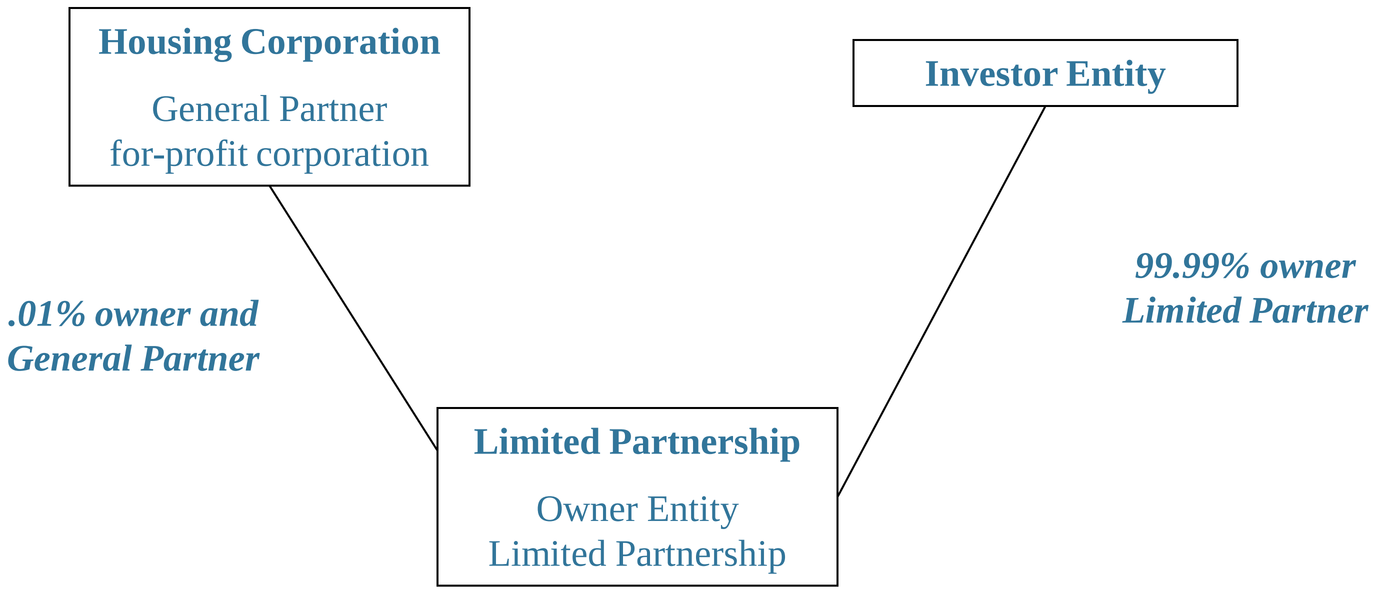
Key Defined Terms for LIHTC

- Extended Use Period
  - 15 year LIHTC compliance period
  - Occupancy restrictions continue for an extended use period of an additional 15 years (Section 42(h)(6)(D)
  - State HFA requirements vary

Review General Deal Structure

- Partnership/LLC as Owner
- GP/LP roles and responsibilities

Standard Development Structure Diagram



Key Parties at the Project Level

- Owner Entity – Limited Partnership of LLC
- General Partner – affiliate of Developer
- Limited Partner – affiliate of LIHTC Investor

Owner Entity: Limited Partnerships & LLCs

- **Popular because**
  - they fit the needed structure of the LIHTC program
  - tax benefits flow to partners/members unlike corporations
  - limited partner's/investor member's liability is limited to investment of capital

Owner Entity: Limited Partnerships & LLCs

- **Other Elements**
  - general partner has broader liability
  - limited partner/investor member cannot participate in management
  - some investors use special limited partners to take on a more involved asset management oversight role in a project

General Partner and Developer

- General Partner owns .01% of the Owner Entity
- GP controls and is responsible for day-to-day oversight of the project and liable for owner entity's debts
- GP entity is typically related to Developer

Limited Partner

- Invests equity in return for 99.99% ownership of the owner entity
- Investor wants: i) tax benefits; ii) limited liability
- Tax benefits from the deal to offset tax liability
    - tax credits
    - losses offset tax liability (including depreciation)
- Liability limited to amount of capital contribution made to owner entity
- Need to avoid being involved in day-to-day control or could lose status as limited partner

Hypothetical LIHTC Project Benefit Schedule – 9% Tax Credits

	Tax Credit Benefit (AFR[1] = 8.08 %) ($)	Other Tax Benefit[2] (depreciation, interest expense, etc.) ($)	Combined Benefit ($)
Qualified basis[3]	10,000,000		
Annual Housing Tax Credits (Qualified basis multiplied by the applicable AFR)	808,000		
Year 1	808,000	180,000	988,000
Year 2	808,000	300,000	1,108,000
Year 3	808,000	250,000	1,058,000
Year 4	808,000	175,000	983,000
Year 5	808,000	170,000	978,000
Year 6	808,000	165,000	973,000
Year 7	808,000	160,000	968,000
Year 8	808,000	155,000	963,000
Year 9	808,000	150,000	958,000
Year 10	808,000	145,000	953,000
Year 11	0	140,000	140,000
Year 12	0	135,000	135,000
Year 13	0	130,000	130,000
Year 14	0	125,000	125,000
Year 15	0	120,000	120,000
Year 16 (Disposition)	0	500,000	500,000
Total	$8,080,000	$3,000,000	$11,080,000

Table from *Community Developments* February 2008 Release, Dept. of the Treasury

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Tax Planning, Compliance and Risk

- To benefit from the credit, investors must be able to project taxable income over the term of the investment
- Potential loss of the tax credit and its recapture by the IRS represent a significant risk to investor

How the Cost/Pricing Structure of LIHTCs Works

- Bank investors use a number of variables to determine the returns associated with proposed LIHTC transactions
  - Price paid per dollar of tax credit, the timing of pay-in and pay-in schedule
  - Typical risk factors associated with real estate development, e.g. guarantees, operations, cash flow and asset management

How Cost/Pricing Structure Works cont'd

- Prices and Yields
  - Passive losses, such as depreciation and interest expenses, are considered in the yield calculations
  - To maintain projected yields on LIHTC investments, investors require tax credit adjusters
- Fees
  - Annual asset management fee typically paid from cash flow

Calculating the LIHTC

- Basic Computation
- Key Defined Terms
- Sample Computation

Computation of the LIHTC

Credit =

Applicable Percentage

x

Qualified Basis

Applicable Percentage

- Applicable percentage relates to type of credit (i.e. 4% or 9%)
- Actual percentages historically were tied to a statutory interest rate formula and fluctuated with changes in the statutory formula
- Under the Housing and Economic Recovery Act of 2008, there is a fixed 9% credit for newly constructed non-Federally subsidized buildings placed in service after the date of enactment until December 31, 2013

Qualified Basis

Qualified Basis =

Eligible Basis

X

Applicable Fraction

X

Basis Boost (if applicable)

Defined Terms for Qualified Basis

- Eligible Basis
  - Depreciable basis of LIHTC rental housing
- Applicable Fraction
  - Lesser of unit percentage or square footage percentage
- Basis Boost
  - Increase basis 30% if project in QCT or DDA
    - Qualified Census Tract
    - Difficult Development Area
    - State HFA Designated Buildings

Eligible Basis

- Basically depreciable basis
- For the 9% credit <u>does not</u> include
  - Acquisition costs
  - Permanent loan fees
  - Tax credit fees
  - Reserves
  - Federal grants
  - Non-residential costs
- Off-site site work may be includable if the real property can reasonably be expected to produce significant economic benefits for the taxpayer (e.g. a bridge primarily used by taxpayer)

Annual Tax Credits

Annual LIHTCs =

Qualified Basis

x

Tax Credit Rate (i.e. 4% or 9%)

Equity Raise

Total Tax Credit Equity =

Annual LIHTCs

x

10 year credit period

x

Equity raise (cents per LIHTC)

Sample Project – LIHTC Calculation

Project characteristics:

- 100 units
- 70 LIHTC units; 30 market rate
- $10,000,000 development budget
- 9% LIHTCs
- In a qualified census tract (QCT)

Sample Computation of LIHTC

Development Budget	=	$10,000,000
Non-basis eligible costs	=	$1,500,000
Eligible Basis	=	$8,500,000
Applicable Fraction	=	x 70%
QCT Basis Boost	=	x 130%
Qualified Basis	=	$7,735,000

Sample Computation of LIHTC

Qualified Basis	=	$7,735,000
Applicable Percentage	=	9%
Annual LIHTCs	=	$696,150
Total Tax Credits (10 years)	=	$6,961,500

Sample Computation of LIHTC

Annual LIHTCs	=	$696,150
Total Tax Credits (10 years)	=	$6,961,500
Equity Raise (per LIHTC)	=	$0.80
Total Equity	=	$5,569,200

Equity Contribution—Market

- Driven by timing, market, geographic region, etc.
- Recent range on various R&C deals
  - $0.92 to $1.05 in 2007 equity commitments to
  - $0.75 to $0.80 for 2008 equity commitments to
  - $0.58 to $0.85 for 2009 equity commitments
  - $0.70 to $0.85 for 2010 equity commitments
  - $0.75 to $0.90 for 2011 equity commitments

Equity Contribution—Process

- Developers solicit competing proposals to determine market range for pricing LIHTCs
- Timing of contribution is key
  - Is equity paid at financial closing, after construction, etc.
  - Time value of money
  - Need for construction period financing, etc.

Developer Fee

- Underwrite the project to determine level of fee that project costs can support
- Investor may require fee to be pledged to cover development deficits or be deferred until project stabilization
- For mixed-finance transactions, there is a HUD Safe Harbor limitation
  - 12% of total development costs

Guaranties to Investors

- **Development Deficit**
  - Developer agrees to fund development shortfalls
  - Often unlimited but may be capped
  - Negotiate for more flexibility if equity is paid in later (i.e. after construction completion)
- **Recapture**
  - Developer agrees to fund loss of credits
  - May carve out for bad acts of Investor

Guarantees to Investors
(contd.)

- **Operating Deficit**
  - Developer agrees to fund operating deficits
  - Usually limited to a period of years (e.g. 3 years or project stabilization)
  - May be capped at developer fee
- **Limitations on Exempt Organizations - Urban Memo/Choi Memo**
  - Requires caps on most guaranties provided by tax exempt entities
  - Investor may require guarantors to have a minimum net worth

Tax Exempt Entities in LIHTC Partnerships

- IRS “Urban Memo” (April 25, 2006)
- Applies to 501(c)(3) and (c)(4) entities
- Provides useful guidance on permissible guaranties, adjusters, removal of GP, etc.

Urban Memo

- Required provisions of owner entity document (i.e. partnership agreement or operating agreement):

  - Charitable Purposes Control. Partnership agreement must state that charitable purposes will control in event of conflict with profit motives of limited partner investor

  - Operating Deficit Guaranty
    - Limit to not more than 5 years from break-even operations
    - Limit guaranty to not more than 6 months of operating expenses (including debt service)

  - Tax Credit Recapture Guaranty
    - Limit tax credit adjusters to amount of developer fees

  - Right to remove general partner only for cause

Other Financing Sources

- **Hard debt**
  - Requires repayment (e.g. conventional private bank debt)
- **Soft Debt**
  - Often from government sources (federal, state or local)
  - Repaid to extent of available cash flow
- **Grants or Capital Contributions**
  - Generally not repayable

Other Financing Sources – Federal Funds

- Previously projects were required to either loan federal funds to the project at the applicable federal rate (AFR) or exclude funds from basis
- HERA only prohibits use of 9% credits with tax-exempt bonds or other obligations with tax-exempt interest or federal grants
- May now loan federal funds to the project at 0% interest or structure a capital contribution

Notes on Certain Federal Sources

- **CDBG**
  - Treated as non-federal funds
  - Eligible for 9% credits and for Basis Boost

- **HOME**
  - New law removed most HOME restrictions with tax credits
  - Previously only eligible for 9% credits if:
    - 40% of units are set aside for families earning below 50% AMI
    - Not eligible for Basis Boost

Cash Flow Distributions

- **Cash Flow**
  - After paying all expenses in connection with the operation of a project
  - Is distributed as negotiated by the investor LP and GP
- **Negotiable Cash Flow items include:**
  - Repayment of loans payable from cash flow
  - Payment of investor fees
  - Preferred returns to GP and LP
  - Repayment of LP and GP loans to project
  - Payment of deferred development or management fees

Right of First Refusal

- **Right of First Refusal**
  - Allows holder to purchase the property if another purchase offer is in place
  - Minimum price is outstanding debt plus investor's exit taxes
  - Set by the Internal Revenue Code
  - Holder must be a qualified non-profit
  - May be exercised for a certain period after the compliance period ends (1-5 years)

Purchase Options

- **Property Purchase Option**
  - Gives holder a period of time to purchase the property after the end of the compliance period
  - Price is typically greater of:
    - Fair market value or Right of First Refusal price
    - Investor may attempt to tack on additional costs such as credit deficiencies or transaction costs
- **GP Interests Purchase Option**
  - Allows the GP to buy out the LP so it becomes the full owner of the property
  - No property transfer, just ownership interest transfer
- **Rights may be held by different entities**

Year 15 Considerations

- Purchase type (property or ownership interests)
- Purchase price
- Reserves
- Debt terms
- Continuing guaranties and liabilities

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