Lawyers Building Community

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

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

**PHA Level of Responsibility**

**Minimum**

**A** PRIVATE DEVELOPER

- Development: Developer
- Ownership: Developer’s Affiliate, Partnership
- Property Management: Developer’s Agent

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

**B** DEVELOPER/PHA JOINT VENTURE

- Development: Developer
- Ownership: PHA Affiliate, Partners (after occupancy)
- Property Management: PHA or private Management Agent

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

**C** PHA AS DEVELOPER

- Development: PHA Affiliate
- Ownership: PHA Affiliate
- Property Management: PHA Affiliate (or Agent)

PHA, with assistance from consultant is responsible for everything.

**Maximum**
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
Non-Public Housing Sources

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

Housing Corporation
General Partner for-profit corporation

Limited Partnership
Owner Entity Limited Partnership

Investor Entity
99.99% owner Limited Partner

.01% owner and General Partner
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 0.01% 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

<table>
<thead>
<tr>
<th>Qualified basis</th>
<th>Tax Credit Benefit (AFR(^1) = 8.08%) ($)</th>
<th>Other Tax Benefit(^2) (depreciation, interest expense, etc.) ($)</th>
<th>Combined Benefit ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified basis(^3)</td>
<td>10,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual Housing Tax Credits (Qualified basis multiplied by the applicable AFR)</td>
<td>808,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td>808,000</td>
<td>180,000</td>
<td>988,000</td>
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<tr>
<td>Year 2</td>
<td>808,000</td>
<td>300,000</td>
<td>1,108,000</td>
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<tr>
<td>Year 3</td>
<td>808,000</td>
<td>250,000</td>
<td>1,058,000</td>
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<tr>
<td>Year 4</td>
<td>808,000</td>
<td>175,000</td>
<td>983,000</td>
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<tr>
<td>Year 5</td>
<td>808,000</td>
<td>170,000</td>
<td>978,000</td>
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<tr>
<td>Year 6</td>
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<td>165,000</td>
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<tr>
<td>Year 7</td>
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<tr>
<td>Year 8</td>
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<td>963,000</td>
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<tr>
<td>Year 9</td>
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<td>150,000</td>
<td>958,000</td>
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<tr>
<td>Year 10</td>
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<td>953,000</td>
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<td>Year 11</td>
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<td>140,000</td>
<td>140,000</td>
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<tr>
<td>Year 12</td>
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<td>Year 13</td>
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<td>Year 14</td>
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<tr>
<td>Year 15</td>
<td>0</td>
<td>120,000</td>
<td>120,000</td>
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<tr>
<td>Year 16 (Disposition)</td>
<td>0</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,080,000</strong></td>
<td><strong>$3,000,000</strong></td>
<td><strong>$11,080,000</strong></td>
</tr>
</tbody>
</table>

Table from Community Developments February 2008 Release, Dept. of the Treasury
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 \times \text{Applicable Fraction} \times \text{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 does not 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 = $6,961,500
(10 years)
Sample Computation of LIHTC

Annual LIHTCs = $696,150
Total Tax Credits = $6,961,500
(10 years)

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.
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

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*RENO & CAVANAUGH PLLC*
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

- 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