

Low-income Housing

Tax Credits

by Catherine Such, Vice President of Originations and Community Development, Columbia Housing

Over the past decade, the federal Low-income Housing Tax Credit (LIHTC) has emerged as an innovative and credible financial instrument that allows banks both a profitable and safe return, and investment credit under Community Reinvestment Act (CRA) requirements. This article discusses, in part, what low income housing tax credits are, how they work, how banks can access them and how they qualify under the CRA.

What is a tax credit?

The credit is a dollar for dollar reduction of the investor's federal income tax liability—if any investor owes \$100 in federal income taxes and holds \$100 in tax credits, the investor's tax liability for that year is zero. The program was created as part of the Tax Reform Act of 1986 in order to encourage the development of rental housing for low-income households (tenants housed in properties generating tax credits must earn 60% or less of median family income for their county and state housing agencies may impose lower income limits).

The program has been very successful, creating over 100,000 units annually and spawning hundreds of millions of dollars in investment. Typically used in multi-family housing development, the equity created by the sale of tax credits allows a reduction of the property's mortgage, which in turn al-

lows the property owner to lower rents, rendering the property affordable to lower-income households. For now, the credit only applies to rental properties, although the Administration has suggested expanding it to facilitate home ownership.

Tax credits are generated when a developer, either for-profit or non-profit, builds an affordable housing rental development. Most of the costs associated with development, except land and associated costs, cash reserves and certain financing costs, are accrued into what is referred to as the property's "eligible basis." The annual credit amount is calculated by multiplying the eligible basis by the applicable credit percentage (which changes monthly). Credits are earned over ten years, although the property must remain affordable for at least fifteen years (state housing agencies may impose longer affordability periods).

Example: Calculating the Credit

Project Cost:	\$7,500,000
Less ineligible costs:	(1,500,000)
Eligible basis:	\$6,000,000
Credit percentage:	x 8.55%
Annual credit amount:	\$ 513,000

The investor earns credits over ten years, and the income compliance period is fifteen years. As a result, the developer has a ten-year stream of tax

credits and a fifteen-year stream of tax losses to sell to an investor. The investor is typically the limited partner of a real estate operating partnership with a general partner (who may be the developer or a separate company) who is responsible for operating the property on a daily basis. The developer sells a majority of the operating partnership (typically 99.99%) to the investor, who then contributes equity to the property in exchange for the tax credits.

What is the investor buying?

The investor is buying a financial asset in the form of a stream of tax benefits (both credits and losses associated with depreciation and interest) with real estate supporting the asset. The investor's return is based on the price paid for this benefit stream. The developer will typically require payment of the capital into the property for development costs, and as a result, the investor's capital is typically paid in several installments dependent on benchmarks such as construction completion. Full payment is due by the time construction is complete, the property is stabilized and the permanent mortgage loan is closed. Returns fluctuate according to the usual economic barometers but are currently in the range of 7%–8% (after tax, assuming a 35% marginal rate taxpayer).

The equity the investor pays is calculated this way, using our previous example above:

Annual credit amount:	\$513,000
Over ten years:	\$5,130,000
Multiplied by price:	.75
<i>(varies significantly by transaction)</i>	
Multiplied by investor's share:	0.9999
TOTAL EQUITY:	\$3,847,115

Because it is a dollar-for-dollar reduction of federal tax liability, the investor's annual credit amount has a positive impact on earnings per share because it reduces tax liability without diluting earnings. In addition to the credit, the investor will earn tax losses as well; these losses do lower tax liability by lowering overall corporate earnings but typically the losses associated with depreciation and interest are much less significant to the overall investment than the credit.

What are the investor's rights and responsibilities?

As a limited partner, the investor is primarily responsible for oversight and the general partner is responsible for day-to-day operations. The relationship between the limited partner and the general partner is governed by an operating partnership agreement which is typically a complex document negotiated with the help of experienced tax counsel.

How do LIHTCs qualify under the Community Reinvestment Act?

An investment in Low-income Housing Tax Credits qualifies under the investment test of the Community Reinvestment Act. Typically, CRA credit is given in the year the investment is made although the benefits from the

investment last for the length of the operating partnership.

How do you access the credit?

This is a long-term and sophisticated financial investment. There is an active secondary market for credits, but many investors choose to keep their investment over the life of the partnership rather than trade it. The Internal Revenue Service has a number of requirements in Section 42 of the tax code including highly specific and ongoing income compliance requirements. The investor is typically a limited partner without daily operational responsibility. For all these reasons, it is important to choose your partners carefully.

Most banks invest in tax credits either directly or through investing with a tax credit syndicator. Banks that choose to invest directly typically make a significant investment in their own infrastructure, hiring relationship managers, underwriters and asset managers to watch over the investment. This may be daunting for smaller banks, particularly those not already involved in financing affordable housing through construction or permanent lending.

Banks interested in investing in tax credits, but uninterested in creating a department to do so, often choose to work with a syndicator. Syndicators are financial intermediaries that can find tax credit properties, underwrite the underlying real estate, work with the developer, general partner and development team (including the property management firm) and then manage the asset for its life. A syndicator performs these services in exchange for a load, or a percentage,

applied to the investment. Loads vary widely depending on the syndicator, services performed and whether the investor wants cash reserves. Loads typically vary between 9% and 12%. There has been consolidation in the syndicator industry over the past 18 months and as a result most syndicators who emerged from that shake-out are relatively sophisticated and in many cases have the financial backing of a significant corporate parent such as a bank.

There are two vehicles for investing with a syndicator: proprietary funds and multi-investor funds. In either scenario, the syndicator will find potential properties, perform underwriting and present the transaction to investors. The investor typically has consent rights to the transaction.

Proprietary funds are best for banks wanting a significant amount of control over the investment. Typically, a proprietary investor will exercise much more due diligence over individual transactions because they are the sole or majority investor and their risk is not mitigated by the presence of other investors. For banks that are interested primarily in maximizing their CRA credit, a proprietary fund may be the best option as the bank will have ultimate control over the geography, acquisition guidelines and pricing of the investment.

The advantage of a multi-investor fund is primarily risk diversification; for example, in a \$50M multi-investment fund, there may be between two and five investors, all of whom share risk. Usually a multi-investor fund will be fully specified, with financial and underwriting details about all the properties in the fund, prior to the fund's offering.

In syndicated transactions, the syndicator is typically responsible for primary contact with the general partner of the operating partnership. This allows the bank investor to focus on areas that are important to that investor. Because the syndicator is typically on the front line of negotiating with the general partner, it is important that the syndicator be experienced and knowledgeable, but also that the organization have competent tax counsel.

How do you choose the right partner?

Whether banks are investing directly or with syndicators, there are several things to look for in a partner. First, the partner should be generally knowledgeable about real estate. Syndicators should have depth of knowledge and experience on their management teams and in the staff working on transactions. Syndicators should also have solid underwriting processes and pro-

cedures that include checks and balances during the approval process. The syndicator should be able to provide the investor with the information necessary to approve a transaction in an organized, accurate and timely fashion. Most investors do a significant amount of due diligence on syndicators, particularly if they intend the relationship to last over a period of years, and may review the syndicator's existing portfolio, tax counsel, underwriting and asset management processes.

Over the past several years, the Low-income Housing Tax Credit has proven to be an excellent investment for banks, both from a CRA and a financial perspective. While relatively more complicated than some forms of real estate finance, with the right financial partners the tax credit is not a daunting investment and it allows banks to participate in a meaningful and financially rewarding way in their community. **CI**

ABOUT THE AUTHOR



CATHERINE H. SUCH, vice president of originations and community development, is responsible for identifying and evaluating potential investment properties and for the preparation of acquisition contracts and preliminary financial analysis. Ms. Such also spearheads Columbia's community development function. In this capacity, she serves as Columbia's liaison to the political community.

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COMMUNITY DEVELOPMENT INVESTMENTS GUIDE AVAILABLE

The Federal Reserve System's updated Directory: Community Development Investments is a great resource for bankers, community development groups and others interested in community development finance. It is currently available via the Federal Reserve Board of Governor's website or by mail.

The directory contains profiles of community development investments made by bank holding companies and state-chartered banks supervised by the Federal Reserve System. The profiles highlight the activities of community development corporations, limited liability companies and limited partnerships in which institutions have invested. Each profile describes the amount of initial capital invested by an institution and community development projects undertaken or planned. Also listed are contact persons who can provide additional information on community development corporation organization and operations.

The directory can be downloaded from the Federal Reserve Board of Governor's Web site:
www.federalreserve.gov/community.htm

REGULATORY OVERVIEW

INVESTMENT TYPE: LOW-INCOME HOUSING TAX CREDITS (LIHTCs)

Definition: The Low-income Housing Tax Credit (LIHTC) is a credit against regular tax liability for investments in affordable housing projects acquired and rehabilitated after 1986. Generally speaking, the credit is available annually over a ten-year period beginning with the tax year in which the project is “placed in service” or, at the owner’s election, the next tax year. A tax credit project must meet one of the “minimum set-aside” requirements noted below. A qualified low-income housing project must comply continuously with these minimum set-aside requirements for a full 15-year compliance period. A failure to meet this requirement will result in a complete invalidation of a portion of the credit already taken. LIHTCs are carried as investments on the investing institution’s balance sheet in accordance with Generally Accepted Accounting Principles (GAAP).

Minimum Set-Aside Requirements

1. **20/50 Test:** Under this test, at least 20 percent of the residential rental units must be both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income, adjusted for family size.
2. **40/60 Test:** Under this test, at least 40 percent of the residential rental units must be both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income, adjusted for family size.
 - Special rules apply with respect to tenants who originally qualified under the governing income levels and whose income subsequently rises above such levels.
 - A unit is “rent-restricted” if gross rent does not exceed 30 percent of the qualifying income levels in either 1 or 2 above. Restricted rents are determined using 1.5 persons per bedroom rather than actual number of occupants. Rental assistance provided by federal, state and local agencies is not considered rent paid by the tenant; utility allowances are, however, included.
 - An election can be made to combine buildings and consider the project as a whole for purposes of meeting the minimum set-aside tests, but all of the buildings in the project must meet the minimum set-aside requirements within twelve months after the first building is placed in service.

CRA Applicability: Examples of qualified investments provided in the CRA regulation include lawful investments, grants, deposits or shares in projects eligible for low-income housing tax credits. If the project complies with the above restrictions, CRA applies.