Low Income Housing Tax Credits Overview

Created by the Tax Reform Act of 1986, Low Income Housing Tax Credits (LIHTC) have leveraged nearly $100 billion in private investment capital and aided in the development of more than 2.6 billion affordable rental homes nationwide. The LIHTC supports 95,000 jobs annually and finances virtually all affordable rental housing.

The LIHTC is an indirect federal subsidy. Investors receive a dollar-for-dollar credit against their federal tax liability each year over a 10 year period once the project has been placed into service. Project sponsors/developers apply for and receive an allocation of tax credits from the designated state agency in charge of allocating the tax credits and then either sell the tax credits directly to an investor or to a syndicator who assembles a group of investors and acts as their representative. In California, the state agency assigned to the awarding of tax credits is the Tax Credit Allocation Committee (TCAC). TCAC administers the federal and state tax credit programs and is located in the State Treasurer's Office.

How Ownership Is Structured

The ownership of a typical tax credit property is either structured as a limited partnership or a limited liability company (LLC). In the limited partnership structure, the investors or equity partners are the limited partners and own 99%+ of the property through the limited partnership. The limited partners, however, are "passive" partners and are not involved in the day-to-day operation of the property. The day-to-day operational responsibility falls upon the general partner who usually has a 1% or less ownership interest in the property (Note: The general partner of most tax credit limited partnerships is a nonprofit entity which automatically qualifies the property for the "welfare exemption" or real estate tax rebate program that decreases the annual amount of real estate taxes owed by the property). The general partner is responsible for the day-to-day operations, including providing or contracting for property management services; hiring the independent accountant for the annual property audit; and making sure that the required schedule and other periodic mortgage payments are made in a timely manner. The limited partnership is governed by a Limited Partnership Agreement (LPA) which outlines each party's responsibilities and how the property can be transferred at the end of specific compliance periods. Finally, the reason for these ownership percentages of 99%+ and less than 1% is to enable the investor/limited partner to take full advantage of the annual tax credits.

The LLC option of ownership is very similar in regards to the percentage of ownership interest with the principal differences being that in the limited liability company structure, the investors are a non-managing member of the LLC. The LLC is governed by an Operating Agreement versus the LPA.

Types of Tax Credits

There are two types of tax credits allocated by TCAC: 9% and 4%. The 9% tax credits are extremely competitive. Twice a year (March and July), TCAC receives applications for an allocation of 9% tax credits. Typically, only about 40-50% of the applicants receive an allocation. The principal advantage to receiving a 9% allocation is that it provides for more tax credits and as a result, more equity into a proposed project. By contrast, the 4% tax credit program is generally under subscribed and is essentially an over-the-counter program. An allocation of 4% tax credits results in less tax credits than a 9% allocation meaning that it generates less equity for a proposed project than 9% tax credits. However, many project sponsors/developers apply for and receive an allocation to utilize tax exempt financing in conjunction with the 4% tax credits (Note: Tax exempt financing cannot be used with 9% tax credits). The California Debt Allocation Committee, which is also located in the State Treasurer's Office, allocates tax exempt financing authority.

As mentioned above, TCAC allocates 9% tax credits twice a year. In the first round for 2014, the average project size was 56 units with a total development cost of $18.8 million. Both 9% and 4% tax credits can be utilized for new construction as well as acquisition/rehabilitation projects. The first round results for 2014 for the 9% tax credits found that the average per unit cost was $337,198 (This is a 12% increase from 2013) for a new construction unit while the average per unit cost was $239,634 (This is a 10% increase from 2013) for an acquisition/rehabilitated unit.

Because of the continual competition for an allocation of 9% tax credits, TCAC implemented the "tie-breaker score" a few years ago. The tie-breaker is the ratio of public dollars to total development costs. The higher the percentage; the more public funds that are in the deal. It is TCAC's belief that this demonstrates the local agency's commitment to the proposed development.

How the Typical Tax Credit Property Is Financed

The amount of tax credit equity yielded via the sale of tax credits to investors fluctuates depending on the market and other factors. Currently, tax credit pricing for both 4% and 9% tax credits is about the same and is in the 98 cents to $1.15 per tax credit range. In addition to demand for tax credits (i.e., the market), pricing varies depending on several factors such as geographic location of the property and the strength of the local market; experience and track record of the project sponsor; experience and track record of the property management company; general conditions of the financial markets; etc.

Generally, tax credit equity represents about 30% of the amount of funds needed in order to construct a proposed tax credit property for a 4% tax credit property and in the 35-50% range if 9% tax credits are involved with public (i.e., federal, state, and local) subsidy funding about 30-35% and private commercial debt about 35-40% comprising the remaining needed funds. However, when a proposed tax credit property involves the funding of special needs housing or housing units that are targeted for extremely low income households with services, many additional sources of funding will usually be needed.

Recently, the County funded three tax credit projects that involved the inclusion of units for special needs/extremely low income households: (1) The Armory, a 58 unit new construction special needs housing development in Sunnyvale which is a 9% tax credit development; (2) Parkside, the companion project to The Armory, also a new construction special needs housing development in Sunnyvale as well as a 9% tax credit development with 61 units; and (3) Sharmon Palms Lane a 60 unit acquisition/rehabilitation scattered site property in Campbell which is a 4% tax credit development.

Here are the general figures associated with each property:

Financing Distribution

	% Private Funds	% Public Funds	%Equity Dollars
Armory*	---	18.6%	81.4%
Parkside*	---	21.2%	78.8%
Sharmon Palms	34.6%	31.4%	34.0%

Note: * Both the Armory and Parkside have no land costs associated with the properties. The City of Sunnyvale owns the land. In addition, because of the projected cash flow of both properties neither is capable of supporting a mortgage from a private lender.

The Role of Special Financing

The Armory will have 27 one-bedroom, 11 two-bedroom, and 20 three-bedroom units. The property will have 13 Project Based Section 8 Vouchers; six (6) VASH Vouchers (Note: These are from the Veteran's Administration and provide rental assistance to veterans similar to the Project Based Vouchers); and 10 MHSA units supported by a capitalized operating subsidy reserve. These operating subsidies are needed in order to ensure that the property operates at break even. The property will have 10 units affordable to households earning at 15% adjusted median income (AMI) and 12 units affordable to households earning at 30% AMI. Parkside will have 60 studio units and one two-bedroom manager's unit. The property will have seven (7) Project Based Section 8 Vouchers and 11 MHSA units supported by a capitalized operating subsidy reserve which will enable the property to operate at break even. Parkside will have 11 units affordable to households earning at 15% AMI.

In contrast, Sharmon Palms is an acquisition/rehabilitation property with seven (7) one-bedroom, 46 two-bedroom, and seven (7) three-bedroom units with six (6) units affordable to households at 30% AMI. Ninety percent (90%) of Sharmon Palms' units are affordable to households in the 40%-60% AMI range.

Conclusions

Tax credits provide an important tool in the financing of affordable rental housing. With the County emphasizing the funding of units affordable to extremely low income households (i.e., at and below 30% AMI) in conjunction with its ongoing efforts to implement the MHSA and other related service oriented programs aimed at assisting County clients, the County has been able to leverage its funds with private sector financing and tax credit equity. Going forward, the use of tax credits will remain an important tool in developing new and rehabilitating existing affordable housing. The County should strategically consider how best to use its funding resources so as to leverage tax credit equity in order to address the continuing needs of the County's clients.