Low Income Housing Tax Credits
("LIHTC")

Section 42, Passed 1986

Affordable Housing in America Today

Research Report
Winter 2015

CHESTERFIELD FARING LTD

Contents

Program Overview. Throughout the 1950's and the 1960's, the federal government sought methods to induce the private sector to build more affordable and low income housing to better the lives of millions of Americans. These programs institutionalized federal spending to subsidize rents but did not yet encourage rehabilitation or new construction of existing or new affordable housing. These measures simply stabilized the existing affordable housing stock. Not until the 1986 Tax Reform Act and the additional Section 42 of the Internal Revenue Code ("**IRC**") was authorized by Congress, did a comprehensive plan to rehabilitate and construct affordable housing commence. This program is known as the Low Income Housing Tax Credit ("**LIHTC**") program. LIHTC is the largest federal funded program for the production and preservation of affordable housing in the US. LIHTC encourages new construction and rehabilitation of affordable housing through the sale of 4.0% or 9.0% tax credits ("**TC(s)**") of the overall cost basis of a project over a 10-year period. This represents 4.0% or 9.0% per annum of the total cost of the Project as a TC. There is an active market to sell the TCs. This market includes large corporations who use the TCs as a dollar for dollar reduction in their federal corporate tax liability. In the case of certain qualified financial institutions such as banks, the TCs fill the Community Re-investment Act ("**CRA**") requirements. In this current market, TCs sell for 90.0% to 105.0% of face value helping to pay up to 100.0% of the equity advanced for any individual project.

- Recently, Congress established a temporary minimum 9.0% credit rate for new construction and substantial rehabilitation in the Housing and Economic Recovery Act of 2008 (HERA). This provision simplified state administration of the program and removed the financial uncertainty and risk associated with underwriting Housing Credit-financed properties using the "floating rate" system.

- Now currently, Congress is attempting to extend the LIHTC program because its structure and benefits support affordable housing and encourage tax incentives for major corporations to put their balance sheets to work for the common good. Representatives Pat Tiberi (R-OH-12) and Richard Neal (D-MA-1) have introduced bipartisan legislation in the House (H.R. 1142) that would enact the continuation of the permanent minimum Housing Credit rates of 9.0% for new construction and substantial rehabilitation and 4.0% TC rate for acquisition. A temporary version of this provision, which would extend the minimum 9.0% rate and establish a minimum 4.0% rate for developments allocated before the end of 2016, was included in the "tax extenders" legislation approved by the Senate Finance Committee in July, 2015. The extension of the 9.0% fixed rate was seen as a good sign. With credit pricing having corrected- or still in the process of correcting- the fixed 9.0% TC rate will make projects "pencil" easier, stimulating investing in the LIHTC program.

Base Requirements for the LIHTC Program. LIHTC allows owners to maintain affordable housing, but also construct and rehabilitate affordable rental housing throughout the US. The Internal Revenue Service ("**IRS"**) sets federal regulations, but the individual states enjoy considerable discretion in implementing the program and setting policy to achieve state and local goals while meeting federal requirements. The IRS allocates TCs to each state's Housing Finance Agency ("**HFA**"). This is based either on a per capita allocation or a minimum allocation of $2,525,000.0 for the small States. Projects must meet a minimum portion of the development's units for households earning 60.0% or less of gross area median income ("**AMI**").

Income Requirements. Usually, the LIHTC program includes new construction, acquisition with substantial rehabilitation of existing properties. LIHTC income limits depend on AMI which HUD sets for every county and metropolitan area. Households earning at or below 30.0% of AMI are defined as "extremely low-income" ("**ELI**"), those earning between 31.0% and 50.0% of AMI as "very low income" ("**VLI**"), and those earning at or below 80.0% of AMI as "low-income." Income limits are defined annually by the U.S. Department of Housing and Urban Development ("**HUD**") based on family size and location. The maximum qualifying income allowances may increase or decrease according to increase and decrease of family size.

Project Requirements. At a minimum a LIHTC development project must; i) Set-aside a minimum of 20.0% of the units as rent restricted and available to tenants whose incomes do not exceed 50.0% of the AMI, or ii) set-aside a minimum of 40.0% of the units as rent restricted and available to tenants whose incomes do not exceed 60.0% of the AMI. In addition, a household's income will be considered to meet the standard if under 140.0% of applicable qualifying income standards. As the tenant's income exceeds 140.0%, that unit ceases to be a qualified low income unit unless the owner later rents the next available unit of comparable or smaller size to a household with the qualifying income.

Rent Requirements. The gross rent paid by a tenant may not exceed 30.0% of the imputed income limitation (i.e.50.0% or 60.0% of the current area median income, adjusted for family size) for the unit. However, rent restriction is based on an imputed family size. For single room occupancy units or studios (units with no separate bedroom), the number of occupants is assumed to be one. For all other units, the number of occupants is assumed to be one and one-half times the number of separate bedrooms.

Number of Bedrooms	Deemed Household Size
0BR	0
1BR	1.5
2BR	3
3BR	4.5
4BR	6

Eligibility of Existing Buildings. The TC is not available to the acquisition of an existing building if the building was placed in service during the 10-year period preceding the acquisition. A building is placed in service under Section 42 upon its first use and upon a change in ownership interests. Because of the limited exception of the 10-year rule, the owner should investigate the ownership history of projects as well as the seller to determine eligibility. The TCs are not available in connection with the acquisition of an existing building (even if it meets the 10-year hold rule) unless the building will be substantially rehabilitated, post-closing. Substantial rehabilitation, as defined by IRS, is a project where rehabilitation costs must be $600.0 or more per unit, or 20.0% of eligible basis of the building, whichever is the lesser. The TCs are not available if the building was previously placed in service by the owner or a related person. Thus, the same owner may only obtain the TC for a building once.

Term/ Length of Affordability. When the LIHTC program was initially created, it only required a 15-year compliance period. Therefore, properties developed between 1986 and 1989 only have 15-year compliance periods. Post-1989 developments have at least 30-year restrictions as required by the Revenue Reconciliation Act. However, the statute allows for owners to opt out by requesting that the state HFA find a “qualified contract” purchaser to buy the property during the 14th year of the initial 15-year compliance period. If no purchaser is found, the owner may exit the LIHTC program. If a purchaser is found, or if the owner will not sell the property, the use restrictions extend to the full 30 years. Some states have required even longer compliance periods. Generally, because TCs are competitively allocated, states may impose more restrictive requirements than the Code minimum, e.g., greater percentages of restricted units, deeper income targeting and rent levels, or longer use restrictions.

Qualified Contracts. According to 30-year affordability criteria, LIHTC property owners can opt out of the program by selling the property in the 14th year to certain buyers at qualified contract prices. The owner would have to signal its intent to sell the property to the state HFA, which would then have one year to find a qualified buyer. If no qualified buyer is produced within the one year period, then the owner may be released from all use restrictions and obligations. However, if the owner refuses to sell the property, it must abide by the extended use restrictions enacted by the Revenue Reconciliation Act.

Section 42(h), (6) (F) of the IRS Code states that the term ''qualified contract'' means a bona fide contract to acquire (within a reasonable period after the contract is entered into) the non-low-income portion of the building for fair market value and the low-income portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing commitment) of: i) The sum of the outstanding indebtedness secured by, or with respect to, the building; ii) The adjusted investor equity in the building; iii) Other capital contributions not reflected in the amounts described in sub-clause (1) or (2), reduced by; iv) Cash distributions from (or available for distribution from) the project.

Qualified Allocation Plan. LIHTC requires each state agency to have a Qualified Allocation Plan ("**QAP**"). The QAP sets out the state's eligibility priorities and criteria for awarding federal TCs to housing properties. In some states, the QAP also sets out threshold criteria for noncompetitive 4.0% TCs and any state low income housing TCs. The QAP is a tool advocates can use to influence how their state's share of annual low income housing TCs is allocated to affordable housing properties. The QAP must also give preference to projects: i) Serving residents with the lowest income; ii) Serving income-eligible residents for the longest period of time; iii) Located in qualified census tracts (**QCTs**) or difficult development areas (**DDAs**), as long as the project contributes to a concerted community revitalization plan. QCTs are census tracts with a poverty rate of 25.0% or in which 50.0% of the households have incomes below 60.0% of the AMI. DDAs are areas in which construction, land, and utility costs are high relative to incomes.

The QAP selection criteria must address 11 items; i) location; ii) housing needs; iii) public housing waiting lists; iv) individuals with children; v) special needs, vi) populations; vii) use of existing housing as part of a community revitalization plan; viii) project sponsor characteristics; ix) projects intended for eventual tenant ownership; x) energy efficiency; and/or xi) historic in nature.

These requirements are minimums, states can adopt more rigorous criteria that target advocates' priority populations and locations. Most states establish detailed QAP selection criteria and set-asides based on the characteristics of their state's needs. HFAs always target TCs several ways: i) QAP selection process give preferences, in the form of extra points, to encourage developers to submit projects more likely to serve particular populations or locations, ii) QAP establishes a set-aside, reserving a specific percentage or dollar amount of any given year's TC allocation for projects more likely to serve particular populations or locations; iii) QAP can establish thresholds, minimum requirements that projects must meet simply to get in the game, thus improving targeting to particular populations or locations, iv) QAP must provide a procedure for notifying IRS of non-compliance, and v) tax-Exempt bond financed projects must "Satisfy" QAP.

Recapture. Recapture exists when there is a decrease in qualified basis from one year-end to the next. This decrease can occur in two ways, either a decrease in the low-income applicable fraction or a decrease in the eligible basis. It is sometimes difficult to identify whether a recapture event has occurred. To determine the recapture amount, the decrease in the qualified basis must be identified. The qualified basis is eligible basis multiplied by the applicable fraction on a building basis, which means the eligible basis, total units, and square footage all need to be taken into account when determining the reduction of qualified basis. Once calculated, the recapture is reported on IRS Form 8611 for each building subject to recapture.

Once the new allocable fraction is determined, it is applied to eligible basis found on Line 7 of the building's IRS Form 8609. After the qualified basis is determined, the previously claimed credits are determined per building, on an annual, cumulative basis, upon which recapture interest will later be determined. In the event of recapture, an owner not only loses the accelerated portion of credits, but also the time value of money associated with claiming the "unearned" credits early. The IRS requires interest to be computed at the overpayment rate determined under section 6621(a)(1), compounded on a daily basis. The overpayment rates are published quarterly by the IRS and can be found online at www.novoco.com by searching for "Interest Rates for TC Recapture." The overpayment rates are based on the federal short-term federal rate, and have remained flat at 2.0% and 3.0% for corporate and non-corporate filers, respectively, since late 2011. Interest is calculated beginning on the due date of the originally filed return claiming credits (excluding extension) through the date that the recapture and interest has been fully repaid to the IRS. The interest is nondeductible. Since July 1, 2008, HERA has allowed investors to dispose of their interest in the properties without facing recapture, as long as the properties continue to be operated as affordable housing. Before HERA's enactment, to avoid recapture of TCs for investments sold before the end of the compliance period, the seller would post a bond with the U.S. Department of the Treasury or provide U.S. Treasury bills in an amount equal to the TCs subject to potential recapture. This provision in HERA enables banks to shorten their investment hold period from 15 years to 11 years if they can comfortably conclude that the properties will continue to be operated as affordable housing through the end of year 15.

State Allocation(s). LIHTCs are first allocated to each states according to its population. In 2012, status received a LIHTC allocation of $2.2 per person, with a minimum population state allocation of $2,525,000.0.

From 1986 through 2002, the TC ceiling for small states and credit allocation amount per capita are increasing, and indexed for inflation annually thereafter. The chart shows partial 2015 TC allocations.

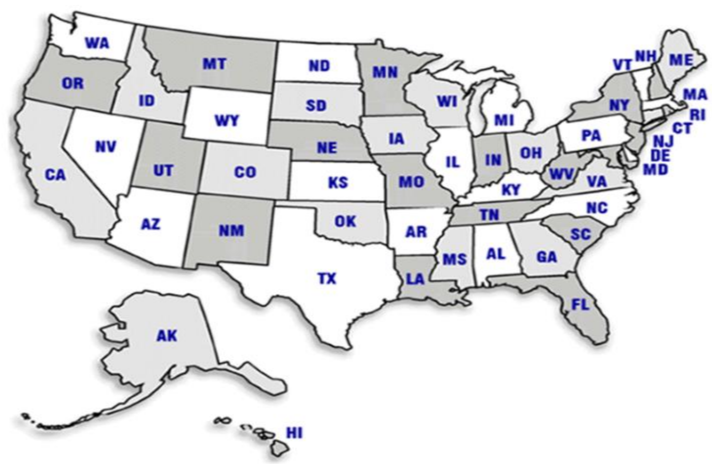
Federal regulations require at least 10.0% of a state's TCs be set-aside for qualified nonprofit organizations that are tax-exempt under Section 501 (c)(3) or 501 (c)(4) of the Internal Revenue Code.

State	Estimated Tax Credits Available in 2015	Bifurcated from Federal LIHTC?	Credit Period	Type of Credit	Novogradac & Company LLP Contact
Arkansas	$250,000	Yes	5 YEars	9 percent	Bentley Stanton
California	$TBD	Yes	4 years	9 percent and 4 percent	Jim Kroger, Mike Morrison
Colorado	$5,000,000	Yes	Not Available	9 percent and 4 percent	Jeff Nishita
Connecticut	Not Available	Yes	1 year	Other	Charlie Rhuda
Georgia	$22,000,000	Yes	10 Years	9 percent and 4 percent	Brad Elphick
Hawaii	Not Available	Yes	10	9 percent and 4 percent	Jon Adkins, Mike Morrison
Illinois	$25,739,111	Yes	1 year	Other	Stacey Stewart
Massachusetts	$20,000,000	Yes	5 years	Other	Jim McGowan
Missouri	$13,850,000	Yes	10 years	9 percent and 4 percent	Mike Kressig
New Mexico	$4,000,000	Yes	1 Year	Other	Phong Tran
New York	Not Available	No	10 years	4 percent	Charlie Rhuda
North Carolina	Contact NCHFA for information	Not Available	Not Available	Other	Bentley Stanton
North Dakota	TBD	Yes	1-10 Years	9 percent	Brad Elphick
Oklahoma	$4,000,000	Yes	Not Available	Not Available	
Utah	Not Available	Yes	10 years	9 percent	Mike Morrison, Bentley Stanton
Vermont	$400,000	Yes	5 Years	Other	Jim McGowan

Project Evaluation. Individual projects are evaluated from two main perspectives: i) the developers and investors who are responsible for the projects; and the ii) the applicable state that is allocating the TCs. First, a project has to be evaluated by the investors interested in initiating the project because of the high demand. There are a number of areas a LIHTC project can be evaluated from: i) State's QAP Evaluation Criteria, ii) financial feasibility for developer/investor, iii) feasibility for Lender based on their underwriting standards, iv) local Housing needs, v) targeted tenants and AMI levels, vi) support from community stakeholders, and vii) viability of receiving local approvals. Before a project can commence, it must be evaluated against the QAP Evaluation Criteria.

Next the project needs to be weighed for its financial feasibility. Because LIHTC is a limited annual resource, financial feasibility is an essential component of any project evaluation. Allocating agencies need to make sure a competitively awarded LIHTC reservation is going to a project that will be financially viable throughout the project's use restriction period. The use of LIHTC financing in an affordable housing project changes many aspects of the development process and structure when compared with a typical multifamily project. These differences include the following: i) nature of the equity changes; ii) projected gross revenues are limited; iii) Product types and mix must meet IRC Sec. 42 & QAP requirements; iv) Changes in occupancies may affect more than only cash-flow; v) Marketplace positioning of the project will be different; vi) Marketing & Leasing will also be different; vii) Operating budget must account for annual monitoring costs and investor oversight fees, among others. A LIHTC property is constrained by the rents that may be charged.

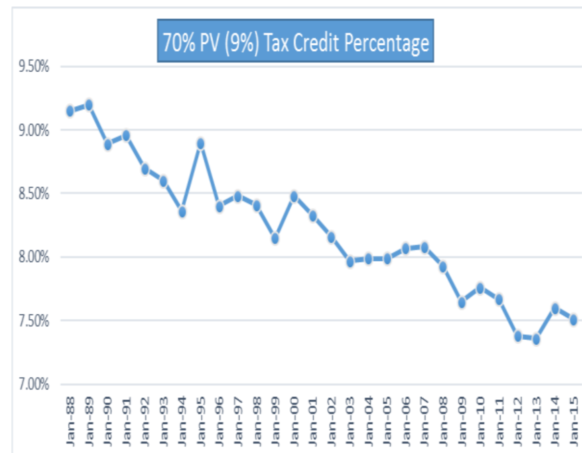
Carryover Allocations and Documents. According to Federal rule, projects must be in service in the year that TC is allocated by the TC agency. From carryover exception, a project which receives a valid carryover allocation may be placed in service no later than the end of the second calendar year after the year that a carryover allocation is made. Requirements for a Valid Carryover Allocation: i) Specific location of building; ii) The name, address and taxpayer identification number of the building owner; iii) The name and address of the state TC agency; iv) The taxpayer identification number of the state TC agency; v) The date of the allocation; vi) The credit dollar amount allocated to the building; vii) The taxpayer's total reasonably expected basis in the project as of the close of the second calendar year after the allocation year; viii) The taxpayer's basis in the project at the close of the calendar year in which the allocation is made and the percentage that this amount bears to the total reasonably expected basis; ix) The date the building is expected to be placed in service; and x) The building identification number assigned to the building.



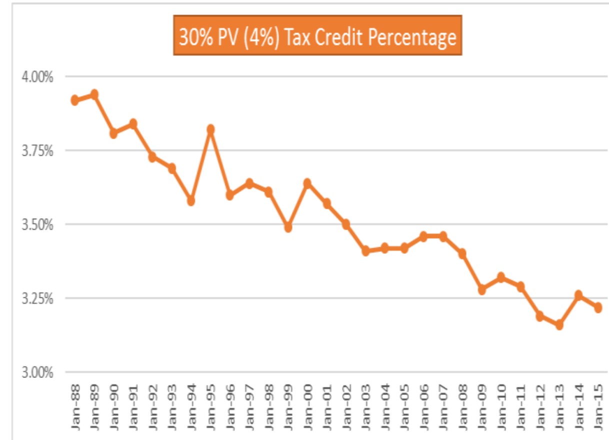
The 10% Test. Ordinary, projects should also satisfy the 10.0% test, which means that 10.0% of the reasonably expected basis in the project (as of the close of the second calendar year) must be paid or incurred within one year of the date of the carryover. While, States may impose stricter standards as long as the terms do not violate the Federal credit rules. The 10.0% test includes reasonably expected basis, which means the adjusted basis of land and depreciable property (whether or not it is included in eligible in basis). Basis attributable to non-residential rental property (i.e., commercial property/site improvements) may be includable in carryover allocation basis even though such property is not included in eligible basis. Eligible costs include building/construction costs, related personal property and land costs, Ineligible costs include permanent loan fees, reserves, syndication fees, partnership organizational costs and TC fees.

Determination of Annual LIHTC. The credit is available at first 10 years when the building is placed in service. To account for lease-up, the credit for the first year is adjusted to reflect the actual low-income occupancy for the year (determined on a monthly basis). The balance of the first- year credit is available in the 11^{th} year. Qualified basis is the portion of project's "eligible basis", which attribute to the acquisition and rehabilitation, or construction, of qualified low-income housing units. The applicable fraction is (1) the ratio of number of qualified low-income housing units to the total number of residential units in the building. (2) the ratio of the total floor area of the qualified low-income housing units to the total floor area of all residential units in the building. The owner must use the fraction that creates a low qualified basis. Eligible basis consists of (1) the properly capitalized and depreciable costs of developing a new building. (2) the properly capitalized and depreciable costs of a substantial rehabilitation of an existing building. (3) the cost of acquisition of certain existing building if a substantial rehabilitation is performed. Eligible basis includes furnishings and other personal property, but excludes land and other separately capitalized costs (whether amortizable or non-amortizable) such as organization costs, syndication costs, marketing and other pre-opening costs, permanent financing costs, and excluding project reserves and deductible expenses. Eligible basis must be reduced by the amount of any historic rehabilitation TC which is attributable to residential rental property. The annual "applicable percentage" which is used to determine the credit amount depends on several factors, including the nature of the project including the date the project is placed in service or the date which a reservation contract is entered into.

Maximum Tax Credit Eligibility. The maximum annual TC available to a development is calculated using an annual TC percentage. That percentage provides a "present value" of either 30.0%-70.0% of the low-income units qualified costs. Development costs eligible for a 30.0% value credit include: i) Qualified acquisition costs of developments that will be substantially rehabilitated; ii) Qualified costs of new construction and substantial rehabilitation developments that will be financed with tax-exempt bonds or subsidized federal loans. Development costs eligible for a 70.0% value credit include qualified costs of new construction and substantial rehabilitation that have no federal financing subsidies, subject to some exemptions. Over the 10- year credit period, the annual rate for a 30.0% value credit is approximately 4.0%; the annual rate for a 70.0% value credit is approximately 9.0%. Maximum TC eligibility is determined by multiplying the applicable annual percentage rate (approximately 4.0%-9.0%) by the eligible costs of development, acquisition, and rehabilitation costs attributable to the designated low-income units in the development. The rates have fluctuated according to a formula related to federal borrowing rates, which have sunk to historic lows. In 2012, it was 7.5% and 3.2%, respective. As a result, there is 15.0% – 20.0% less Housing Credit equity available for any given development.



While, in 2013-2014, there was a recovery, and then keep flat. As to the 4.0% TCs, which have been widely used by affordable housing developers, can partner with tax-exempt bonds. Tax-exempt bonds are debt obligations issued by state or local government agencies for rental housing, infrastructure improvements and other qualified municipal endeavors having a public purpose. IRS Code (Section 103) allows the purchasers of the bonds to deduct the interest income from their federal gross income taxes. Furthermore, tax-exempt bonds provide non-competitive 4.0% LIHTC for housing projects. Compared to taxable bonds, tax-exempt bonds have lower interest rate and come with tax credits.

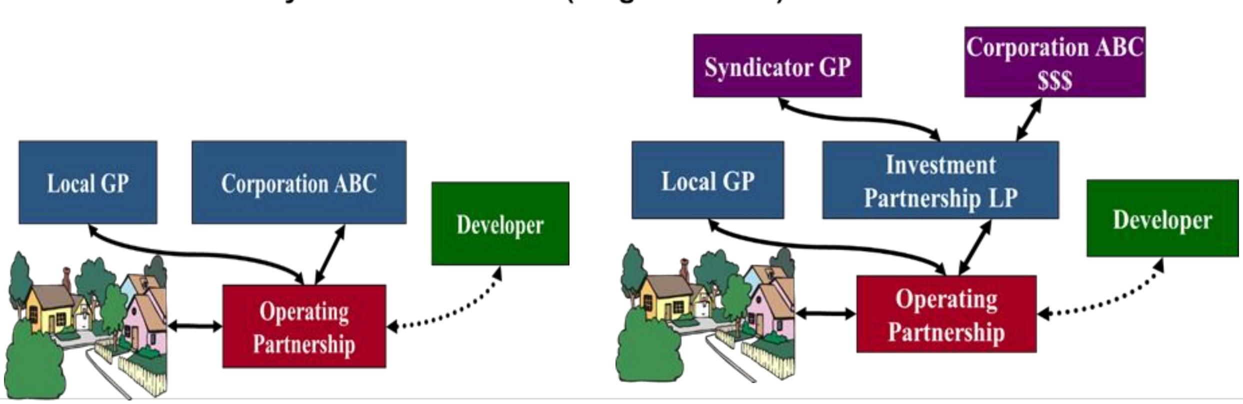


State Allocations. Usually, only certain states or local public (or quasi-public) agencies are authorized to issue tax-exempt bonds, and only these agencies can participate in the program outlined here. In all states, the HFA is authorized to issue tax-exempt bonds for multifamily rental housing, and most major cities also have local authorities (e.g., housing or redevelopment agencies) that can also issue bonds. However, the tax-exempt bonds are capped by federal government. The limits impose by the IRS Code is the greater of $85.0 per state resident or $256,235,000. State with large populations as New York and California receive significant allocations. According to regulations, at least 95% of bond proceeds must be used to pay for or reimburse “good cost”, which are incurred after the project. While, less than 5.0% of the bonds may be used for “bad costs”, which are incurred before the inducement, and non-residential costs. Also, only up to 25.0% of the bonds can be used to pay for acquisition costs, and the bond funding used for the cost of issuance of the bonds is limited to 2.0%. In order to qualify for an allocation of 4.0% LIHTCs, 50.0% or more of the project’s development costs must be funded by bonds during construction. The bonds need not come into the project at construction closing, but must be committed to the project before construction is completed.

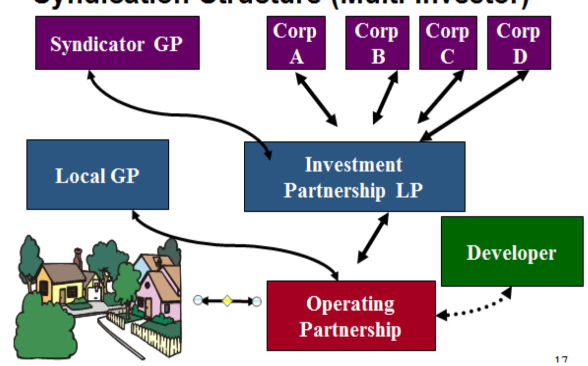
Roughly, there are two distinct financing models employed when using tax-exempt bonds and 4 credits for supportive housing: bonds used during construction only and bonds used for both construction and permanent financing. In addition, there is a hybrid of the two models us where bonds are used during construction and then bought-down by other sources at permanent conversion.

Program Investors. Owner may allocate the tax and economic benefits of a project disproportionately among its members (within reasonable limitations) by using a partnership to own the project. Even though any partnership can be used, most of the developers prefer limited partnership or LLC in order to control day-to-day matters and investor to obtain pass though benefits. Generally, the validity of such allocations must be determined pursuant to the regulation under IRC Section 704(b). LIHTC entities are structured as real estate partnerships under the Internal Revenue Code (26 UCS 704(a)), which allows banks to be considered passive investors/limited partners and to receive distributive shares of the TCs and other passive losses. Investments can be made either directly or through funds offered by syndicators, which comprise limited partnerships or limited liability companies (LLC) that invest in numerous LIHTC properties. Both options allow for various degrees of investment size, asset diversification, compliance monitoring, and investment screening. A direct investment is generally made by taking an ownership interest in a limited partnership or limited liability company that owns an LIHTC property. An investor must assume responsibility for all underwriting and compliance monitoring activities.

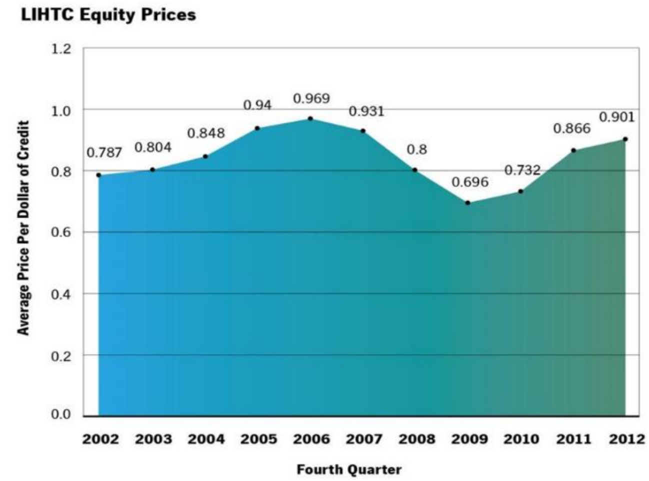
Syndication Structure (Single Investor)



Syndication Structure (Multi-Investor)



Compliance Monitoring. Equity prices have grown up to 100% but the chart to left shows the trends from the recession recouping to over 90% by 2012 as corporate profits have risen. Federal law mandates many features of a state's compliance programs. For instance, project owners must keep records for each building showing the total number of residential rental units, the percentage of low-income units, the rent charged on each residential unit, the ow-income unit vacancies and the rentals of the next available units, the low-income certification of each low-income tenant and supporting documentation, and the character and use of the nonresidential portion of the building (if any) included in the building's eligible basis.



Source: AFFORDABLE HOUSING FINANCE annual syndicator surveys

In addition, project owners must certify at least annually under penalty of perjury that the project meets the applicable minimum set-aside requirements, and that the owner has received an annual low-income certification from each low-income tenant, along with supporting documentation; that each low-income unit is rent-restricted; that all units are available for use by the general public on a non-transient basis.

Each building in the project is suitable for occupancy under local health, safety and building codes; that there has been no change in any building's eligible basis (or that there has been a change, with an explanation of the nature of the change); that all tenant facilities included in eligible basis are provided on a comparable basis without separate charge to all tenants.

Reasonable attempts are made to rent low-income units that become vacant during the year to tenants with qualifying income and while vacant no units of comparable or small size are rented to non-qualifying tenants; and that if the incomes of tenants of low-income units increase above the allowable limit, the next available units of comparable or smaller size are rented to tenants with qualifying income. Finally, the state housing credit agency has the right to inspect each building in the project and the right to audit the owner's records during the 15-year compliance period.

Going Forward. The LIHTC program is one of the federal government's primary policy tools for encouraging the development and rehabilitation of affordable rental housing. Since 1987, it has helped create more than **1.6 million affordable units**. Nowadays, investors engaged in LIHTC program are increasing, most of investors place high expectation on the markets in the next couple of years. Most projects now yield in excess of 95% which is an all-time high market for TCs. This increase is a result predominantly driven by record profits at the major regional and national banks, excess liquidity in the capital markets, and very low pre-tax and post-tax investment opportunities in more traditional real estate vehicles and investments.