

HOUSING TAX CREDITS AND HOME FUNDS

Note: This section provides general information on the Housing Tax Credit program and guidance about the issues involved in combined HTC and HOME developments. For a more detailed explanation of the HTC Program, please refer to the “Housing Tax Credit Program, A Guide For Development of Rental Properties” and “Housing Tax Credit Program, Compliance Monitoring Procedures and Reporting Forms”, publications of the Kansas Housing Resources Corporation.

Housing Tax Credit Overview

Under the provisions of the Tax Reform Act of 1986, a federal Housing Tax Credit (HTC) was created to encourage the development of rental housing for limited income households. The tax credit provides a source of equity to owners willing to designate at least 20% of their units for limited income families.

The HTC provides a maximum present value of either 30% or 70% of certain costs of development or acquisition/rehabilitation for eligible rental properties. The applicable present value credit (30% PVC or, 70% PVC) is dependent upon project and financing characteristics. Over a ten-year credit period, the 30% present value credit equates to approximately four percent annually, and the 70% present value credit equates to approximately nine percent annually. For example: a project with 100% qualified occupancy which is eligible for the 30% PVC and has \$1,000,000 in qualified costs would be eligible for a maximum \$40,000 annual tax credit ($\$1,000,000 \times 4\%$). This annual credit would amount to maximum \$400,000 over the ten-year credit period.

Eligible developments must designate a minimum of 20% of its units for persons whose incomes are at or below 50% of the area median gross income, or 40% of its units for persons whose incomes are at or below 60% of the area median gross income. To be eligible for 100% of the tax credits, however, a development must reserve 100% of its units for low-income use. Units designated for low-income use must be rent restricted with maximum rents (including a utility allowance) equal to 30% of imputed income limitations determined by the number of bedrooms per unit.

Eligible projects are subject to an Extended Use Commitment to Low Income Housing for a term of 30 years with sale provisions. The 30 year term may be reduced to the term designated by the owner (15 years or more) if the owner or the allocating agency is unable to sell the property to a buyer willing to continue the low income use. (There are sale price restrictions if the allocating agency is requested to market the property). In such event, owners may convert the project to market rate use, but may not evict qualified tenants or raise rents beyond those available under the tax credit program for a period of three years.

The tax credit provides a valuable resource in generating capital for housing projects, but it is complex. Developers or owners interested in utilizing the tax credit should consult a qualified tax accountant and/or legal counsel to ensure that their development is qualified, that the most advantageous alternatives are implemented, and that the property will remain in compliance with the tax credit regulations throughout the compliance period.

Structure of HOME funds

There are three ways in which HOME funds can be structured to work with the HTC Program:

- When HOME funds are structured as a below market interest rate (BMIR) loan, the development is eligible to receive the 9% credit (assuming no other source of federal financing is present). If HOME funds are provided as a BMIR, those funds may be included in the eligible basis if 40% of the units are set-aside for households at or below 50% area median income on a building-by-building basis. If this structure is utilized, the development is not eligible for the 130 percent of eligible basis provision for properties located in Qualified Census Tracts or Difficult Development Areas.

Example: A CHDO proposes a 12-unit elderly HTC/HOME development (two six-unit buildings) where three units are identified as HOME-assisted units. The HOME funds are being provided as a 3% (BMIR) loan. To qualify for the 9% credit, 40% of the units (three) in each building [six total] must be set-aside for those at or below 50% of the area median income. Typically, HOME rent limits are lower than those of the Housing Tax Credit Program, and as such, the HOME units would also qualify as HTC units. Thus, three non-HOME HTC units would need to be targeted to those at or below 50% of the area median income

- HOME funds can also be structured as a below market rate loan, and only the 4% credit is applicable. Developments that include other federal funding or tax-exempt mortgage revenue bonds qualify only for the 4% credit, regardless of any affordability restrictions.
- When HOME funds are provided as a market rate loan, they are not considered to be a federal subsidy. The development would qualify for both the 9% credit and the 130% of eligible basis (assuming the development is located in a HUD defined Qualified Census Tract or Difficult Development Area).

Note: A fourth possible structure is HOME funds as a grant. However, the KHRC does not structure HOME CHDO allocations as grants, so this option is not available.

In an HTC/CHDO development, a certain number of units will need to satisfy the HOME requirements (see “HOME Rental Development” chapter) and a certain number will need to satisfy HTC requirements. Units can qualify as both as long as the stricter income and rent limit is met (the lower of the HOME rent vs. the HTC rent).

The CHDO’s Role

When a non-profit organization undertakes a HTC development, it needs to be keenly aware of the Internal Revenue Service (IRS) rules and regulations regarding what non-profits can and cannot do. The IRS has created a two-pronged test that must be met for a non-profit to participate in partnership with for-profit entities.

The first prong is that the activities of the partnership furthers the non-profit's mission (its tax-exempt purpose). In this instance, a non-profit must have a commitment to affordable housing as its purpose. Furthermore, at least 75 percent of the units within the development must be restricted to low-income households (most HTC developments are 100 percent income and rent restricted).

The second prong is that the partnership is structured to ensure the non-profit will act exclusively to further its tax-exempt purpose and not for the purpose of benefiting the for-profit partners. This prong is further divided into two tests:

- **Control of the partnership.** The first approach is when the non-profit is acting as the sole general partner. As the sole general partner, the non-profit is responsible for the day-to-day operation of the partnership and any decisions by the limited partners will not affect the purpose of the non-profit. The second safe harbor is when the non-profit is the controlling interest in a joint venture with a for-profit. Both entities are general partners, however the non-profit must have the majority vote, thus having effective control over the partnership.
- **Risk of the non-profit's assets.** As with most partnerships, the general partners are required to provide certain financial guarantees (i.e. credit adjusters and operating deficit guarantees). When the non-profit is involved in a joint venture with a for-profit, the for-profit typically provides the guarantees. However, when a non-profit is required to provide guarantees, the issue becomes whether the non-profit's assets are being put at risk to protect the investment of the for-profit partners, thus overly benefiting the for-profit members.

As with all rental development, it is wise for funds to be built into the development budget to fund operating reserves (HOME funds can be utilized to fund initial operating reserves), which would lessen the potential risk of non-profit assets. When a non-profit does provides guarantees, funds should be contributed as a capital contribution, and be returned to the non-profit upon liquidation of the partnership. Another alternative is the utilization cash flow generated by the development to fund reserves to cover potential credit recaptures, etc.

Like all CHDO developments, when a CHDO is undertaking a HTC/HOME development, it must play one of three roles on a project: Owner, Developer, or Sponsor. In typical HTC/HOME developments, the CHDO will either be the owner/developer or owner. In all cases, the CHDO **MUST BE** in a controlling position over the entire development.

When a CHDO is the sole-general partner, the CHDO typically plays the role of owner/developer. This means the CHDO has both an ownership interest and a contractual obligation to the other owners (limited partners) to develop the property and perform all the functions typically expected of the developer and assumes the risks and rewards associated with being the project developer. As a developer, the CHDO must obtain financing, and rehabilitate or construct the project.

When a CHDO is part of a joint venture with a for-profit organization, attention must be paid to what roles each plays in the development. In these deals, both the CHDO and the for-profit organization are general partners of the partnership, however the CHDO must be the managing general partner. The roles and responsibilities of each must be incorporated into the partnership agreement.

It is at the CHDO's discretion as to how much it is involved in day-to-day property management (leasing, etc.) once the development aspect is complete. The CHDO may contract the property management out, but the CHDO must ultimately control management decisions (as the managing general partner) and is responsible to the State for compliance with the HOME and HTC requirements.

Two additional items that a CHDO must have in place is counsel to wade through the various legal issues (including protecting the tax-exempt status) and an accountant who preferably has experience with tax credit finance.

Managing an HTC/HOME Development

There are a number of issues when managing a joint HTC/HOME development. Certain units may be HTC units, certain units may be HOME units, and some units may be both. For units to qualify as both, the stricter rule of the two programs applies.

Initial Tenant Income Certification

Both programs utilize the Section 8 definition of annual income. However, the HTC program allows tenants to "self-certify" assets below \$5,000. The HOME program requires all assets to be verified via a third-party, regardless of the amount. Thus, in a joint unit, all assets need to be verified (the stricter standard).

Income Recertifications

Both programs require annual recertification of income and assets. The HOME program allows a tenant to self-certify his/her income and assets at recertification. Managers are only required to obtain third party documentation at the initial certification and then every sixth year thereafter. The HTC program requires managers to verify income and assets, through third party documentation, during the annual recertification. For joint HTC/HOME units, the more stringent HTC requirements apply.

However, in an HTC/HOME development where all units are considered HTC units, the owner can apply for a recertification waiver. If the waiver is granted, the HOME units must still meet the HOME requirements (which become the more stringent due to the waiver).

Increases in Tenant's Income

Tenants are not required to move because of an increase in income. Both programs require that the next available unit be rented to an income-eligible tenant. In the HOME program, when a tenant's income increases above 80% of the median income limit, the rent charged should be equal to 30% of his/her adjusted income. In a HTC unit, the rent is restricted to the HTC limits,

and the Next Available Unit Rule (NAUR) becomes applicable. When a unit is considered both HTC and HOME, the tax credit rule regarding increases in tenant income applies.

Note: When dealing with income increases of tenants in HOME units, the manager must take into account High Home rents versus Low Home rents, fixed versus floating units, etc.

Sample HTC/HOME Development

Housing Tax Credit/HOME developments come in all sorts of shapes and size. This section shall examine how one could be structured.

Development Summary

ABC CHDO considers a rental housing development with the follow assumptions:

- ABC will be the sole-general partner
- Construct a 12-unit subdivision (six duplexes, two bedrooms each) in Great Bend, Kansas.
- Occupancy will be restricted to elderly persons (55 and older)
- Anticipates utilizing Housing Tax Credits, conventional financing, and needing HOME funds to fill in the “gap”

Market Study

ABC commissions a Market Study to determine if the need is truly present. The market analyst reviews the following factors (not all inclusive):

- A statement of the competence of the market analyst
- Description of the proposed site
- Demographic analysis of the number of households in the market area, which are income eligible, and can afford to pay the rent.
- Geographic definition and analysis of the market area
- Analysis of household sizes and types in the market area
- A description of comparable developments in the market area
- A description of rent levels and vacancy rates of comparable properties
- Analysis of practical available operating expenses and turnover rates of comparable properties in the market area
- Projected operating funds and expenses when available at the time of the study; and
- Expected market absorption of the proposed rental housing, including a description of the effect on the market area.

Determining Units

Because they anticipate needing HOME funds, ABC proceeds with calculating numbers of unit to be restricted for each program. ABC assumes all 12 units will qualify as HTC units, and at least six units need to be HOME units to address the HTC 40/50 rule. The number of HOME units may be altered once ABC determines the amount of HOME funds needed.

Initial Rent Structure

Based on the results of the market study, ABC decides to proceed with the proposal and finalizes the initial rent structure.

<u>Unit Designation</u>	<u># of Units</u>	<u>Monthly Rent</u>	<u>Tenant Utility Allowance</u>	<u>Annual Rent Collected</u>
HTC only	6	350	123	\$25,200
HOME/HTC	6	285	123	\$20,520
Total	12	-	-	\$45,720

Anticipated Income and Operating

ABC next develops its annual operating budget to determine the amount of conventional financing the property can carry. ABC has a strong track record with local banks that will allow ABC to go as low as 1.15 on the debt coverage (a net operating income equal to 115% of the debt service).

Annual Gross Income	\$45,720
Vacancy Rate (5%)	<u>\$(2,286)</u>
Effective Gross Income	\$43,434
Annual Operating Expense (\$2,500/unit)	\$30,000
Replacement Reserves (\$200/unit)	<u>\$2,500</u>
Net Operating Income	\$10,934
Debt Coverage Ratio	1.15
Maximum Debt Service	<u>\$9,508</u>
Cash Flow	\$1,426

Development Budget

ABC next creates its development budget. Based on previous experience, ABC formulates the following budget:

Land	\$55,000
Site Work	\$20,000
Construction Hard Cost	\$840,000
Construction Contingency	\$20,000
Architectural & Engineering	\$35,000
Interim Costs	\$28,260
Financing Fees	\$10,000
Soft Cost	\$7,500
HTC Syndication Cost	\$15,000
Developer Fee	\$140,000
<u>Operating Reserve</u>	<u>\$30,000</u>
Total Development Cost	\$1,200,760

Determining the HTC

Utilizing the development budget, ABC determines the amount of HTCs that the property would be eligible to receive.

Total Development Cost	\$1,200,760
Eligible Basis ¹	\$1,090,760
Qualified Basis ²	\$1,090,760
Tax Credit Percentage ³	8.4%
Annual Tax Credit	\$91,624
Ten Year Tax Credit	\$916,240
Equity Percentage (minimum)	75%
Equity from Credit	\$687,180

¹ Certain items, such as land, are not eligible for credit. The total cost, less ineligible item is the “eligible basis.

² Credits can only be taken on restricted units. As all the units are to be restricted, the “qualified basis” is 100%

³ The development will be eligible for the nine percent credits, however, the actual percentage is adjusted monthly. This represents the actual percentage at time of application.

Development Financing

ABC has determined the amount of equity from the HTC and the bank has agreed to provide \$115,000 of conventional financing. ABC now looks to fill in the gaps.

Total Development Cost	\$1,200,760
Tax Credit Equity	\$687,180
<u>Bank Loan</u>	<u>\$115,000</u>
Gap	\$(398,580)

ABC realizes that it must apply for \$98,580 of funding from another source, in addition to the \$300,000 through the HOME program. ABC applies to the local government to rebate the taxes paid for ten years. This allow ABC to defer a portion (\$38,580) of it developer fee and be paid back utilizing the rebates, leaving a gap of \$60,000. To address this, ABC will apply for Federal Home Loan Bank, Affordable Housing Program funds. The multi-layered financing is as follows:

Total Development Cost	\$1,200,760
Tax Credit Equity	\$687,180
Bank Loan	\$115,000
HOME Program	\$300,000
FHLB AHP	\$60,000
<u>Tax Rebate/Deferred Fee</u>	<u>\$38,580</u>
Gap	\$0

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HOUSING TAX CREDIT & HOME EXHIBITS

Using HOME with Low-Income Housing Tax Credits 9 – E1

Note: This exhibit is currently not available online. Please contact the KHRC for a hardcopy.