Development of Investment Tax Credit Eligible Projects

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VERMONT DEVELOPMENT CONFERENCE

TAKEAWAYS

(1) Mechanics of the Low-Income Housing Tax Credit ("LIHTC" or "Housing Credit") allocation process and compliance

(2) Securities regulations governing the marketing and sale of equity interests

(3) Understanding of typical organizational techniques that facilitate the flow of tax credits generated by a project to its equity investors

WHAT ARE INVESTMENT TAX CREDITS?

- Investment Tax Credits ("ITCs") offset income tax
- Federal Income Tax Credits you might be familiar with:
  - Solar Energy ITC
  - Renewable Energy Production Tax Credit
  - New Markets Tax Credit
- Possible State Tax Credits

BACKGROUND: FEDERAL SUPPORT FOR PRIVATE LOW-INCOME HOUSING DEVELOPMENT

- 1986: Congress Passes the Tax Reform Act of 1986

- 1986 to Today: The LIHTC's Impact on Housing Affordability
    - ~$10 billion annual program cost
    - Over 2.4 million units created
    - For-profit developers produced approximately 78% of the LIHTC projects placed in service between 1987 and 2013

THE LOW-INCOME HOUSING TAX CREDIT OVERVIEW

- How much incentive is available each year in Vermont?:
  - ~$3,100,000.00 each year through 2021
- Access to Credit:
  - Credit awards involve a competitive application process administered by states' allocating agencies
  - In Vermont the Vermont Housing Finance Agency ("VHFA") awards credits pursuant to its Qualified Allocation Plan ("QAP")
- Level of Incentive:
  - New Construction = 9% credit on Qualified Basis; Existing Construction/Projects funded by tax-free bonds = 4% credit on Qualified Basis
- 15-year Credit Period:
  - The LIHTC is a 15-year credit paid out over an accelerated period of 10 years
- Compliance:
  - Affordability restrictions on rental rates must remain in place according to federal minimum, or state guidelines
    - Federal minimum = 30 years; some states longer; Vermont permanent
  - Program non-compliance can result in credit recapture
- What is the Opportunity for Investors and Developers?
  - Developer Fee / Pass-Through Credits

DETERMINING THE INCENTIVE AMOUNT

- On new construction, the LIHTC provides a 9% credit on the project's "Qualified Basis."

- Formula for determining the "Qualified Basis" in your investment =

    - **Eligible Basis**
        - **Depreciable assets as a starting point**
        - **Depreciable assets do not include land acquisition costs and expenses**
    - x Basis Boost?
    - x Applicable Fraction
    - = Qualified Basis

- Formula for determining your level of incentive =

        - Qualified Basis
        - x Tax Credit (either 4% or 9%)
        - = The LIHTC Credit

DETERMINING THE INCENTIVE AMOUNT

- Formula for determining the "Qualified Basis" in your investment =
  - Eligible Basis
  - **x Basis Boost?**
    - **Some projects qualify for a "Basis Boost" allowing up to a 130% increase in Eligible Basis**
    - x Applicable Fraction
    - = Qualified Basis

- Formula for determining your level of incentive =
  - Qualified Basis
  - x Tax Credit (either 4% or 9%)
  - = The LIHTC Credit

DETERMINING THE INCENTIVE AMOUNT

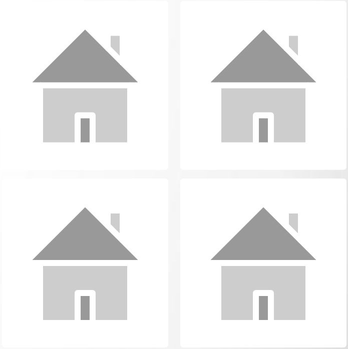
- Formula for determining the "Qualified Basis" in your investment =
  - Eligible Basis
  - x Basis Boost
  - **x Applicable Fraction**
    - **Floorspace fraction**
    - **Unit Fraction**
  - = Qualified Basis

- Formula for determining your level of incentive =
  - Qualified Basis
  - x Tax Credit (either 4% or 9%)
  - = The LIHTC Credit

DETERMINING THE INCENTIVE AMOUNT

- **Example: Project cost (includes building & land) = $1,200,000.00**

- Formula for determining the “Qualified Basis” in your investment =
  - **Eligible Basis** = $1,000,000 (cost of land = $200k)
  - **x Basis Boost** = 100% (none)
  - **x Applicable Fraction** = 1 (all units rent restricted)
    - **Floorspace Fraction** = each unit is the same size
    - **Unit Fraction** = 4/4 (all units are affordable)
  - **= Qualified Basis** =$1,000,000



DETERMINING THE INCENTIVE AMOUNT

- Formula for determining the "Qualified Basis" in your investment =
  - Eligible Basis
  - x Basis Boost
  - x Applicable Fraction
  - = Qualified Basis ($1,000,000 from our example)
- Formula for determining your level of incentive =
  - **Qualified Basis**
  - x Tax Credit (new construction = 9%)
  - = The LIHTC Credit

DETERMINING THE INCENTIVE AMOUNT

- Formula for determining the "Qualified Basis" in your investment =
  - Eligible Basis
  - x Basis Boost
  - x Applicable Fraction
  - = Qualified Basis

- Formula for determining your level of incentive =
  - Qualified Basis
  - **x Tax Credit**
    - **The 9% Credit: 70% subsidy on new construction and renovations to low-income property**
    - **The 4% Credit: 30% subsidy on already-constructed buildings, placed in service for purposes of providing low-income units**
  - = The LIHTC credit

DETERMINING THE INCENTIVE AMOUNT

- **Example: Project cost (includes building & land) = $1,200,000.00**

- Formula for determining the "Qualified Basis" in your investment =
  - Eligible Basis 1,000,000
  - x Basis Boost = 100%
  - x Applicable Fraction = 100%
    - Floorspace Fraction = each unit is the same size
    - Unit Fraction = 4/4 (all units are affordable)
  - = **Qualified Basis = $1,000,000**

- Formula for determining your level of incentive =
  - **Qualified Basis = $1,000,000**
  - **x tax credit**
    - **9% = new construction and renovations to low-income property**
  - **The LIHTC credit = $90,000**
  - **Total low-income tax credit paid over 10 years = $900,000**

ENTITY STRUCTURING

- Limited Liability Companies / Partnerships enable pass-through of tax credits to entities' owners
- The entities' owners may claim LIHTC and depreciation
- The Limited Liability Company Agreement or Partnership Agreement will dictate key terms governing the arrangement

ENTITY STRUCTURING

Investor = Member of LLC / Limited Partner of Partnership

Developer = Managing Member of LLC / General Partner of Partnership

LLC or Partnership

Lenders = Construction or permanent financing

Tax Credit Allocating Agency

Ex.) $1,000,000 Qualified Basis; 9% eligible tax credit; $90,000 annual credit allocation

ENTITY STRUCTURING

- Key Entity Governance document provisions
  - Sale of LLC membership or partnership interests
  - Language allocating the tax credit benefits amongst members or LPs
  - Developer guaranty of completion of project and/or delivery of tax credits
  - Fee schedule for developers and any other active parties to the project
  - Capital Call requirements
  - Oversight rights of investors or entity acting on behalf of investors

SECURITIES REGULATIONS GOVERNING THE MARKETING AND SALE OF EQUITY INTERESTS

- Allocating Agency provides developer a commitment to a future tax credit allocation
- Developer "sells" equity in its project entity in exchange for future tax credits generated by the project
- Sale of equity interests in entity governed by federal securities laws

SECURITIES REGULATIONS GOVERNING THE MARKETING AND SALE OF EQUITY INTERESTS

- Key law for our purposes: Securities Act of 1933 regulating the initial issuance of securities passed by Congress

- Securities Exchange Act of 1934 regulating the resale of securities passed by Congress

- The SEC promulgates rules and regulations based on these statutes

- Why not a public offering?

SECURITIES REGULATIONS GOVERNING THE MARKETING AND SALE OF EQUITY INTERESTS

- What are the key exemptions?
  - Exemptions under Regulation D
    - Rule 506(b)
    - Rule 506(c)
  - Notice Requirement
- What are state requirements?
  - Must comply with state securities (i.e., "Blue Sky") laws
  - Depending on the circumstances and the state, notice filing may be required
- Restrictions on resale

OPERATION & COMPLIANCE

- In a nutshell, how do I maintain compliance?
  - All units receiving a housing credit must be "rent restricted"
    - Rents may not exceed 30% of a tenant household income
  - To receive any housing credit, certain rent restricted units must then be reserved for tenants falling below a certain income level as determined relative to Area Median Income (AMI)
    - 40/60 = 40% of units must be rented to households earning less than 60% of AMI
    - 20/50 = 20% of units must be rented to households earning less than 50% of AMI
    - 2017 change allow averaging
  - Heating and utility allowances

OPERATION & COMPLIANCE

FY 2019 MTSP Income Limits										
FY 2019 MTSP Income Limit Area	Median Family Income	Income Limit Category	1 Person	2 Person	3 Person	4 Person	5 Person	6 Person	7 Person	8 Person
Burlington-South Burlington, VT MSA	$91,600	50 Percent Income Limits	$32,100	$36,650	$41,250	***$45,800***	$49,500	$53,150	$56,800	$60,500
		60 Percent Income Limits	$38,520	$43,980	$49,500	***$54,960***	$59,400	$63,780	$68,160	$72,600

Source: https://www.huduser.gov/portal/datasets/il/il2019/2019sum_mtsp.odn

OPERATION & COMPLIANCE

- The Relevant Compliance Periods:
  - **10 years**: period over which the credit pays out
  - **15 years**: the credit period during which failure to maintain eligibility can result in credit recapture
  - **The Extended Use Period:**
    - Program must maintain low-income housing commitment during this time
    - Federal minimum: 30 years (15 years after initial 15 years)
    - Perpetuity in Vermont
- Failure to Maintain Compliance:
  - Credit recapture
  - State enforcement; Negatively impact ability to obtain credit allocation in Vermont and other states

OPERATION & COMPLIANCE

- Exiting the project: what if a developer or investor wishes to exit its investment before the 10-, 15- year or extended use periods are up?

QUESTIONS?

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