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Low-Income Housing Tax Credits - Introduction

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Do you have any idea how most affordable housing units get built in the United States? Does the federal government build them or are they built by private developers? The answer is both, but together. In 1986, Congress enacted Section 42 of the Internal Revenue Code which included the Low-Income Housing Tax Credit ("LIHTC"), thus giving an incentive to private developers to develop and rehabilitate affordable rental housing.

A New York Times editorial written in 2012 stated that the LIHTC is responsible for almost 90 percent of all affordable housing units built in the United States. Although it accounts for a large percentage of affordable housing, many developers, investors, and lenders have little knowledge about the program. This article provides an introduction to the LIHTC program; however, it should not be considered a comprehensive guide to the program, as the LIHTC contains many nuances and exceptions that are beyond the scope of this article.

Why Use the LIHTC?

The short answer is that the LIHTC indirectly allows developers to replace debt financing with equity investments, thereby making it feasible and financially rewarding for them to develop affordable housing. For example, without the LIHTC, a typical development would generally be funded through a loan from a lending institution. As the debt service on the loan increases, the rent the developer has to charge its tenants also increases. When a developer can replace this debt service with equity investments that do not have to be repaid, the developer can reduce the rent it has to charge tenants and still create a development that is financially rewarding for the developer and its investor-owners.

How Does the LIHTC Program Work?

Each year the IRS allocates tax credits to state agencies which then use a competitive process, generally described in a state's Qualified Allocation Plan, to award the credits to affordable housing projects. An applicant-developer must abide by the rules of the LIHTC program, including rules regarding rent limits, affordability requirements, and ongoing maintenance. When a project is awarded tax credits, and assuming the developer follows the rules of the LIHTC program, the developer can claim the credits over a ten-year period. Some developers keep the tax credits for their own use, but others "sell" the credits to investors by creating a pass-through tax entity, such as an LLC, in which the investor becomes an equity owner so that the credits can be allocated to the investor in exchange for the investor's capital contribution of funds to the entity. That equity contribution is then used to help fund the project, thereby reducing the amount of debt required.

What Are the Credits Worth?

There are two tax credit rates available under the LIHTC program. They are commonly referred to as the "4 percent rate" and the "9 percent rate" although, as explained below, the actual rates may not be 4 percent or 9 percent. The actual rates are published each month by the United States Department of the Treasury.

Factors outside the scope of this article will dictate whether the 4 percent rate or the 9 percent rate is used, but generally the 9 percent rate is for new construction and substantial rehabilitation projects that are not otherwise subsidized by the federal government. This article will focus on the 9 percent rate.

The amount of tax credits created by a project depends on multiple factors including the project's cost, its location, and the percentage of units that are qualified affordable housing units.

The starting point for calculating the value of the tax credits that can be generated by a project is the project's "eligible basis." As the cost of a project increases, typically the eligible basis also increases. The eligible basis is the amount of depreciable development costs including hard costs and some soft costs. Generally, the design and construction costs are included in the eligible basis, but the cost of the land on which the project is, or is to be, located is excluded. A project's location can also play a role in the amount of the eligible basis. For example, some areas are designated as qualified census tracts ("QCT") or difficult development areas ("DDA"). If a project is located in one of these areas, it may be entitled to an increased eligible basis.

The second step is to calculate the "applicable fraction." The applicable fraction is equal to the percentage of qualified affordable housing units located in the project and is the lesser of (i) the total number of affordable housing units divided by the total number of rental units, and (ii) the total floor space of affordable housing units divided by the total floor space of all of the rental units.

The next step is to calculate the project's "qualified basis." The qualified basis is equal to the eligible basis multiplied by the applicable fraction.

Finally, to calculate the annual tax credit, the qualified basis is multiplied by the applicable tax percentage rate. The total value of the tax credits, since they are claimed over a period of ten years, is equal to the annual tax credit multiplied by ten.

An Example

To illustrate how the LIHTC works, assume a hypothetical project consists of one building with a total development cost of $8 million. One million dollars of the $8 million is the cost of the land and other costs that are excluded from the eligible basis. The number of buildings is important because separate buildings within a project will have separate tax credit calculations. In addition, assume that the building is not eligible for an increased basis because of its location.

The hypothetical project's eligible basis will be equal to the total development cost of $8 million, minus the $1 million of ineligible costs, or $7 million. The building is comprised solely of affordable housing units, thereby making the applicable fraction equal to one (or 100%). The qualified basis is equal to the eligible basis multiplied by the applicable fraction. Since our applicable fraction is equal to one, the qualified basis is equal to $7 million.

The last step in determining the amount of tax credits is to multiply the qualified basis by the tax credit percentage. As stated above, this article is focused on the credit that is commonly referred to as the "9 percent rate." Every month, the United States Department of the Treasury publishes the 9 percent rate percentages which may not, and probably will not, be 9 percent. For example, for July 2014, the 9 percent rate percentage was actually closer to 7.6 percent. If this is not confusing enough, note that at times, laws have been in effect that essentially provide a percentage rate floor that will apply even if the published rate is lower.

For our example, assume that the 9 percent rate percentage is actually 9 percent. Using that assumption, the hypothetical project would have annual tax credits equal to $630,000 ($7 million multiplied by 9%). As stated above, the tax credits are for a ten-year period. Thus, the total tax credits for our hypothetical project would be $6,300,000.

The developer of the hypothetical project will benefit from the tax credits by either (i) taking the tax credits for itself in order to offset its tax liability, or (ii) "selling" the credits to an investor by forming a pass-through tax entity with the investor and allocating the credits to the investor in exchange for a capital contribution from the investor. If the developer sells the credits to an investor, the developer also generally receives a development fee for the project.

The investor will benefit from the tax credits by "buying" the credits for less than the present value of the credits. Said another way, the investor provides a capital contribution to the project that is less than the present value of the entire ten years' worth of credits.

Conclusion

The LIHTC program can provide a financially rewarding vehicle for developing affordable housing. As mentioned above, this article is merely an introduction to the LIHTC. The Internal Revenue Code contains many special rules not discussed herein. Whether you are a developer or an investor, it is extremely important to seek legal advice to ensure that you are abiding by the rules of the LIHTC program and documenting the relationships between and among the various entities involved in a project.

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