What is a LIHTC?

Tax Credit Basics

June 25, 2009

Presented By: Terry Kimm
Principal, Real Estate Consulting Group
Reznick Group
Terry.Kimm@reznickgroup.com
www.reznickgroup.com

Topics to be Covered

- Background
- Credits vs. deductions
- Why & Who of investing in housing tax credits
- How tax credits flow
- Methods of investing in housing tax credits
- Turning the credit into money
- What are the pricing considerations
- Investment Horizons
- New Legislation

Background

- Tax Reform Act of 1986
- Section 42 of IRC of 1986
  - Housing Program in the Tax Code
  - Statute Amended Several Times, Including The American Reinvestment & Recovery Act (ARRA) of 2009
- Objective to Provide Investor Equity
- Credit is a Dollar-for-Dollar Tax Reduction
- Program Administered by Each State’s Housing Finance Agency
- Eligibility is Based on Tenant Income

Credits Versus Deductions

- $1 of <u>credit</u> reduces $1 of taxes owed by $1
- $1 of <u>deduction</u> reduces $1 of taxes owed by the applicable tax rate (i.e. 35%)

Example of Credit Versus Deduction

Reznick Group
Building Business Value

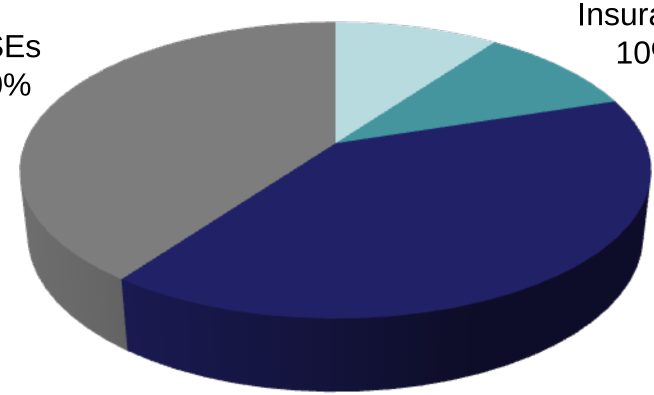
	Taxpayer A Credit	Taxpayer B Deduction
Gross Income	$1,000,000	$1,000,000
Less Deduction		($100,000)
Adjusted Income	$1,000,000	$900,000
Taxes @ 35%	$350,000	$315,000
Less Housing Credits	($100,000)	
Taxes Owed	$250,000	$315,000

Why Invest in Housing Credits

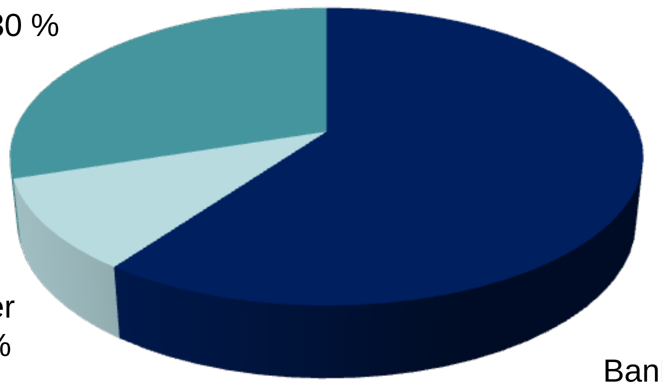
- Provides financial return on investment (credits and depreciation losses)
- Provides financial performance which is similar to bond instruments
- Receives consideration under the Investment Test of the Community Reinvestment Act (CRA)
- Provides safe and affordable housing to residents
- Provides community banks an additional vehicle for their investment strategy

Who Invests in Housing Credits?

<u>2007</u>
(~ $9 Billion Market)

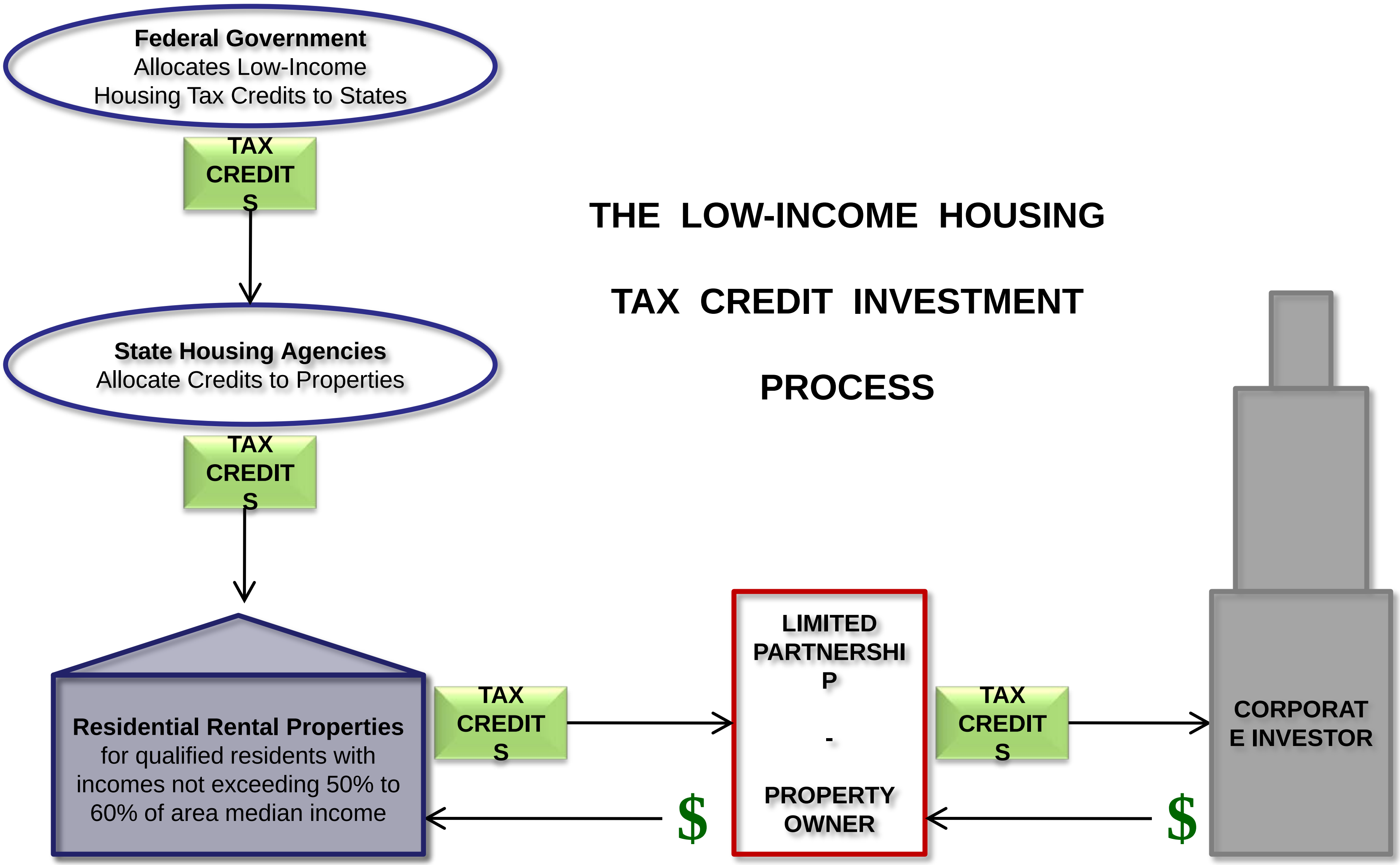


<u>Projected 2008</u>
(~ $5 Billion Market)



How Tax Credits Flow

THE LOW-INCOME HOUSING TAX CREDIT INVESTMENT PROCESS



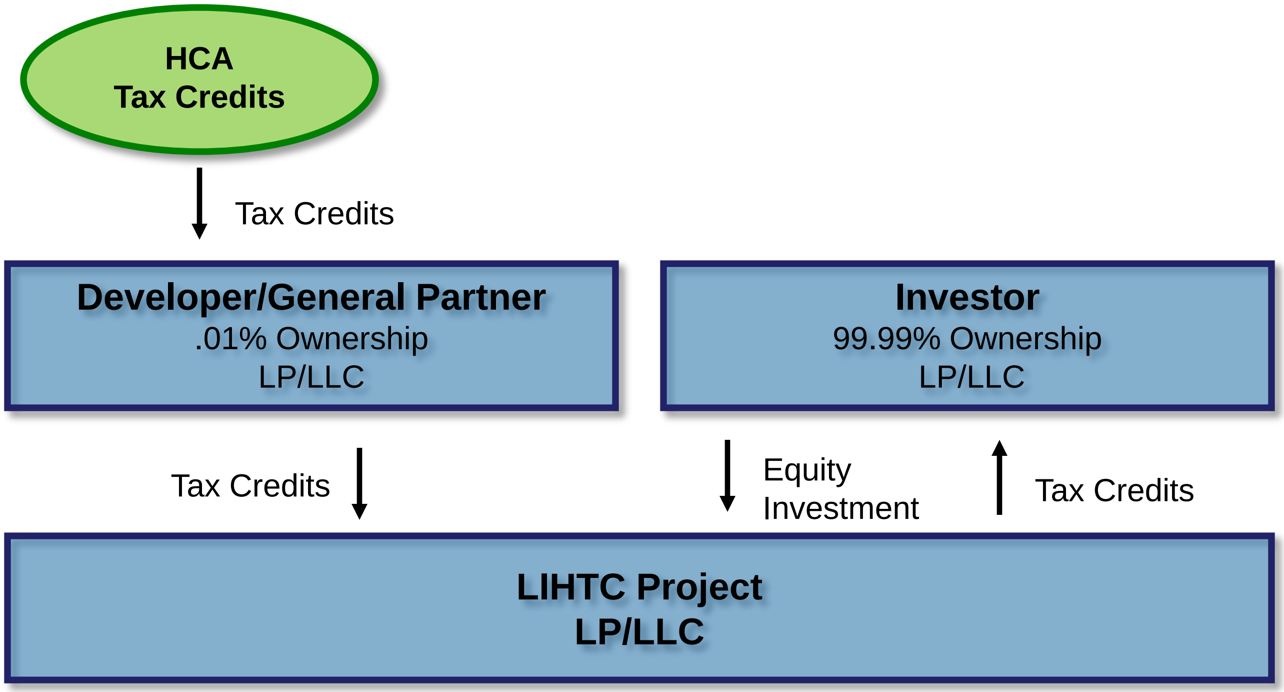
Methods of Investing in Housing Tax Credits

Reznick Group
Building Business Value

- Direct Investment
  - Amount of control vs. resource commitment
  - Higher return via higher underwriting and asset management responsibilities

- Fund Investments
  - Flexible size of investment
  - Lower return via lower underwriting and asset management responsibilities

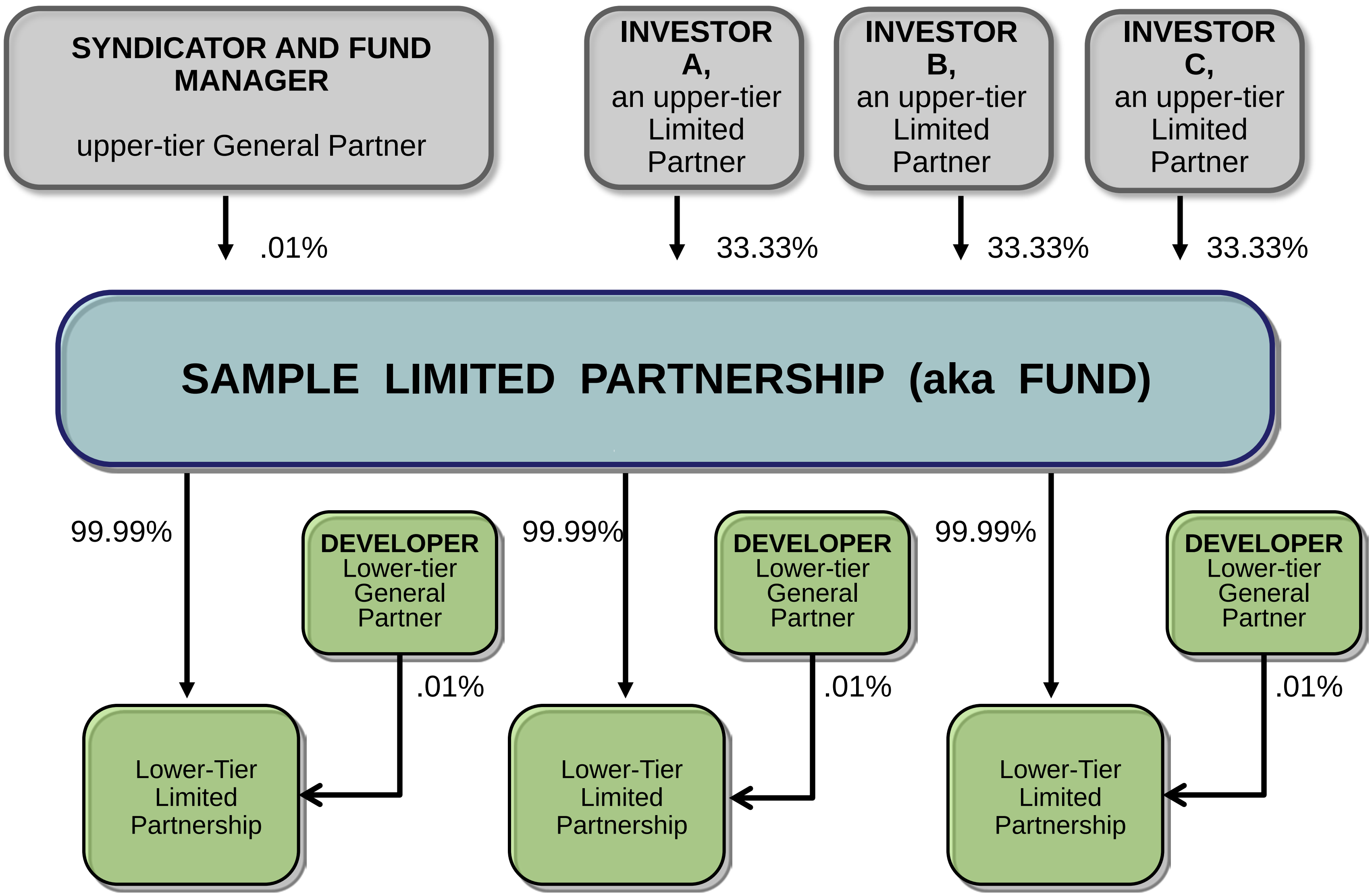
Direct Investment



Flow of Tax Credits and Equity Direct Investment

- Developer receives tax credits from the HCA for the LIHTC project.
- Developer establishes a limited partnership (LP) or a limited liability company (LLC) and is .01% owner of the LIHTC Project LP/LLC.
- Investor acquires 99.99% ownership interest in the LIHTC project, contributes equity to the project, and receives tax credits.

Sample Fund Structure



Turning the Credit into Money

Units	50
Multiplied by Unit Cost (including Land)	$80,000
Total Cost	$4,000,000
Land Cost	($400,000)
Non-Depreciable Expenses	($100,000)
Depreciable Basis	$3,500,000

Multiplied by Tax Credit Rate	9.00%
Annual Credit Amount	$315,000
Multiplied by	10 years
Available Credits	$3,150,000
Multiplied by Credit Price	$0.83
Available Equity	$2, 614,500

Turning the Credit into Money
(continued)

- Pricing Primarily Based on Total Amount of 10 Year Credits Available to Investor and Market Conditions
- Expressed as “Cents Per Tax Credit Dollar”
- In example, if Investor Will Pay 83 Cents Per Tax Credit Dollar, Equity Equals $2,614,500
- The credit is claimed by the owners of the project in the same percentages as they claim depreciation and other tax losses
- The credit investor will be:
  - A 99.99% or 99.9% limited partner or LLC member
  - Generally a widely held C corporation (not subject to passive activity loss and “At Risk” limitations)

Credit Period

- Generally, LIHTC is claimed in equal annual amounts for 10 years
- In the first year, the amount will depend upon when the project is placed in service and what percentage of residential units had tenants in place on the last day of each month
- If the full annual amount is not claimed in the first year, the difference is claimed in year 11

What are a Project's Pricing Considerations

- Timing of the equity investment (pay-in schedule) and the delivery of benefits (credits and tax savings) to the investor
- Desirability of property for CRA purposes
- Strength of development team and guarantors
- Strength of market including net demand from income qualified households and likely achievable rents given income restrictions and asking rents at competing properties
- May the LIHTC's be used to offset Alternative Minimum Tax (AMT)

    -Effective for buildings placed in service after 2007

- Alignment of project yield versus investment target

Simplified Investor Benefits Projection

Year	Equity Capital Contributed	Taxable Income (Loss)	Tax Deductions Earned (@35% tax rate)	Federal Tax Credit	Total Annual Benefit	Net Annual Benefit
2008	(200,000)	(34,286)	12,000	-	12,000	(188,000)
2009	(300,000)	(51,429)	18,000	-	18,000	(282,000)
2010	(500,000)	(94,286)	33,000	110,000	143,000	(357,000)
2011	-	(77,143)	27,000	110,000	137,000	137,000
2012	-	(77,143)	27,000	110,000	137,000	137,000
2013	-	(77,143)	27,000	110,000	137,000	137,000
2014	-	(77,143)	27,000	110,000	137,000	137,000
2015	-	(77,143)	27,000	110,000	137,000	137,000
2016	-	(77,143)	27,000	110,000	137,000	137,000
2017	-	(77,143)	27,000	110,000	137,000	137,000
2018	-	(77,143)	27,000	110,000	137,000	137,000
2019	-	(77,143)	27,000	110,000	137,000	137,000
2020	-	(62,857)	22,000	-	22,000	22,000
2021	-	(62,857)	22,000	-	22,000	22,000
2022	-	(62,857)	22,000	-	22,000	22,000
2023	-	(62,857)	22,000	-	22,000	22,000
2024	-	125,714	(44,000)	-	(44,000)	(44,000)
Total	(1,000,000)	(1,000,000)	350,000	1,100,000	1,450,000	450,000
					IRR to Tax Credit Investor	**7.92%**

Investment Horizons

- LIHTC projects have a 15 year compliance period
- In addition, there will be at a minimum a 15 year extended use requirement
- Recapture rules apply in the first 15 years
- Investors typically exit after 15 year compliance period

New Legislation

Reznick Group
Building Business Value

- Due to lack of equity, the American Reinvestment & Recovery Act (ARRA)of 2009 created two new programs to help fund the equity gap created by the decreased investor pool.
    - TCAP Program
    - Exchange Program

TCAP Program

- Administered by HUD
- 2.25 Billion available nationwide apportioned among state allocation agencies based on 2008 HOME funds apportionment.
- Funds to be distributed competitively pursuant to state's QAP.
- To be distributed to projects that have LIHTC allocations (tax-exempt bond deals are eligible) and need additional funds to complete – GAP filler
- Funds can only be used for capital investment in LIHTC projects – Eligible basis items
- Funds subject to some but not all HOME fund restrictions
- Projects may receive funds as either a loan or grant
- Timing restrictions on use of TCAP funds

Exchange Program

- Administered by Treasury / IRS
- Allows state allocating agencies to elect to receive cash grants with respect to a certain portion of the state's LIHTC allocation
- Grants will equal $.85 per $1.00 X 10 of LIHTC's exchanged ($1.00 exchanged equals $8.50 of grant proceeds)
- Allocating agencies my exchange 100% of prior year credits returned during 2009 and any unused 2008 credit ceiling.
- Allocating agencies may also exchange up to 40% of their 2009 credit ceiling amount.
- Funds must be awarded to projects as grants that will not reduce eligible basis. Grants are not taxable income.
- Projects must show good faith effort to obtain an investment commitment before exchange funds can be awarded
- Section 42 governs as to how awards are made, rent and income limitations and use restrictions.
- Timing restrictions on use of exchange funds