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INSIGHTS

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Gimme Shelter: An Overview on Low-Income Housing Tax Credits for Developers, Investors, and Lenders

Q: HOW DO LOW-INCOME HOUSING TAX CREDIT (LIHTC) PROJECTS PROVIDE AFFORDABLE HOUSING?

CHRISTOPHER S. MCLOON: In a nutshell, LIHTC projects provide housing to people who otherwise couldn’t afford it. To qualify for the federal low-income housing tax credit, a project must rent no less than a certain percentage of units to low-income persons, i.e., a person whose income is no more than a certain percentage of “area median income”. The percentages of units and area median income depend on which test the project uses to qualify for LIHTC. The Department of Housing and Urban Development posts rent limits for each area and qualifying incomes on its website. Those rents are low enough so that people renting are paying rent they can afford without sacrificing other essential needs. As a consequence, tenants get a safe, clean, and decent apartment for a below-market price they can afford.

Q: HOW CAN DEVELOPERS AFFORD TO BUILD SUITABLE APARTMENTS THAT RENT FOR SO LITTLE?

CSM: Low-income housing tax credits help a lot. These credits are valuable to some taxpayers. Those taxpayers make equity investments in the entity that owns the project (usually a limited partnership). In return, those taxpayers are allocated the credits. The capital those taxpayers contribute finance up to 75% of project cost. Since that financing is equity financing, the project loan to value ratio–and the project’s demand for cash to service that debt–are very low. Since the project does not need so much cash to service debt, it can survive while charging below-market rents.

Q: WHO ARE THE PLAYERS INVOLVED IN LIHTC PROJECTS?

CSM: LIHTC projects only work if a lot of people participate. The project needs a developer, a commercial lender for debt financing, tax credit equity investors, and governmental organizations to combine the right mix of bond financing, credit allocations, hard-money subordinate debt, soft-money debt, property tax relief, and credit enhancements. After the project is placed in service and as it is operating, the Internal Revenue Service, Housing and Urban Development, and state agencies monitor the project’s compliance with LIHTC and other financing conditions. To say it takes a village understates the breadth of support and review required to make a project work.

Q: WHY ARE LIHTC DEALS ATTRACTIVE TO BANKS?

CSM: Banks lending money to or investing equity capital in LIHTC projects can benefit from Community Reinvestment Act (CRA) credit. Federal regulations stipulate that banks must invest a certain amount of capital in loans within the community they serve. Our Banking and Financial Services practice can provide current guidance on CRA. In addition, a bank investing equity in a LIHTC project can claim low-income housing tax credits over 10 years. So, if the project is successful, an investing bank could conceivably enjoy three benefits: a steady investment tax credit, CRA credit, and cash flow.

Q: HOW CAN DEVELOPERS DETERMINE WHICH LOW-INCOME HOUSING TAX CREDIT PROGRAM BEST MEETS THEIR NEEDS?

CSM: There are a few ways to obtain low-income housing tax credits. The first is an allocated credit, which is a 9% credit. You would apply to the state housing agency and compete with other projects for those credits. A state’s share of tax credits that it can allocate is based on its population. A second method would be a 4% credit, and would be available if you finance at least 50% of construction costs with tax-exempt bonds. Each program has stress points in making it work, so there isn’t always a clear choice.

Q: DO YOU HAVE ANY TIPS FOR DEVELOPERS, INVESTORS, AND LENDERS INTERESTED IN PURSUING LIHTC PROJECTS?

CSM: Expect to be surprised, but don’t let these surprises deter you. Affordable housing is an intensely important priority throughout the United States. There are many people involved in these deals, and they all share the goal of making the project succeed.

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