Tax Notes

The Life Cycle of Low-Income Housing Tax Credits (LIHTC)

Part 1 – Formation

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The low-income housing tax credit program, or LIHTC as it is called, was created as part of the 1986 Tax Reform Act, specifically in Section 42 of the Internal Revenue Code (IRC). The program establishes restrictions on maximum rents and tenant eligibility in exchange for non-refundable tax credits. These restrictions require that tenants meet certain income thresholds to qualify.

We will take our readers from the LIHTC formation stage to the development phase and, finally, to the occupation period noting the various legal requirements and constraints along the way.

Formation

The life of a LIHTC begins with its development. The property can be one built specifically for low-income housing with the additional objective of attaining tax credits or can be an existing property which is undergoing extensive rehabilitation to bring new life to low-income housing accompanied by tax credits.

The Sponsor

This initial planning all starts with a Sponsor. The Sponsor is the driving force behind getting these rental units constructed or rehabilitated. Sponsors are often not-for-profit organizations with missions that encompass low-income housing. The Sponsors have the passion to make such housing available.

We now move on to those entities with the means to build these projects; namely, the Investors. Investors have choices – so why invest in properties where the rents are capped and the tenancy restricted?

Tax Credits

This is where the LIHTC program comes into play. The tax credits issued are used to entice investment in these properties. There are two basic types: 9% and 4% credits.

Each state is allocated a stipulated amount of 9% credits annually by the federal government. The appointed state agency administers the tax credit allocation process on a project level. A few states actually have multiple credit agencies due to their large population centers. In New York, for instance, there are two agencies – New York State Homes and Community Renewal (HCR) and the New York City Department of Housing ouHPreservation and Development (HPD).

The 4% credits (also known as Bond Deals) are supported by Municipal Tax-Exempt Bonds issued – and not federal tax credit allocations. The appointed state agencies administer the tax credit allocation process for these types of credits as well.

Beyond the tax credits, Investors in these properties receive pass-through losses to offset other income.

Many Investors in LIHTCs are banks. The Community Reinvestment Act requires financial institutions to “invest” in the communities in which they have branches. This is why a large number of the Investors are banks like RBC, Boston Financial, PNC.

The Syndicator

So, let’s go through a basic set up for a LIHTC development.

We have already addressed the Sponsor. It is the Syndicator who connects the Sponsors to Investors and keeps this whole process running. You'll often hear references to Enterprise, NEF or Richman Group – these are just a few major Syndication Entities on the east coast.

The Syndicators form Limited Partner Entities. These are the "Investors." They are limited in their liability for debts/obligations of the properties and have limited control over the operations of the property. They provide equity money for the development.

Where there's a Limited Partner, there also needs to be a General Partner or Managing Member. (We will use these terms interchangeably.)

General Partners are for-profit entities (typically owned 100% by the Sponsor). General Partners have control. With that control comes responsibility. They can legally bind the partnership and are liable for the debts and obligations.

Now we have two partners. When we join the two, we create a partnership. Each of these projects is set up as a limited liability entity – either a Limited Partnership (commonly referred to as an "LP") or Limited Liability Company ("LLC").

The partnership entities are formed to develop/rehabilitate, own and maintain properties designated for rental to program-qualified low-income individuals. Typically, these entities are owned 99.99% by Investors and 0.01% by General Partners.

Although they do not have direct control over the partnership, the Investors still want to monitor the operations. Quarterly compiled reports and annual audited reports are key pieces of that monitoring.

Many times, in conjunction with LIHTC, HUD funding will be used to subsidize the development and operations of the property. This can be in the form of mortgages or rental subsidies, such as project-based Section 8.

You probably associate HUD subsidies with not-for-profit entities, but they can be a key part of for-profit projects. Affordable housing in all its forms is very similar.

At this point, the Sponsor and Investors have gotten together, they have their plan – now on to development!

Contact Us

We have taken you full circle – from Development to Operations to Year 15 – of the low-income housing tax credit program. If you have any questions or need additional information, please contact the partner in charge of your account or Partner Jennifer M. Galasso at jgalasso@pkfod.com.

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