BedfordLending

LIHTC & HUD Overview

The Low-Income Housing Tax Credit (LIHTC) program was enacted in 1986 and is run by the US Treasury Department and State Finance Authorities. LIHTC is the federal government's primary program for encouraging the investment of private equity in the development of affordable rental housing. Since its creation in 1986, LIHTC has helped finance more than 2.5 million affordable rental-housing units for low-income households.

HUD financing (debt) can be combined with LIHTC (equity) to:

- Cover 100% of cash required at closing, provide a Developer's Fee, and pay for HUD escrows required during construction (i.e. for operating deficits and construction contingencies).
- Qualify for streamlined HUD processing, which typically reduces processing time by up to 2 months.
- Remove limits on secondary financing.
- Secure reduced HUD processing fees.
- Secure higher leverage (including a smaller vacancy factor) in underwriting.

How does it work?

LIHTC (pronounced lie-tech) is an indirect federal subsidy. To promote affordable multifamily housing, the IRS allocates tax credits each year to State Finance Authorities and developers subsequently apply for an allocation of these credits for their project. 4% credits are lower leverage and non-competitive. 9% credits are higher leverage and competitive.

Googling [Your State Name] plus "QAP" or Qualified Allocation Plan will provide more guidance on the application process and guidelines in your area.

Investors are eager to purchase tax credits as they can provide a substantial return on investment. See the following chart for a hypothetical transaction:

Project Budget/Total Cost	$10,000,000
Amount of LIHTC Credits allocated by State Housing Authority towards project	$4,000,000 (Assuming a 4% LIHTC Scenario)
Investor Purchase Price of Credits	**$3,600,000** (Estimated 90 cents per credit)

This $3,600,000 figure is the equity delivered to the project. Essentially the investor is contributing that money towards the project, but receiving the full $4,000,000 amount as a federal tax credit. In addition, the investor is allowed to recognize the project's real estate losses such as depreciation and interest expense, and *derives* income from these losses.

Structure

The investor and developer form a formal partnership as part of the LIHTC transaction. This structure allows tax credit benefits and real estate losses to pass through to the investor. While having an ownership interest, the investor typically has no management authority, and the developer typically retains the majority of the cash flow.

Investors typically leave the partnership in years 11-16 because they no longer receive tax credits. At this point the general partner secures 100% ownership of the project.

LIHTC can be a win-win-win, as the developer receives equity and a fee for completing the project, lower income households secure quality housing, and the investor receives a substantial return on their investment.

Of note, if the project site is in a particularly difficult economic area (Google "DDA" or "QCT"), the developer potentially qualifies for an even greater amount of LIHTC equity. Also the project must remain affordable for at least 30 years, regardless of whether the tax credit partner leaves or not.

Rent Restrictions

Unlike *subsidized* properties that carry tenant vouchers or rental assistance contracts, LIHTC properties do not receive a direct government rental subsidy. A tenant's rent cannot exceed 30% *of* a certain percent of the area's median income (typically 40-60%), and rent is paid directly to the owner of the property. Rents can be determined online using tools like the "Novogradac LIHTC Rent Calculator".

Projects with LIHTC *can* use Section 8 vouchers for rental subsidies if desired / available, and "income averaging" can be completed to have some rents higher than others as long as on an average the project is complying with rent limitation guidelines.

Reasons Not to Go LIHTC?

LIHTC is not "free" or "easy" money. The investor partner that will partner with you will be very conservative and will even dictate to us or other lenders how we should underwrite (vacancy factors, debt coverage ratios, etc). LIHTC investors generally only want to work with established, well capitalized individuals as they don't receive their return on investment for a decade.

Special consideration should be given to the dissolution of the partnership in year 15 - how you structure a LIHTC deal up front can make all the difference when it comes to the investor partner leaving. If not structured carefully, this can become a major challenge down the road.

In markets with strong demand, restricting your income and engaging in a 15 year partnership with the tax credit investor may provide a lower return on investment than developing a traditional market rate project. In addition, the tax credit process is dependent upon working with the State Housing Authority to receive an allocation of credits. Some states can be more difficult to work with than others. The process also requires significant soft costs to structure, which typically makes LIHTC unfeasible for smaller developments or inexperienced developers.

Case Study – *New England Apartment Construction project*

An experienced developer approached Bedford Lending to assess the construction of a new market rate apartment project in New England using our 221(d)(4) Program. Rents in the market were reasonably strong, however they could not support current construction costs and the deal required $7,600,452 in equity at closing which made the project unfeasible.

Bedford Lending completed a second finance analysis using our 221(d)(4) program with LIHTC. We used the same construction costs and projected expenses and lowered rents to comply with the LIHTC affordability requirements. Under the new structure the client did not have to bring in any equity, will receive a $1,216,000 Developer's fee and a sizable construction profit. The following chart compares the key metrics of the transaction:

	Market Rate	LIHTC
NOI	$ 1,253,359	$ 1,197,149
HUD Mortgage Amount	$ 18,083,000	$ 18,626,973
Equity Required at Closing	$ 7,600,452	None
LIHTC Equity	None	$ 8,567,503
Developer's Fee	None	$ 1,216,000
Cash Flow	$ 188,007	$ 155,684
Cushion*	None	$ 1,221,935

*The cushion is the amount a project's construction cost could increase (or LIHTC equity decrease) without impacting the Developer's Fee.

If you are curious why the mortgage amount under LIHTC is higher than market rate even though the total revenue is lower in the LIHTC scenario, it's because HUD increases the loan to cost, decreases the vacancy factor, decreases the MIP, and boosts other metrics in underwriting for affordable transactions as an incentive to develop affordable housing.

In addition to the debt provided with our direct HUD loans, Bedford Lending facilitates the entire bond transaction for our clients at no additional fee. Bedford Lending is the principal contact and coordinates with all parties to ensure an efficient process. BLC has been a direct HUD lender for 25 years and our principals average 30 years' commercial finance experience.

Please contact us today to learn more.

Kyle Jean
kylej@bedfordlending.com
603-647-4646