The Low Income Housing Tax Credit for Nonprofits Developing Rural Rental Housing

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The Low Income Housing Tax Credit (LIHTC) provides an incentive for private, profit motivated entities to develop affordable housing. Structuring a development project to use the tax credit is complex, but may well be worthwhile. This Funding Summary provides only very brief introductory material about the tax credit. To evaluate potential tax credit funding for a specific project, perform detailed calculations, carry out the syndication process, develop a project, and then manage it, the would-be developer will want not only to learn more about the tax credit but also to acquire the services of experts such as an accountant, an attorney, and perhaps a syndicator.

PROGRAM BASICS

The LIHTC, adopted by Congress in the 1986 Tax Reform Act, is a reduction in the dollar amount of federal taxes owed by an individual or corporation, in exchange for his/her/its investment in low-income rental housing. The amount of tax reduction is tied directly to the proportion of low-income persons among the residents of the housing produced. To obtain the tax reduction, an investor provides the cash – called capital or equity in development terms – that will be used to help develop the project. The investor has no role in the development process or the management of the project after it is rented up. A for profit or nonprofit developer does those tasks. The investor receives a tax credit paid annually over a 10-year period and cannot withdraw his/her/its investment for 15 years.

ELIGIBLE ACTIVITIES

The tax credit program provides funding for two types of rental housing development: construction of new buildings or substantial rehabilitation of existing buildings. New construction can produce single-family houses, apartment buildings, duplexes, rowhouses, or townhouses. Rehabilitation can be performed on these same types of buildings, and conversion of structures like warehouses, schools, and motels is also possible.

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PROJECT REQUIREMENTS

The value of the tax credit depends on the type of financing used. A larger credit is provided for development that does not use federal financing (except for the HOME program in some situations). For projects with federal financing, the tax credit is approximately 4 percent of development cost, excluding land; for projects without federal financing, it is approximately 9 percent.

A tax credit project can be partly occupied by households that are not low -income. However, the incentive is structured to encourage low-income occupancy by increasing the amount of credit for a higher proportion of low-income residents or for lower incomes of the residents. The tax credit provides investment benefits only for the amount of investment attributable to the portion of the building occupied by low-income tenants.

The project must comply with the chosen income levels, and with certain rent limitations, for at least 15 years. Because the tax credit's benefits are tied directly to the characteristics of the tenants, management of a tax credit project throughout the credit's 15-year term is a vitally important function. Of course, if a project receives financing from a program or a lender that imposes stricter tenant income requirements or longer use restrictions, it must comply with those provisions as w ell as the LIHTC provisions.

While the investors' benefits from the Low Income Housing Tax Credit are provided by the Internal Revenue Service, states bear most of the responsibility for administering the tax credit program itself. Each state must set aside at least 10 percent of its credit allocation for projects developed by nonprofits.

Syndication is the process of selling the tax credits to investors and thus raising capital for a project. The nonprofit developer that holds the tax credit allocation can solicit the market for the best price and terms to generate cash for project development. Most often, investors or investor funds will seek out the holder of the tax credit instead. A syndicator may be contacted by either party and works as a professional to bring investors and nonprofit developers together. A nonprofit – particularly one that has served as a general partner in a tax credit deal – may receive calls from syndicators or potential investors looking for general partners and tax credit projects.

BENEFITS FOR NONPROFITS

Nonprofits are exempt from paying income taxes, so the tax-related values of the tax credit are meaningless to them. However, there are other benefits for a nonprofit organization in a tax credit project, including:

- opportunity to develop the project – the tax credit brings to the development process various players that might not otherwise come together, assisting nonprofit groups that do not have enough staff knowledge, capacity, or seed capital to develop a project alone;
- leverage for financing;
- fees for the organization to cover overhead costs – once a property is developed and syndicated, the general partner (the nonprofit) should receive a developer's fee, a property management fee (if it manages the property), a partnership management fee, and an incentive management fee;
- opportunity for project ownership – usually the nonprofit developer will have an option to purchase the project at the end of the 15-year tax credit compliance period, creating permanently affordable housing;
- publicity to help raise funds; and
- opportunity for property management.

RISKS FOR NONPROFITS

Like any development process, the tax credit market involves risk. For example:

- A syndicator representing funds that are not yet sold to investors may provide a verbal commitment but not be able to carry through with the arrangement.
- There are standard risks associated with any real estate deal. The strength of the real estate market, the financial viability of the nonprofit developer, the experience of the developer and other factors can determine the pricing a nonprofit group will receive.
- Poor forecasting could result in inadequate revenues to carry debt service, leading to project decline or foreclosure and thus to loss of the tax credit.
- Uninsured losses such as natural disasters could destroy the property and with it the tax credit.
- If the rate of low-income tenancy changes, the tax credit could be lost or tax credits could be recaptured.

Some risks can be avoided by an experienced attorney and/or consultant making sure the partnership is properly set up. The partnership agreement should include provisions about title insurance, fire and casualty insurance, contractor bonding, vacancy limits, guarantees, and other language that generally minimizes risk.