Financing For-Sale Housing in Distressed Communities: NMTCs and Beyond

Building for-sale affordable housing in economically distressed areas is a challenge that many for-profit and nonprofit developers face and a key hurdle is gaining financial equity. One method is the use of new markets tax credits to finance such housing and in today's Tax Credit Tuesday, Michael Novogradac, CPA, and Novogradac partner George Barlow, CPA, discuss the issues and opportunities related to such financing. They begin by talking about possible sources for such housing, then discuss the requirements for NMTC-financed for-sale housing, who is involved in this and where it works best. They also discuss how and when to contact a community development entity, significant tax issues and more.

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Transcript

Introduction

[00:00:09] **Michael Novogradac, CPA:** Hello, I'm Michael Novogradac, and this is Tax Credit Tuesday. This is the May 30th, 2023, podcast.

We frequently talk on this podcast about affordable housing, and when we use the term affordable housing, we're generally referring to apartments rented to low-income tenants at restricted rent levels. These properties are nearly universally funded with equity from the low-income housing tax credit and/or through funding from the Department of Housing and Urban Development. That said, there is another type of affordable housing and that's for-sale housing that's affordable to low- to moderate-income owners.

This type of housing is often located in economically distressed communities and nearly universally also requires some nontraditional funding sources. In today's podcast, we're going to discuss for-sale housing in distressed communities and we're going to look at various funding sources with the central focus of today's Tax Credit Tuesday being the use of new markets tax credit equity to close financing gaps.

Now for some listeners, the use of new market tax credits to finance for-sale housing might be a bit of a surprise. Traditionally, new markets tax credit equity is used to fund investments in or loans to operating businesses, commercial real estate and construction in qualified census tracks.

Furthermore, residential rental real estate is generally an ineligible business. Now, I say generally because there is a key exception and many of our listeners know that would be for mixed-use rental developments.

That said, new markets tax credits can finance a construction or renovation of for-sale homes, and that's what the purpose of today's podcast is.

Now, if you do plan on using new market tax credit financing for residential real estate, there are additional nontax-code related limitations that are put in place by the CDFI fund, with the CDFI Fund being the allocator of the new market tax credit allocation issuance authority. One such requirement is that at least 20% of the total housing units that are financed by new market tax credits must be maintained as affordable housing units. And that comes with some specific definitions, which broadly mean that the properties are affordable to households with income equal to or less than 80% of the area median income. Furthermore, those households should pay no more than 30% of their income for the housing.

Now, my guest today is George Barlow, partner in Novogradac's Dover, Ohio office. George is active in the new markets tax credit space, as well as working with clients in the historic tax credit, renewable energy tax credit and opportunity zones arenas. George has help clients use the new market test credit to help finance for-sale housing for most of his career. So, he is an expert in this area and will share his experiences and insights in developing for-sale housing in distressed areas.

In today's podcast, we'll begin by looking at various sources of financing for for-sale housing. Then we'll look at the requirements for doing so with new market tax credits, followed by discussion of who does this type of financing and areas in the country where it works best. After that, we'll look at when a developer should begin working with a community development entity, and that is the entity that controls the new markets tax credits, and then we'll wrap up with some specific issues that developers should consider if they're working in this area. There's a lot to talk about, so if you're ready, let's get started. George, welcome back to Tax Credit Tuesday. It's been about a year and a half since you were last at guest. It's good to have you back.

[00:03:45] **George Barlow, CPA:** Thank you, Mike. It's great to be here.

[00:03:48] **Michael Novogradac, CPA:** So, in this podcast, the financing source we're going to spend the most time on is using equity for new markets tax credits to finance for-sale housing and we'll get into more of those details in a bit. But the new market tax credit, as I mentioned in the intro, is just one of several sources of financing that make up the financial stack when you're financing for-sale housing.

I was wondering if you could explain some of the other sources, or list some of the other sources of financing for for-sale housing, as well as explain some of the challenges in using these other types of financing with new markets tax credits.

Financing Sources, Challenges

[00:04:21] **George Barlow, CPA:** Sure. The financial stack can include equity, loans, charitable donations, state and local grants, state new markets tax credits and donated labor.

Transactions can be financed with any of these sources without federal new markets tax credits, but it becomes more difficult. The federal new markets tax credits provide a subsidy to the project to help offset the increased construction costs that the industry has been in experiencing over the last few years.

Some challenges combining these financing sources with the new markets tax credit include collateral issues, donated labor not being an expenditure for the business and supporting prior expenditures, which can be used as leverage for the new markets tax credit transaction.

[00:05:15] **Michael Novogradac, CPA:** So, as I mentioned in the intro, many don't usually think of the new market tax as a tool to finance for-sale housing. I was wondering if you could provide a high-level overview to our listeners as to how new markets tax credit can be used to support for-sale housing and also maybe discuss some of the restrictions developers face when they use new market tax credit financing.

[00:05:36] **George Barlow, CPA:** The developer or a portion of a business of the developer will receive a qualified low-income community investment, or QLICI, which they will use the loan proceeds to pay for construction costs to build the houses. The QALICB then sells a home to a low- to moderate-income family, typically at a reduced price. Some developers provide a discount and rely on the families to obtain third-party financing for their mortgage. Where other, typically nonprofit, developers will provide a first and second mortgage where the second mortgage can be forgiven at a later date under certain stipulations. Some of these conditions could be that they donate some of their time and labor to build other houses that their stay current on their payments and stay in the home. In order to qualify, the QALICB must satisfy the tangible property, employee services, gross income, collectibles and nonqualified financial property tests for the compliance period. Additionally, they must meet the active standard. And to do this, they have to build and sell at least one house for the seven-year compliance period. Many projects use the portion of a business rules to satisfy these tests as there can be times where the developer would hold too much cash or they might have tangible assets that are outside of a low-income census tract.

[00:07:16] **Michael Novogradac, CPA:** Great. Thank you for that. And when I think about the new markets tax credit financing for for-sale housing, you mentioned QLICIs, and for the less informed listeners, that's qualified low-income community investment, and that's the loan or investment that the CDE makes in the qualifying business. And the qualifying business ends up being the developer.

So, the developer themselves are the qualifying business, and that's where you get into the QALICB rules, qualified active low-income community business rules that George was mentioning, in terms of the developer being the qualified active low-income community business with ultimately the homeowner buying the homes from the developer. And there's various ways in which the new markets tax credit subsidy finds its way to the end-user, homeowner. And we can maybe talk about that more in a bit if we have time, but I thought it'd be useful, we talk about qualified active low-income community business. We talk about qualified low-income community investment, QLICI and QALICB. They both have low-income community in their title which is a bit of a foreshadowing as to the geographic restrictions that apply when you're using new market tax credits to finance for-sale housing. So maybe you could elaborate on this low-income community requirement or general requirement.

Meeting 'Low-Income' Requirements

[00:08:38] **George Barlow, CPA:** Sure. So, to qualify the houses, the tangible property, which is going to be a house in this case, must be located in a census tract that has at least 20% poverty or has a median family income that does not exceed 80% of the statewide median family income. Now to further expand upon it, in order to obtain allocation, many CDEs check the box and they're looking for severely distressed census tracts.

And so to give yourself the best chance of obtaining allocation, you might want to go to the level of severely distressed census tracts and they usually get preference from community development entities. In order to qualify as a severely distressed census tract, you have to have poverty rates greater than 30%, your median family income for the census tract cannot exceed 60% of the statewide median family income or you can have unemployment rate that's one and a half times the national average.

[00:09:48] **Michael Novogradac, CPA:** S I think what you're discussing here is that there's the federal rule as to eligible areas that technically become low-income communities for purposes of the QLICI and QALICB definitions, but as part of the competition process, the CDFI Fund encourages commitments to deeper distressed. And as a practical matter, if you're a developer out there, you need to be in one of the deeper distressed communities to get a CDE interested in using their allocation for your development. Would you agree with that?

[00:10:16] **George Barlow, CPA:** Yes, exactly. Thank you for further expanding upon my explanation.

[00:10:21] **Michael Novogradac, CPA:** Now, I hinted at generally you have to be in this type of geographic area, but there's probably a listener saying, well, Mike, why did you say generally? Or they might be thinking that they have a for-sale development that's not located in a distressed area as you just described, and you and I both know that all is not lost. There is a more nuanced option if you're not geographically located in a distressed community. So, if you could explain that alternative at a high level to our listeners.

[00:10:54] **George Barlow, CPA:** Yes, they can potentially qualify under the targeted population rules. In order to qualify, at least 50% of your homes that you're selling must be to low-income individuals and those houses must be located in census tracks that do not exceed 120% of the statewide median income.

There are additional compliance requirements when you're doing targeted populations, but I know in the past we've had specific podcasts on targeted populations, and I would suggest that listeners go back to that podcast.

[00:11:32] **Michael Novogradac, CPA:** Yeah. We did do a podcast on targeted populations with our partner Bryan Hung and not that many months ago. So, I'll include a link to that podcast in today's show notes. But as always, if you just said target populations, Bryan, Novogradac, Tax Credit Tuesday, I

suspect Google will bring it up. I mentioned earlier that using new markets tax credits for for-sale housing, it's not that common, at least not that common yet. So maybe be useful if we share with our listeners who some of your typical clients are here.

Who Builds These Homes and Where?

[00:12:05] **George Barlow, CPA:** I mostly work with nonprofit developers. I've successfully closed many transactions with Habitat for Humanity affiliates. I've closed several with for-profit developers. They typically have a philanthropic interest as well as part of the transaction. Smith NMTC Associates is a consultant and a client of mine that has obtained allocation, closed and provides compliance services to many for-sale housing transactions. They have lots of experience and they, in my opinion, provide excellent service which result in a quick, efficient new markets tax credit closing.

[00:12:50] **Michael Novogradac, CPA:** Yeah, I'm glad that you mentioned Smith NMTC Associates and we'll discuss more about our upcoming conference, but I do expect that they'll be at our upcoming conference in Washington, D.C., in June. If you're interested in meeting with them in person, that might be a great venue for you. But getting back to the purpose of the podcast and not talking about the conference, if I'm thinking of, if I'm a developer listening to this podcast or know of a developer listening to the podcast, and I'm trying to decide if my development might be appropriate for this type of financing or at least a portion of my development, one of the questions that would come to my mind is, well, how many homes are typically involved in a single new market tax-credit financing? So maybe you could describe that.

[00:13:36] **George Barlow, CPA:** So, in my experience, typically between 10 and 50 homes that each developer uses in a transaction. The main threshold is you need to be able to use your QLICI proceeds within 12 to 18 months from the closing. It is common for several developers to combine together into one closing of new markets tax credits. It helps gain economies of scale and minimize the transaction cost. I have done a few projects here or there where they are using condos and larger buildings that will reduce that number. But the most common is the single-family housing and 10- to 50-unit houses.

[00:14:26] **Michael Novogradac, CPA:** We discussed earlier how generally speaking, unless you're using target populations, the development has to be within a low-income community, which is a geographic designation. But beyond those specificities, I suspect there are other attributes to a geography that make for-sale housing new market tax credit transactions more attractive to developers who developing entities and investors. So maybe you could discuss some of the broader geographic indicators that might make this type of financing more achievable.

[00:14:59] **George Barlow, CPA:** I believe it can work anywhere, but it seems to be most successful in locations with housing shortages and available land. Popular projects are located in some of the underserved states, referenced in the new markets tax credit application.

[00:15:20] **Michael Novogradac, CPA:** Just to unpack your reference to underserved states a bit, the CDFI Fund ends up identifying certain states that are underserved in the sense that they haven't gotten as much new market tax credit allocation proportionately as other states as a consequence CDEs that are going to agree to serve those states will be looking for developments in those states and investments in those states, so it gives you a leg up if you have a development in one of those states because you're going to be that much more attractive to the CDEs. And the one thing about using new market tax credit financing or seeking new market tax credit financing for for-sale housing, as with any community development project, you have to first come up with a project that's financially feasible but for the new market tax credits and then you also have to find a CDE that's willing to use their new market tax credit allocation for your development. And we all know that new market tax credits are way oversubscribed. We need to get increases in the allocation available, but until we do, there'll be this ongoing competition. So, you'll need to be as attractive as possible to attract a CDE.

Making Contact with a CDE

Which brings me to my next question. If I am a for-sale housing developer or I have a development or know of one and I'm thinking of using new market tax credit equity in my capital stack, I just heard, they just heard me say, how you have to attract a CDE to want to finance your development. So what, or not so much what, but when should developers be reaching out to CDEs to try to save new market tax credit financing? Because there's always this gap between the CDEs want to use the financing once they get an award, they want to get the money out as quickly as possible. These types of developments take time, CDEs make commitments during the application phase. Maybe you just describe the process that a developer should be thinking about if they want to use new market tax credit financing and haven't approached to CDE yet.

[00:17:21] **George Barlow, CPA:** I would suggest they get started as early as possible. You should connect with CDEs that have a service area in your location. Talk with them about the benefits and your projects in the pipeline so that you can get, potentially get listed in their application and listed in their pipeline of transactions, so if they do get a new markets tax credit allocation that they can provide it to your project.

[00:17:55] **Michael Novogradac, CPA:** Yeah. It's, as they say, never too early. It's never too early to start. I would just echo that in terms of going, getting to the CDE early in the process and once you get another pipeline, that means you're going to be a year-plus away from when they could actually finance your development. So it is very early in the pipeline and if you are wondering which CDEs to reach out to, feel free to reach out to George and he can help give you some names of CDEs that might be interested in your developments.

So now the next question runs a risk of adding really, really wonky and I love wonk. I love tax wonky, but let's not get too wonky here, but I do think we should touch upon some of the major tax issues that

are involved when new market tax credits are used to finance for-sale housing. So if you could just describe three or four of some of the major issues. And once again without getting too wonky, but because I'm sure some listeners are who are already familiar with the market tax credits might have some questions on that front.

Major Tax Issues

[00:19:04] **George Barlow, CPA:** Sure. The first one I'd say is the leverage structure. Just knowing what sources you have for leverage and having differentiation between a leverage lender and your project, so it'll be respected.

The second one specific to for-sale housing is a lot of times there's volunteer labor and dealing with how to measure those costs and whether they can be included or not. And then the third one, and deal more with on the compliance side, as I mentioned early in the podcast, but the non-qualified financial property can trip up a transaction and thinking about having enough expenditures within 18 months to use your QLICI proceeds so that it does not trigger this non-qualified financial property test.

[00:19:56] **Michael Novogradac, CPA:** Thank you for that. And what portion of the businesses that you work with on for-sale housing, would you say, just roughly percentage wise, would you say the developer is providing some degree of carryback financing to the buyer?

[00:20:16] **George Barlow, CPA:** I would say 75% or so.

[00:20:21] **Michael Novogradac, CPA:** So, it's a high percentage?

[00:20:22] **George Barlow, CPA:** Yes.

[00:20:23] **Michael Novogradac, CPA:** Carryback financing, and I won't reveal all the ins and outs here, but many listeners may be looking at that and saying, are those loans non-qualified financial property? And you and I know they're not. But if you want to know more details on how that works, give George a call.

So this is an interesting topic. Thanks for joining me on the podcast to talk about for-sale housing financing, particularly with respect to new market tax credit financing. We obviously just skimmed the surface today. To our listeners, I will provide George's email address in today's show notes. If you any questions, you can email me at cpas@novoco.com. George, before I wrap up, is there anything else you wanted listeners to know?

[00:21:14] **George Barlow, CPA:** Yes. I work on and close several of these every year and if anybody's interested in doing one or has a potential transaction, I happily would provide the financial forecast that's needed to close a transaction. I traditionally do compliance AUPs, whether it's targeted or standard QALICB requirement AUPs. I do tax returns for some of the leverage lender entities that are

involved in the for-sale housing, new markets tax credit transactions. And also I wanted to remind everybody if our New Markets Tax Credit Conference in Washington, D.C., June 8-9. I will be there and would be glad to talk with you if you are thinking about or have a for-sale housing transaction.

[00:22:05] **Michael Novogradac, CPA:** Great, thank you. And thanks for mentioning the new market tax credit conference. It'll be a lot of great information to share and it's always a great opportunity to network and it's particularly useful in the new market tax credit community to get introduced to more CDEs and fellow developers, investors, leverage lenders and the like.

Switching topics for a moment to our listeners, please be sure to tune into next week's podcast with Peter Lawrence, who's Novogradac Director of Public Policy and Government Relations. He will join me to talk about the Affordable Housing Credit Improvement Act of 2023. That legislation was recently introduced, and Peter will be to talk about the low-income housing tax credit provisions contained within the legislation. He'll also talk about, and this might be more important to many listeners, what are the chances that portions of the bill will be included in other tax legislation this year. If you're involved in affordable housing, this is a chance to get a better understanding of what's happening in Washington D.C., with the low-income housing tax credit and where we're headed this year.

Plus, if you have any questions you suggest we cover in that episode, please email me at cpas@novoco.com.

Off-Mike Section

So George, now I'm pleased to have reached our Off-Mike section where I get to ask you for some fun, off-topic recommendations or get you to share some words of wisdom. One question that I enjoy asking my guests, because I always learn from them, is what is the best leadership lesson you've learned?

[00:23:36] **George Barlow, CPA:** That would be know when to delegate tasks. This is something I still struggle with in getting correct all the time. But I keep trying to improve each year. Sometimes it's difficult to delegate everything, but for the most part, you should be able to delegate a lot of your tasks and you have a limited amount of time and you have to leverage with your employees as much as possible.

[00:24:08] **Michael Novogradac, CPA:** Thank you for that, George. That's one of my challenges as well is to delegate more. Most things can be delegated and sometimes I think I can't delegate something when, if I'm prodded, I'll realize I can delegate it, which is also a bit of a lesson. Kind of the inverse of that is to go to others, particularly if there's a reporting structure. Like if you have a manager or a principal, senior staff for them to go to you and ask for the task. So if you can train your team to encourage you to delegate, it can help you delegate some of the tasks that maybe you're not aware that you could be delegating because you haven't identified it yet.

So, you've been practicing as a CPA long enough to have a pretty interesting perspective on a career as a CPA. What would you say is the most important thing that you know now that you didn't know at the start of your career?

[00:25:09] **George Barlow, CPA:** I would say building rapport is important, and whether that be co-workers, clients, potential clients, I used to always think people would prefer just to get to the point, get down to business. I always assumed that everybody was busy and just want to get to the point. But I've read some research and papers saying that's not the case. That developing a rapport, getting to know people, that you're more successful and you just have improved outcomes once you build rapport.

[00:25:42] **Michael Novogradac, CPA:** No, that's a great idea. Plus, there's so many things that you can analyze and solve and optimize when you're having a dialogue back and forth that you don't necessarily get when you're in your lab by yourself. So it's not a surprise that the research that you've seen shows that building rapport can lead to better outcomes.

So, thank you, George. And to our listeners, I'm Mike Novogradac. Thanks for listening.

Additional Resources

Email

George Barlow

Conference

Novogradac 2023 Spring New Markets Tax Credit Conference

Previous Podcast

June 7, 2022: Why QALICBs, CDEs Should Consider Qualifying for Targeted Populations