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Special Comment

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Using Low Income Tax Credits In Affordable Housing Deals: Two Sides Of The Story

Moody's Rating Incorporates An Analysis Of Both Benefits And Potential Risks

Summary Opinion

- The combination of 4% tax credits and tax-exempt bonds is considered by many to be one of the most important tools for providing affordable housing to lower and moderate income households.
- The use of tax credits produces equity, which enables a property to offer lower rents than traditional borrowing. Additionally, the use of the LIHTC may provide substantial oversight strength to the property.
- While Moody's acknowledges the benefits associated with tax credits, Moody's review of a property does not, generally, allow the tax credits to offset a weaker property or financial condition. These benefits need to be weighed against the potential costs such as additional compliance complexity, risks of noncompliance, and the differing interests of equity investors versus bondholders.

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Introduction

Since the inception of the Low Income Housing Tax Credit (LIHTC) Program in 1986, the use of tax credits in conjunction with tax-exempt bonds has become a popular and effective tool for financing low-income multifamily housing. Tax credits provide a number of benefits and incentives to participants, creating equity and greater flexibility within the financing. Despite these benefits, increased compliance complexity, heightened restrictions on rental revenue and the differing interests of equity investors versus bondholders can mitigate the total benefit of the tax credit within the financing from a rating perspective.

This article outlines Moody's view on the impact the presence of tax credits can have on bond-financed transactions by discussing the mechanics of the LIHTC program, the motivations for using tax credits and the various impacts tax credits can have on a bond rating. This article supplements Moody's overall approach to affordable housing transactions which incorporates an analysis of the construction period letter of credit support (if applicable), the property's historical and projected financial performance, physical condition, market demand, and ownership and management. While the emphasis of Moody's analysis continues to be on the property's debt service coverage, the loan to value (LTV) and the use of LIHTC equity is a significant factor in our analysis. (For more information on Moody's approach to rating affordable housing bonds, please refer to *Questions and Answers Regarding Moody's Approach to Reviewing Affordable Housing Transactions*, published in July 1999 and *Moody's Anticipates Increase In Volume of Affordable Housing Bonds: More Credit Risk Than Traditional Housing Bonds*, March 1998).

What Are Low Income Housing Tax Credits?

HISTORY AND LIMITATIONS ON USE

The Low-Income Housing Tax Credit, part of the Tax Reform Act of 1986, is considered by most to be one of the most important tools for providing affordable housing to lower and moderate income households, assisting in the development and availability of more than 850,000 units of affordable housing nationwide. The LIHTC is included in Section 42 of the Internal Revenue Code (IRC) and is administered by the Treasury Department on the Federal level and by the tax credit allocating agencies, often the State Housing Finance Agencies (HFAs), on the state level.

9% VS. 4% CREDITS

The 9% credit is used with non-federally subsidized new construction and substantial rehabilitation expenditures and the 4% credit is used in conjunction with tax-exempt bonds or below-market federal loans for new construction or acquisition and substantial rehabilitation. Developers may apply for an allocation of 9% credits or apply for tax exempt bond allocation to facilitate the receipt of 4% credits. Under the 4% credit program, the developer may be exempted entirely from the volume limitations on LIHTC allocations if they satisfy a number of requirements. These requirements include the 50% test, in which 50% or more of the aggregate basis in land and building must be financed with tax exempt bonds. Given the larger equity amount and the additional restrictions for developers using the tax-exempt bonds, the application process for the 9% credit is highly competitive and generally oversubscribed.

The Participants

Tax credit projects are generally owned by ***operating partnerships*** comprised of a general partner, often the developer or a developer related entity, and an investment partnership, which acts as the ***limited partner***. The general partner typically must guarantee completion, the amount of tax credits and fund operating deficits. Limited partners may own between 99% and 99.99% of the tax credits, losses and profits. The distribution of cash flow and sale residuals are normally negotiated among the partners. Within limited partnerships, all partners are viewed as owners and an investor must be a partner to receive the credits. Although federal tax credits cannot be sold separately, certain state tax credit programs, such as California, do allow for a bifurcation of the tax credits.

In the case of a ***syndicate transaction***, there will generally be two or three separate partnerships. The investment partnerships within these transactions are comprised of one or more investors, often large corporations. The syndicator will generally act as the facilitator for the investment partnership and has reporting responsibilities to the funds it organizes.

Non-profit organizations are often involved in LIHTC transactions. Since the LIHTC has no value for nonprofit or tax-exempt organizations as a credit to their taxes, the nonprofit generally serves as a general partner and the for-profit investors act as limited partners. Utilizing this structure, the for-profit investors are able to take advantage of the tax credit against their regular tax liability during the tax credit period and the nonprofit may negotiate the right to purchase the project after the compliance period expires.

Differences between the LIHTC and the Historic Tax Credit

In addition to the LIHTC, there is another type of tax credit available to developers and investors, the Historic Rehabilitation Tax Credit, or HRTC. The HRTC, established in 1978, was also provided for in the Internal Revenue Code. The HRTC is only available for the rehabilitation of certified historic structure expenditures. The HRTC may be used in conjunction with the LIHTC, most commonly seen in adapting schools or office buildings for residential use, but is generally not available to a property owned by a tax-exempt entity. The following highlights some of the differences between the two programs.

Unlike the LIHTC program administered by the state allocating agencies, in most cases the state housing finance agencies, the HRTC program is administered by the Department of the Interior, mainly the National Park Service. The Historical Rehabilitation Tax Credit is equal to 20% of the amount of qualified rehabilitation expenditures versus the 4% and 9% credits under the LIHTC program. The HRTC is not competitive like the LIHTC program, as HRTC are available without any governmental allocation or approval process except for those approvals required from the Department of the Interior with regard to the historic quality and character of the building.

Unlike the LIHTC, which is claimed over a 10-year period commencing with occupancy of the qualified low-income units, the full amount of the HRTC is claimed in the year in which the qualified rehabilitation expenditures are placed in service, usually when a certificate of occupancy is received. The HRTC is subject to the recapture of credits for improper use for the first five years, while the LIHTC is subject to recapture over a 15-year period in the event of non-compliance.

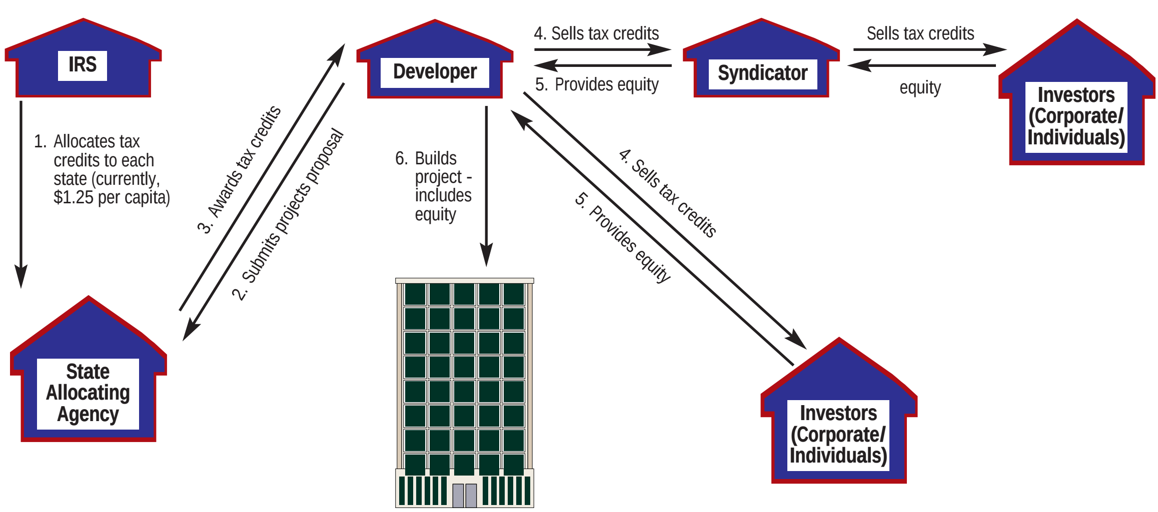
Purchase Of The Tax Credits

Upon the purchase of the tax credits, investors will make equity contributions based on the amount of the 10-year credits available to the investor. The amount the investor will pay for each credit varies with market conditions, type of project location and other structural variables. Investors may purchase the credits directly from the developer or through a syndicator who buys them from the developer. Equity raised from the sale of the tax credits is generally phased in based on an agreed upon pay-in schedule.

The following is an example of a typical equity pay-in schedule:

- 25% upon 50% construction completion
- 25% upon 100% construction completion
- 20% upon closing of permanent financing
- 10% upon receipt of the IRS forms 8609
- 10% upon achievement of break-even operations for a defined period of time plus a determined debt coverage ratio for a defined period of time.

The LIHTC Program: Structure and Participants



Structuring The Deal With LIHTC — How Tax Credits Impact Your Tax-Exempt Bond Rating

While Moody's recognizes the benefits associated with tax credits, Moody's review of a property does not, generally, allow the tax credits to offset a weaker property or financial condition. The benefits of the tax credit such as equity and additional oversight should be weighed against the potential costs such as additional compliance complexity and risks of noncompliance. The focus of Moody's analysis continues to be the property's debt service coverage, loan to value ratio, historical and projected financial performance, physical condition, market demand, ownership and management. However, due to the additional complexity within the LIHTC program, Moody's places particular emphasis on the owner and management team's demonstrated experience in successfully operating tax credit properties. Thus, in measuring the impact of tax credits on a bond rating, Moody's carefully weighs both the positive and negative factors associated with the use of tax credits, as discussed below.

Short-Term Tax-Exempt Construction Bonds

Section 42(i)(2) of the IRC allows developers to use tax exempt bonds or below market federal loans to finance construction, as long as the bonds are redeemed prior to when the building is placed in service. However, in a private letter ruling (PLR 9853036), the IRS concluded that projects could remain eligible for tax credits even if the bonds are redeemed on or after the placed-in-service date. In so doing, developers would be allowed to use tax exempt bonds to obtain 4% credits and then take out the bonds with a favorable form of permanent financing. In analyzing these types of short-term bond financings, Moody's will look at the security of the source of financing and the strength of the transaction's structure as part of its review process.

CREDIT FACTORS

The Use of Equity Provides Fundamental Strength To Structure

Tax credit equity is commonly used in conjunction with tax-exempt private activity bonds to finance affordable multi-family housing projects. Moody's looks for a property that is not over-leveraged and has owner's equity at closing. Equity may come from a number of sources including HOME funds or the LIHTC. The sponsor may use the proceeds of the sale of the tax credits as equity for their project, reducing the required mortgage amount and providing an opportunity for lower tenant rental levels.

A strong incentive exists for the redemption of bonds after the fifteen-year compliance period, given that the LIHTC is claimed by the taxpayer (LLP) for only a ten-year period, and that at the end of fifteen years the owner is free to sell the property. Although creating concerns for the continuation of low income housing, the structure does provide greater credit strength for the bonds, as the bonds' probability of redemption increases just as the potential for property deterioration increases as the property ages.

New Construction or Rehabilitation — LIHTC Properties Often Strongly Situated Relative To Competition

The combination of LIHTC and tax-exempt bond financing allows for the financing of two types of developments, new construction or the acquisition and rehabilitation of an existing structure. Given the necessary rehabilitation or the modern amenities provided by new construction, the LIHTC property is often very competitive relative to existing properties in its submarket given their generally below-market rents and age relative to the rest of the housing stock. However, these new construction LIHTC properties are often built near the periphery of large metropolitan statistical areas (MSAs), allowing the property to benefit from both a higher median income than many rural areas, and slightly below market land costs as the areas are generally not fully developed. Although this can create a strongly situated LIHTC property if development continues as expected, a considerable downturn in the local market could significantly impact these peripheral properties.

While newly constructed and substantially rehabilitated properties tend to be well situated in the market, risks inherent in these types of projects, such as those associated with construction and lease up, are factored into Moody's analysis of tax credit projects. Moody's looks to some form of liquidity facility, typically a letter of credit (LOC), to be in place during the construction phase and up to stabilization. The LOC or other liquidity facility must be structured properly so that the interest component is sized to cover all debt service payments until the property reaches stabilization. Moreover, the rating of the provider must be sufficient to support the rating on the bonds. (For more information on Moody's approach to rating LOCs, please refer to *A Guideline for Sizing the Interest Component of a Letter of Credit Facility*, published in June 1998)

The stabilization factors generally include a specific debt service coverage ratio for twelve consecutive months, meeting occupancy standards for twelve months and receiving Moody's confirmation of the rating on the bonds. If the LOC release criteria are not met prior to the termination date of the LOC, the LOC must be extended or the trustee is instructed to draw on the LOC and redeem all of the bonds. Moody's views these elements as providing solid credit strength for the bonds during the new construction or substantial rehabilitation phase.

Additional Participant Oversight Provides Strength

The use of the LIHTC may provide additional oversight strength to the property. Often the LIHTC investor, or LLP, has the ability per the loan documents to remove the general partner for non-performance if necessary. This coupled with initial syndicate participation often provides an additional layer of oversight to the LIHTC property. Additionally, although the LIHTC investor is not required to support troubled properties with additional equity, the investor may find a cash infusion in its best interest as weighed against the potential of the recapture of tax credits. These factors, although not foolproof, do provide additional comfort on the maintenance and strength of the underlying asset.

Oversight by the federal and state government agencies may provide another level of credit strength to properties financed with tax credits. Pursuant to Section 42(m)(1)(B)(iii) of the IRC, the credit agency's allocation plan must include procedures for monitoring compliance with provisions of the tax credit program. While the allocating agency is given a certain amount of latitude in developing its oversight plan, it is required to monitor noncompliance with set-aside and rent restrictions and maintaining habitability, among other things. Allocating agencies typically fulfill these requirements by conducting regular site visits to properties in their tax credit portfolio and reviewing annual income certifications and rent records. In the event of any noncompliance, the state is required to notify the IRS of any such instances by filing a form 8823.

LIHTC Regulations Create Additional Compliance Complexity

The presence of tax credits adds complexity to bond-financed transactions through the additional layers of regulations and compliance requirements under the tax credit program, such as rent restrictions, set-aside requirements and federal and state monitoring. Moreover, a tax credit property may have other restrictions due to additional covenants promised during the application process to make the project more competitive and requirements for other financing sources such as tax exempt bond financing, HOME funds and Section 8 subsidies. The compliance period for tax credit projects begins on the date when at least 10% of the units are occupied and ends on the later of 15 years after which 50% of units are occupied, when no tax exempt bonds are outstanding or when any Section 8 assistance terminates.

Under both the tax credit and tax exempt bond financing programs, the owner must satisfy one of two set-aside requirements. The owner may elect to have a minimum of 20% of the units occupied by households whose incomes do not exceed 50% of the area median gross income or 40% of the units to be occupied by households whose incomes do not exceed 60% of median income. Due to the scarcity of tax credits and the increasing competitiveness of the allocation process, however, many owners elect much more stringent income requirements in order to be more competitive. It is, therefore, not uncommon to see tax credit properties in which 100% of the units are very-low to low income. Income tests must be conducted annually, although incomes may increase to 140%, or 170% in some cases, of applicable income limits before another comparable unit must be rented to a qualifying tenant. Given the complexities of complying with the additional layers of restrictions under the LIHTC program, the owner and management team's proven track record in operating tax credit properties will be a critical element of Moody's analysis.

LIHTC Rent Restrictions Can Significantly Reduce Revenue-Raising Flexibility

While tax exempt bond financed properties without tax credits generally have no restrictions on rents as long as set-aside requirements are met, tax credit properties must satisfy the maximum allowable rent guidelines under the LIHTC program, significantly reducing the revenue-raising flexibility of owners of tax credit properties. These maximum allowable rents are based on tenants paying no more than 30% of their income on rent. Income limits are based on an area's median gross income for a four-person household, which are published annually by HUD. The restricted rent levels are calculated by multiplying the area median income by the set aside requirements (i.e. 60% of income) and then multiplying this number by the 30% income limit. Rent levels are also adjusted for unit size. However, because LIHTC rent levels are calculated on the expected occupancy of the unit, which is one person for a studio and 1.5 persons per bedroom, rather than the actual occupancy of the unit, it is possible for tenants to pay more than 30% of their income on rent.

The stringent rent restrictions under the tax credit program can significantly impair the revenue-raising flexibility of property managers. For example, if rents at a particular tax credit property are currently at the maximum rent levels allowable under the program, any increases will be capped by the annual adjustments in the area median income published by HUD. Therefore, the manager may not have the flexibility to raise rents to improve cash flow and maintain certain debt service coverage levels. As such, the degree of revenue-generating flexibility, as evidenced by the difference between the proposed rents and the maximum allowable rents, will be incorporated into Moody's analysis.

Troubled LIHTC Properties May Result in Conflicting Interests Between Tax Credit Investors and Bondholders

In the case of troubled tax credit properties, the interests of the LIHTC investors may conflict with those of bondholders. While the bondholder is concerned about timely payment of debt service, the LIHTC investor is concerned with whether or not it makes financial sense to maintain the property's cash flow, such as removing the General Partner or injecting additional equity into the property. The timing of when the property runs into trouble may be a critical factor in the investor's decision-making process. For example, in the later years of the 15-year compliance period when the investor has already infused substantial amounts of equity into the property, it may be more prudent for the investor to take remedial steps to avoid a payment default. In the early years of the credit period, however, when the investor has not paid in the total equity contribution, the investor may decide against providing more capital to maintain debt service payments, potentially triggering a draw on the LOC or payment default and an early redemption of bonds. Thus, while the presence of tax credits may increase the likelihood that the LIHTC investor will bail out troubled properties and ensure enough cash flow to meet debt service obligations, Moody's believes that the timing, size and nature of the property's deterioration will greatly impact the investor's decision.

The Future of the Tax Credit Program: The Challenge of Preserving Affordability

A primary challenge for states will be preserving the affordability of projects after the 15-year compliance period when investors may exit their partnership. As the tax credit program matures, many states will be faced with the challenge of how best to spend their allocations, whether on preservation or new housing production. The first crop of tax credit projects, those built in 1987, will reach the end of the affordability period in 2002 and will provide the first indication of how these properties will fare during the transition period. Amendments made to the tax code in 1989 and 1990, however, have increased the probability of preservation through affordability extensions and right-of-first refusal protections, respectively. Moreover, the increasing competitiveness of the tax credit allocation process increases the likelihood that the projects built after 1990 will remain affordable and if not, be better situated to make the transition into market rate properties.

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Special Comment

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