



## **TAX CREDITS for People Who Always Wanted to Know but Were Afraid to Ask**

*Note: The Low Income Housing Tax Credit program is complicated. What follows covers some of the basics, however there are many ifs, ands, and buts that anyone who is actually developing or managing tax credit properties would need to know. Contact the Bay Area LISC office at (415) 397-7322, or see the Training page of the Community Development Exchange website for information about how to learn more.*

The federal government established the Low Income Housing Tax Credit (LIHTC) in 1986. This tax credit provides an incentive for private investment in affordable housing. Since established, the tax credit program has helped produce housing for over one million families and individuals nationwide, including tens of thousands of affordable rental units in California. The annual amount of credits each state is allowed to allocate is based on \$1.75 per state resident.

Section 42 is the portion of the Internal Revenue Code (IRC) that establishes the regulations for the Low Income Housing Tax Credit Program administered by the Internal Revenue Service (IRS). The tax credit allows investors to reduce their tax liability based upon their financial investment in affordable housing and the property's ongoing compliance with IRS regulations. The tax credit is taken over ten years, though the housing must continue to comply with tenant eligibility and rent restrictions for at least fifteen years.

While the IRS oversees the program and sets minimum guidelines, it allows state agencies to set priorities for the types of housing that will receive tax credit funding. States also are responsible for selecting the applicants that present the best housing proposals based on those published priorities. In California, the agency that allocates and monitors the tax credit program is the California Tax Credit Allocation Committee (TCAC). For a full description of the California program, see [www.treasurer.ca.gov/ctcac/programdescription.pdf](http://www.treasurer.ca.gov/ctcac/programdescription.pdf). California also has a state tax credit program that is used to supplement the federal credits.

Since most developers of affordable housing do not have a large enough tax liability or in the case of nonprofit developers, have no tax liability, to profit from direct use of the low income housing tax credit, most California tax credit properties are organized in a Limited Partnership structure that allows an investment (or limited) partner to profit from the tax credit. The Partnership is required to own the property for 15 years. A General Partner is responsible for seeing that the property is maintained on a day to day basis and that it remains in compliance with IRS regulations. A Limited Partner is an investor (such as a corporation) or group of investors, whose investment offsets the cost of developing or financing a property, making reduced rents feasible. In return for their investment they receive the right to use the tax credit and other tax benefits to offset tax liability on their tax returns.

## A FEW DEFINITIONS...

Minimum Set Aside is the minimum number of units that the owner has elected under Section 42 to be income and rent-restricted (either 20% at 50% Area Median Income or 40% at 60% AMI). Minimum set aside is calculated on a property-wide basis.

Applicable Fraction (also known as Low Income Occupancy Percentage) is the lesser of:

- a. The ratio of the number of low income units to the total number of units in the building  
or
- b. The ratio of the total floor space of the low income units to the total floor space of all units in the building

In the first year, the applicable fraction is pro-rated by the percentage of qualified occupancies each month. In following years, the applicable fraction is based on the actual fraction at the end of each tax year. Applicable fraction is calculated building by building in multi-building properties.

Eligible Basis generally includes capital costs incurred in the construction, rehabilitation, or acquisition of the property, minus non-depreciable costs such as land and certain other items such as financing fees. While it may not include costs for commercial space, it may include the cost of facilities for use by tenants to the extent that there is no separate fee for their use and they are available to all tenants.

Qualified Basis is the portion of the eligible basis attributable to low income rental units. It is equal to the eligible basis multiplied by the applicable fraction.

The Applicable Tax Credit Percentage is a percentage determined monthly by the U.S. Treasury, which is used to calculate the value of tax credits. Although credits are commonly described as 9% and 4% credits, the percentages are approximate figures. For instance the published figures for October 2003 were 8.03% for the 9% credit and 3.44% for the 4% credit. Once the percentage is established for a building, the percentage applies for the entire 10 year credit period.

## HOW MUCH IS THE TAX CREDIT WORTH?

The capital received from tax credit investors is only a portion of the total amount needed to develop an affordable housing project. How does a developer estimate how much money she can obtain for a given project?

**Example:** A developer is exploring the feasibility of a 30-unit affordable housing development. Total development costs are estimated to be \$8 million dollars. After deducting land and other ineligible costs, the Eligible Basis is estimated at \$5 million.

$$\begin{aligned} \text{Total development costs} - \text{land and other ineligible costs} &= \text{eligible basis} \\ \$8,000,000 - \$3,000,000 &= \$5,000,000 \end{aligned}$$

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The developer intends all 30 units to be tax credit units, so Applicable Fraction is 100%, and the Qualified Basis will also be \$5 million.

$$\begin{array}{rcll} \text{Applicable fraction} \times \text{eligible basis} & = & \text{qualified basis} & \\ 100\% & \times & \$5,000,000 & = \$5,000,000 \end{array}$$

To estimate the annual tax credit that this project will yield for its investors, multiple the qualified basis by the tax credit percentage. As noted above, the tax credit percentage is published monthly, and is somewhat lower than 9%. Let's assume an 8.5% figure:

$$\begin{array}{rcll} \text{Qualified basis} \times \text{tax credit percentage} & = & \text{tax credits per year} & \\ \$5,000,000 & \times & 8.5\% & = \$425,000 \end{array}$$

Therefore, the total tax credits that this project will yield over ten years will be \$4,250,000. In the current market, a prospective investor will pay \$.80-.90 per \$1.00 of tax credit. In the above example, this would mean that the developer can expect to obtain between \$3.4 and \$3.825 million of capital for her \$8 million project.

$$\begin{array}{rcll} \text{Annual tax credit} \times \text{10 year credit period} & = & \text{total tax credit} & \\ \$425,000 & \times & 10 & = \$4,250,000 \end{array}$$

\$4,250,000 x \$.80 on the dollar = \$3,400,000 estimated investment proceeds  
or, \$4,250,000 x \$.90 on the dollar = \$3,825,000 estimated investment proceeds

**NOTE: This is a simplified version of how credits are calculated. The actual calculation involves following TCAC's guidelines as well as negotiating with an investor on their pricing.**

For more detail about the role low income housing tax credits plays in overall financing of affordable housing, on another CD Exchange resource document (see pages 23-28):

<http://lo.redjupiter.com/gems/lisc/2003housingintro.pdf>

### A FEW IMPORTANT FORMS...

IRS Form 8609. This is the form issued by the Tax Credit Allocation Committee after the housing is built and after the developer has submitted a financial report, often referred to as the cost certification, of the total development costs and that portion of the costs that are included in eligible basis. The 8609 certifies TCAC's final determination of the maximum tax credits that can be claimed by the partnership.

IRS Form 8823. This is the form that the state monitoring agency, e.g. the California Tax Credit Allocation Committee, uses to report a compliance issue to the IRS. If an issue cited in an 8823 report is not satisfactorily resolved by the property owner, this may lead to loss of tax credits, or recapture of credits already claimed.

K-1's. The K-1's are part of the annual partnership tax return, and are also needed by the individual investor partners for their own tax returns. Each partner receives a K-1 which details that partner's share of the annual tax credit, as well as the partner's share of annual operating gains or losses.