

The Acquisition Rehabilitation Tax Credit Transaction – A New Look at Four Percent LIHTCs

Escalating construction costs and the increasing complexity of structuring a federal low-income housing tax credit (“LIHTC”) transaction have shifted the attention of developers of affordable housing to 9% LIHTC transactions and away from projects that combine 4% LIHTCs with tax-exempt bonds. While the potential equity generated by 9% LIHTCs is significantly more than 4% LIHTCs which must also support real debt in the form of the tax-exempt bonds, State Housing Finance Agencies now have extremely competitive 9% LIHTC allocation rounds with little interest by developers in the 4% LIHTCs which are available with an allocation of tax-exempt volume cap for residential rental housing. However, the preservation of an affordable housing transaction which combines the acquisition and rehabilitation LIHTCs is an excellent opportunity to use the less competitive 4% LIHTCs coupled with tax-exempt bonds.

In the typical preservation transaction, the “eligible basis” for LIHTCs is based on the acquisition cost of the building provided that 1) the 10-year test is satisfied (there must be a period of at least 10 years between the date of acquisition of the building and the later of the date the building was last placed in service or the most recent nonqualified substantial improvement to the building) and provided that 2) the minimum expenditure test is satisfied (the taxpayer must spend not less than the greater of \$3,000 per unit or 10% of the adjusted basis of the building within a 24-month period). While a developer may be entitled to LIHTCs based on the acquisition cost of the building, the amount of the LIHTCs is limited to the 4% LIHTC based on the acquisition cost of the building and the eligible basis is not entitled to a 130% basis boost if the building is located in a qualified census tract (“QCT”) or a difficult to develop area

(“DDA”). Accordingly, an allocation of 9% LIHTCs for the acquisition and rehabilitation of a building would be reduced to a 4% LIHTC with respect to the eligible basis of the acquisition cost of the building.

Because less tax credit equity is generated by using 4% LIHTCs rather than 9% LIHTCs, it is important to look for the following three factors that assist the financial viability of a 4% LIHTC transaction. First, a 4% LIHTC project typically needs more “soft money” than the traditional 9% LIHTC transaction. It is important to have local, state, or federal “soft money” programs available to support a 4% LIHTC project. Second, while the eligible basis used to calculate the acquisition credit would not be increased as a result of a QCT or a DDA, the eligible basis of the rehabilitation costs of the building would be increased by the basis boost available in the QCT or the DDA and would not be limited by the amount of a reservation since it is not a 9% allocation of LIHTCs. Third, it is important to have high “area median incomes” because of the real debt the 4% LIHTC project must support.

Finally, structure and timing of a 4% LIHTC transaction is critical. For a project to be eligible for 4% LIHTCs at least 50% of the land and improvements of the project must be “financed” with the proceeds of volume cap tax-exempt bonds. In this vein, while cost overruns in a 4% LIHTC transaction may increase eligible basis and as a result the amount of 4% LIHTCs available to the project, unlike 9% LIHTCs, cost overruns may endanger the 50% test. As construction costs increase, the percentage of the costs financed by the amount of the tax-exempt bond decreases. If there is a risk that the 50% test will not be met, LIHTC investors typically require the

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developer's fee to be reduced. However, this has the effect of not only reducing the developer's fee paid, but also reducing the eligible basis and consequently the amount of the 4% LIHTCs. Also the critical requirement is that the project be "financed" by the proceeds of tax-exempt bonds. It is not unusual for a transaction to have tax-exempt construction financing which is taken out by permanent financing and tax credit equity, or traditional construction financing which is taken out by tax-exempt bonds coupled with tax credit equity and soft loan programs. The question is how long does tax-exempt construction financing have to be outstanding for the project to have been "financed" by tax-exempt bonds, and when must tax-exempt bond proceeds be used to retire construction financing for the project to be "financed" with tax-exempt bonds. With respect to the point in time to be used to determine whether tax-exempt

bonds financed 50% of the aggregate basis, three possibilities exist. First, the end of the building's first credit year. Second, the date the form 8609 is issued for the building. And, third, the placed in service date of the building. Historically, LIHTC investors have had different views on the appropriate date. With respect to the date on which tax-exempt bonds must be used to retire construction financing, there is authority from the Service that where bonds have been properly induced prior to construction, the tax-exempt bonds should "take-out" the construction loan before the end of the building's first credit year.

To sum, with the diminishing competition for 4% LIHTCs available with tax-exempt volume cap bond allocations, structuring preservation transactions with 4% LIHTCs should be examined. |||

Brian Hudson, Guest of Honor, at Duane Morris Affordable Housing Party

On Thursday, February 23, the Duane Morris Affordable Housing and Community Development Group held its annual affordable housing and community development party at Morris', a restaurant at the Philadelphia offices of Duane Morris. The guest of honor at the party, Brian Hudson, Executive Director of the Pennsylvania Housing Finance Agency, was greeted by a room filled with clients and friends of the Duane Morris Affordable

Housing Group. Mr. Hudson was honored by Duane Morris for his more than thirty years of service to the Pennsylvania Housing Finance Agency. As the Executive Director of the Pennsylvania Housing and Finance Agency, Mr. Hudson shared with those in attendance the Agency's goals and initiatives to address Pennsylvania's needs for affordable housing in the future. |||

Summary of Additional Tax Incentives for the Federal Low-Income Tax Credit, Rehabilitation Tax Credit and New Market Tax Credit Programs Created by the 2005 Gulf Opportunity Zone Act

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The Gulf Opportunity Zone Act of 2005, which was signed into law on December 21, 2005, provides a number of critical tax incentives to encourage the rebuilding of areas ravaged by Hurricanes Katrina, Rita and Wilma.

The 2005 Gulf Opportunity Zone Act complements the Katrina Emergency Tax Relief Act of 2005, which was signed into law on September 23, 2005. The 2005 Gulf Opportunity Zone Act provides additional tax incentives in connection with the Federal Low-Income Housing Tax Credit, Rehabilitation Credit, and New Market Tax Credit Programs.

New Code Section 1400M created the following new definitions for the 2005 Gulf Opportunity Zone Act and the Katrina Emergency Tax Relief Act of 2005. The term "GO Zone" means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The "GO Zone" includes 11 counties in Alabama, 31 parishes in Louisiana, and 49 counties in Mississippi.

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The term “Hurricane Katrina Disaster Area” means with respect to a major disaster declared by the President before September 14, 2005 under section 401 of the Stafford Act by reason of Hurricane Katrina.

The term “Rita GO Zone” means that portion of the Hurricane Rita disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Stafford Act by reason of Hurricane Rita.

The 2005 Gulf Opportunity Zone Act allows states to allocate additional federal low-income housing tax credits in the years 2006, 2007 and 2008 of \$18 per person in the GO Zone. In addition, Florida and Texas each receive an additional allocation of \$3.5 million in federal low-income housing tax credits in 2006. The Gulf Opportunity Zone Act also provides that property placed in service during 2006, 2007 and 2008 in the GO Zone, Hurricane Katrina Area, and Rita GO Zone will be treated as a “difficult development area,” allowing federal low-income housing tax credits for a project to be calculated on the amount equal to 130% of new construction or rehabilitation expenditures.

The 2005 Gulf Opportunity Zone Act increases the federal rehabilitation credit pursuant to Section 47 of the Internal Revenue Code for projects in the GO Zone. The 10% credit for rehabilitation of a certified building is increased to 13% and the 20% credit for the rehabilitation of a certified historic building is increased to 26%.

Under the pre-2005 Gulf Opportunity Zone Act, the nationwide New Market Tax Credit Authority for allocation was \$2 billion for calendar year 2005 and \$3.5 billion for each of calendar years 2006 and 2007. The 2005 Gulf Opportunity Zone Act provides that the federal new market tax credit investment authority is increased by \$300 million for 2005 and 2006 and \$400 million for 2007 to be allocated among qualified community development entities to make qualified low-income community investments within the GO Zone.

In summary, the 2005 Gulf Opportunity Act creates significant tax incentives under the federal low-income housing tax credit, rehabilitation, and new markets tax credit programs for the development of areas ravaged by Hurricanes Katrina, Rita and Wilma. |||

Recent Matters Handled by Duane Morris Affordable Housing and Community Development Group

Duane Morris attorneys represented a community development entity in closing an \$8 million qualified equity investment with a new market tax credit investor at the end of 2005.

Duane Morris attorneys represented a faith-based nonprofit in closing a debt and equity for the construction of a transitional housing project for individuals with AIDS. The transaction combined federal low-income housing tax credits, McKinney grant monies, Federal Home Loan Bank Affordable Housing Program, county Home money, and funding from the New Jersey Housing and Mortgage Finance Agency.

Duane Morris attorneys represented a direct investor in federal low-income housing tax credits in the acquisition and moderate rehabilitation of an apartment complex in southern New Jersey.

Duane Morris attorneys represented a community development corporation, and served as bond counsel, in the development and financing of a 473-bed student-housing complex in a blighted community adjacent to a major university. The project was financed with \$18,360,000 in private activity bonds enhanced with bond insurance and with additional support provided by a limited five-year guaranty from the university. The deal was structured in a way to avoid concerns raised by the IRS’s scrutiny of student-housing bonds and to minimize liability to the CDC. The deal also involved significant issues in the condemnation of blighted properties and their re-use for student housing. The completed project has helped to spur other large investments in the immediate area. |||

About the Affordable Housing Practice Group

Since 1975, Duane Morris has assisted clients to structure, implement and complete government-supported low-income housing projects. Through our representation of for-profit developers, nonprofit organizations, syndicators, banks and underwriters and bond counsel engagements, our Affordable Housing Practice Group has assisted in the financing of more than 1,000 projects consisting of more than 100,000 housing units in 18 states.

From our initial concentration in the mid-Atlantic states, we have expanded our offices and services to provide assistance on projects nationwide. We often work closely with other Duane Morris practice groups such as corporate, finance, real estate, reorganization and tax to assist our clients in solving problems. In addition, our lawyers frequently coordinate their work with that of our clients' government relations consultants, including our affiliate Duane Morris Government Affairs LLC. |||

About Duane Morris

Duane Morris LLP, among the 100 largest law firms in the United States, is a full-service firm of more than 600 lawyers. In addition to legal services, Duane Morris has independent affiliates employing approximately 100 professionals engaged in other

disciplines. With offices in major markets, and as part of an international network of independent law firms, Duane Morris represents clients across the nation and around the world. |||

AFFORDABLE HOUSING AND COMMUNITY DEVELOPMENT GROUP

These attorneys collaborate as necessary with other attorneys in the firm whose practices focus on real estate, healthcare and public finance matters to address specific transaction requirements.

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