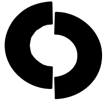
Comptroller of the Currency
Administrator of National Banks

Low-Income Housing Tax Credit Funds: Investment Opportunities for Banks

Wednesday, September 10, 2008
2:00 p.m. – 3:30 p.m. EDT

Reading Materials

- Community Developments Fact Sheet: Part 24
- CD-1 National Bank Community Development (Part 24) Investments Form
- Community Developments Insights, Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks



Comptroller of the Currency
Administrator of National Banks

Community Developments

Community Affairs
Department

Fact Sheet

Part 24 Community Development Investments

What are Part 24 investments?

Under the OCC's community development investment authority, national banks may make investments in community and economic development entities (CEDE) and projects that are designed primarily to promote the public welfare, as specified in the statute (12 USC 24 (Eleventh)) and regulation (12 CFR part 24) commonly known as "part 24"). Part 24 allows national banks to make investments not otherwise expressly permitted under the National Bank Act.

Part 24 requires that a bank's investment must be designed primarily to promote the public welfare, such as by providing housing, services, or jobs. Specifically, a national bank or national bank subsidiary may make an investment directly or indirectly if the investment primarily benefits low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted by a governmental entity for redevelopment, or the investment would receive consideration as a "qualified investment" under 12 CFR 25.23 of the Community Reinvestment Act (CRA).

National banks use the part 24 authority to make investments in a variety of activities, such as creating affordable housing and supporting other residential and commercial real estate development, providing equity for small business start-ups and expansions, and revitalizing or stabilizing government-designated development areas. Many of the activities undertaken by banks under part 24 are eligible to receive positive consideration as qualified investments under CRA.

Banks make part 24 investments directly or indirectly through community and economic development entities (CEDEs) that make or conduct eligible activities. CEDEs may include (but are not limited to) subsidiary community development corporations (CDCs), multi-investor CDCs, limited partnerships and limited liability companies, community development financial institutions (CDFIs), and community development (CD) loan funds.

What does a bank need to do to make a part 24 investment?

A national bank seeking to make a part 24 community development investment may provide after-the-fact notifications or seek prior OCC approval. With either approach, the bank must complete the OCC's CD-1 *Form for Processing National Bank Community Development (Part 24) Investments.* A Bank may access and submit the form electronically through the OCC's Banknet web site: https://www.banknet.occ/cd1invest/default.aspx.

After-the-Fact Notifications

Banks eligible to provide after-the-fact notifications may make part 24 investments without prior OCC approval, but should notify the OCC within 10 days of making the investment. The requirements for after-the-fact notifications are described in 12 CFR 24.5(a).

A well-capitalized bank is eligible to provide an after-the-fact notification if it meets all of the following criteria outlined in 12 CFR 24.2(e):

- Has a composite rating of 1 or 2 under the Uniform Institutions Rating System
- Has a CRA rating of "Outstanding" or "Satisfactory"
- Is not subject to a cease-and-desist order, consent order, formal written agreement, or Prompt Corrective Action directive

If a bank does not meet all of these criteria it will not be eligible to provide an after-the-fact notification. However, if the bank is at least adequately capitalized and has a composite rating of at least 3 with improving trends it may send a letter to the OCC requesting authorization to provide an after-the-fact notification. With that special written permission, the bank may provide after-the-fact notifications. Otherwise the banks must request prior OCC approval for a part 24 investment. In addition, to provide an after-the-fact notification, a bank's part 24 investment must meet the tests for qualifying public welfare investments and investment limits. A bank may not provide an after-the-fact notification if any of the following apply:

- The bank's aggregate Part 24 investments and outstanding commitments, including the proposed investment, exceed 5 percent of its capital and surplus. Note that a bank whose aggregate Part 24 investments exceeds 5 percent of its capital and surplus may seek prior OCC approval to provide after-the-fact notifications up to an amount not exceeding 15 percent of capital and surplus.
- The investment involves properties carried on the bank's books as "other real estate owned" (OREO).
- The OCC determines in published guidance that the investment is inappropriate for submission through the after-the-fact notice process. This information is maintained on OCC's Web site at: http://www.occ.treas.gov/cdd/PriorAprvlReq.pdf
- Generally, for after-the-fact notification process, a bank's Part 24 investment is consistent with the examples of qualifying public welfare investments found at 12 CFR 24.6. Further, the investment structure generally should be consistent with the list of examples of the types of CEDEs found at 12 CFR 24.2(c).

Prior OCC Approval

If either the bank or the proposed part 24 investment does not meet the requirements for providing an after-the-fact notification, then the bank must submit a request for prior approval and must receive such approval from the OCC before it can make the investment. The process for prior approval and the factors that the OCC considers when evaluating a bank's proposal are described in 12 CFR 24.5(b). The OCC, generally, will notify a bank of the agency's decision in writing within 30 days after receiving the request. It may extend the review period by notifying the bank. The OCC may also impose conditions in connection with its approval of an investment under part 24. A bank should maintain information concerning its Part 24 investment in a form that is readily accessible and available for OCC examination.

Where to send the form

The CD-1 form should be sent to:

Community Affairs Department
Office of the Comptroller of the Currency
Washington, DC 20219

Fax: (301) 433-9062

email: CommunityAffairs@occ.treas.gov

BankNet filings

National banks may also submit their part 24 filings electronically through BankNet at: https://www.banknet.occ/cd1invest/default.aspx.

For more information

The OCC's Community Affairs Department maintains information about national bank investments in CDCs, community development projects, and other public welfare investments on its Web-site at: http://www.occ.treas.gov/cdd/pt24toppage.htm.

That site provides banks with a host of community development investment resources, including examples of specific bank investments and OCC policy materials, such as:

- Common Part 24 questions
  http://www.occ.treas.gov/cdd/commonpart24.htm
- Part 24 precedent letters
  http://www.occ.treas.gov/interp/monthly.htm
- At-a-Glance Chart
  http://www.occ.treas.gov/cdd/2005quarter1.pdf
- Compendium of National Bank Part 24 National and Regional Funds
  http://www.occ.treas.gov/cdd/fundslist.htm

In addition, the OCC's District Community Affairs Officers, located in each district, can provide assistance to banks interested in establishing or participating in a CDC, investing in low-income housing tax credit projects, or making other part 24 community development investments. A listing of community affairs officers is provided at: http://www.occ.treas.gov/cdd/contacts.htm.

Comptroller of the Currency
Administrator of National Banks

CD-1 – National Bank Community Development (Part 24) Investments

For Official Use Only

OMB Number
1557-0194

A national bank or national bank subsidiary may make an investment directly or indirectly under this part if the investment primarily promotes the public welfare under the community development investment authority in 12 USC 24(Eleventh) and its implementing regulation, 12 CFR 24 (Part 24). Part 24 contains the OCC guidelines to determine whether an investment is designed primarily to promote the public welfare and procedures that apply to those investments. National banks must submit the completed form to provide an after-the-fact notice or to request prior approval of a public welfare investment to the Community Affairs Department, Office of the Comptroller of the Currency, Washington, DC 20219. Please contact the Community Affairs Department at (202) 874-4930 or CommunityAffairs@occ.treas.gov for more information.

PLEASE PROVIDE THE FOLLOWING INFORMATION ABOUT THE INVESTING BANK.

Bank name:	Mailing address *(street or P.O. box):*
Bank charter number:	City, State, ZIP Code:
Telephone number:	Fax number:
E-mail address:	URL:

CONTACT FOR INFORMATION:

Name of bank contact responsible for form's information:	Name of bank contact responsible for CD investment (if different):
Mailing address *(street or P.O. box):*	Mailing address *(street or P.O. box)*:
City, State, ZIP Code:	City, State, ZIP Code:
Telephone number:	Telephone number:
Fax number:	Fax number:
E-mail address:	E-mail address:

PLEASE INDICATE THE PROCESS THE BANK REQUESTS BY CHECKING THE APPROPRIATE BOX, BELOW.

After-the-fact notice (12 CFR 24.5(a)) - complete sections 1 and 2. ☐
Prior approval (12 CFR 24.5(b)) - complete section 2. ☐

Section 1 – After-The-Fact Notice Only (12 CFR 24.5(a))

A bank may provide an after-the-fact notice of its Part 24 investment if the bank responds affirmatively to all of the following requirements.

The bank is "well-capitalized," as defined in 12 CFR 24.2(i). Yes ☐ No ☐

The bank has a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System. Yes ☐ No ☐

The bank's most recent Community Reinvestment Act rating is satisfactory or outstanding. Yes ☐ No ☐

The bank is not under a cease and desist order, consent order, formal written agreement, or Prompt Corrective Action directive.

Yes ☐ No ☐

Including this investment, the bank's aggregate outstanding investments and commitments under Part 24 do not exceed 5 percent of its capital and surplus, unless the OCC has provided written approval of a written request by the bank allowing the bank to provide after-the-fact notices for investments that would raise the aggregate amount of the bank's Part 24 investments beyond 5 percent of its capital and surplus.

Yes ☐ No ☐

The investment does not involve properties carried on the bank's books as "other real estate owned." Yes ☐ No ☐

The OCC has not determined, in published guidance, that the investment is inappropriate for the after-the-fact notification. Yes ☐ No ☐

Has the bank responded affirmatively to all of the above requirements in order to provide an after-the-fact notice of its Part 24 investment? [The OCC may have provided written notification that the bank may submit Part 24 after-the-fact notices. If so, please provide the date or a copy of the OCC's written notification.]

Yes ☐ (The bank may make an investment authorized by 12 USC 24(Eleventh) and this part and notify the OCC within 10 working days by submitting a completed after-the-fact notice.)

No ☐ (The bank must seek prior OCC approval of its investment and submit a completed investment proposal before making the investment.)

(To complete the after-the-fact notice process or to request prior OCC approval, please proceed to section 2 of this form.)

Section 2 — All Requests

1. **Please indicate how the bank's investment is consistent with Part 24 requirements for public welfare investments, under 12 CFR 24.3.**

   a. Check at least one of the following that applies to the bank's investment:

   The investment primarily benefits low- and moderate-income individuals. ☐

   The investment primarily benefits low- and moderate-income areas. ☐

   The investment primarily benefits areas targeted for redevelopment by a government entity. ☐

   The investment is a "qualified investment" under 12 CFR 25.23 for purposes of the Community Reinvestment Act. ☐

2. **Please indicate how the bank's investment is consistent with Part 24 requirements for investment limits under 12 CFR 24.4 by responding to the following questions.**

   a. Dollar amount of the bank's investment that is the subject of this submission: ______.

   b. Percentage of the bank's capital and surplus represented by the bank's investment that is the subject of this submission: ______%.

   c. Percentage of the bank's capital and surplus represented by the aggregate outstanding Part 24 investments and commitments, including this investment: ______%.

   d. Does this investment expose the bank to unlimited liability?

   Yes ☐ (This investment cannot be made under Part 24.)

   No ☐

3. **Please attach a brief description of the bank's investment. (*See* 12 CFR 24.5(a)(3)(i) and (b)(2)(i)). Include the following information in the description.**

   a. The name of the community and economic development entity (CEDE) into which the bank's investment has been (or will be) made.

   b. The type of bank investment (equity, debt, or other).

   c. The activity or activities of the CEDE in which the bank has invested (or will invest). (*See* examples of qualifying investment activities described in 12 CFR 24.6 (a), (b), (c), and (d).)

   d. How the investment is structured so that it does not expose the bank to unlimited liability, such as by describing the structure of the CEDE (*e.g.*, CDC subsidiary, multi-bank CDC, multi-investor CDC, limited partnership, limited liability company, community development bank, community development financial institution, community development entity, community development venture capital fund, community development lending consortia, community development closed-end mutual funds, non-diversified closed-end investment companies, or any other CEDE) and by providing any other relevant information.

   e. The geographic area served by the CEDE.

f. The total funding or other support by community development partners involved in the project (*e.g.*, government or public agencies, nonprofits, other investors), if known.

g. Supplemental information (*e.g.*, prospectus, annual report, Web address that contains information about the CEDE in which the investment is or will be made), if available.

4. Evidence of qualification is readily available for examination purposes.

The bank maintains information concerning this investment in a form readily accessible and available for examination that supports the certifications contained in this form and demonstrates that the investment meets the standards set out in 12 CFR 24.3, including, where applicable, the criteria of 12 CFR 25.23.

Yes ☐ No ☐

5. Certification

The undersigned hereby certifies that the foregoing information in this form is accurate and complete. It is further certified that the undersigned is authorized to file this form on Part 24 investments for the bank.

Name: ______________________________

Title: ______________________________

Signature: ______________________________

Date: ______________________________

DESCRIPTION OF THE BANK'S CD INVESTMENT. (S*ee information previously requested*)

(Type the description of the bank's Part 24 investment here. You may type as much text as necessary. You will have access to all of MS Word's editing features.)

Comptroller of the Currency
Administrator of National Banks
US Department of the Treasury

Community Developments

February 2008

Insights

Community Affairs Department

Low-Income Housing Tax Credits:

Affordable Housing Investment Opportunities for Banks

Abstract:

Over the past two decades, the Low-Income Housing Tax Credit (LIHTC) program has addressed the nation's affordable housing needs by financing nearly two million low-income units. This *Insights* report describes how LIHTCs are used to develop affordable rental housing and how banks can benefit from investing in LIHTC-financed projects. It describes the two approaches for investing in LIHTCs — direct investments in individual affordable housing projects and fund investments that have multiple projects managed by third parties. The report outlines risks and regulatory considerations of LIHTC investments and describes how these investments would be treated in a Community Reinvestment Act (CRA) examination.

This information includes a general overview of United States federal income tax laws and regulations, but does not constitute tax advice. Institutions should consult their tax advisors about the tax treatments described in this report and the consequences that may apply to their transactions.

I. What Is the Low-Income Housing Tax Credit Program?

The passage of the Tax Reform Act of 1986 established the LIHTC program to provide market incentives to acquire and develop or rehabilitate affordable rental housing.[1] Over the past two decades this program has helped construct and rehabilitate the nation's affordable housing stock.

The program works as follows. The Internal Revenue Service (IRS) allocates federal tax credits to State Housing Credit Agencies (HCAs).[2] HCAs award tax credits to eligible affordable housing developers. The developers use the equity capital generated from the sale of the tax credits to lower the debt burden on tax credit properties, making it easier to offer lower, more affordable rents. Investors, such as banks, purchase the tax credits to lower their federal tax liability.

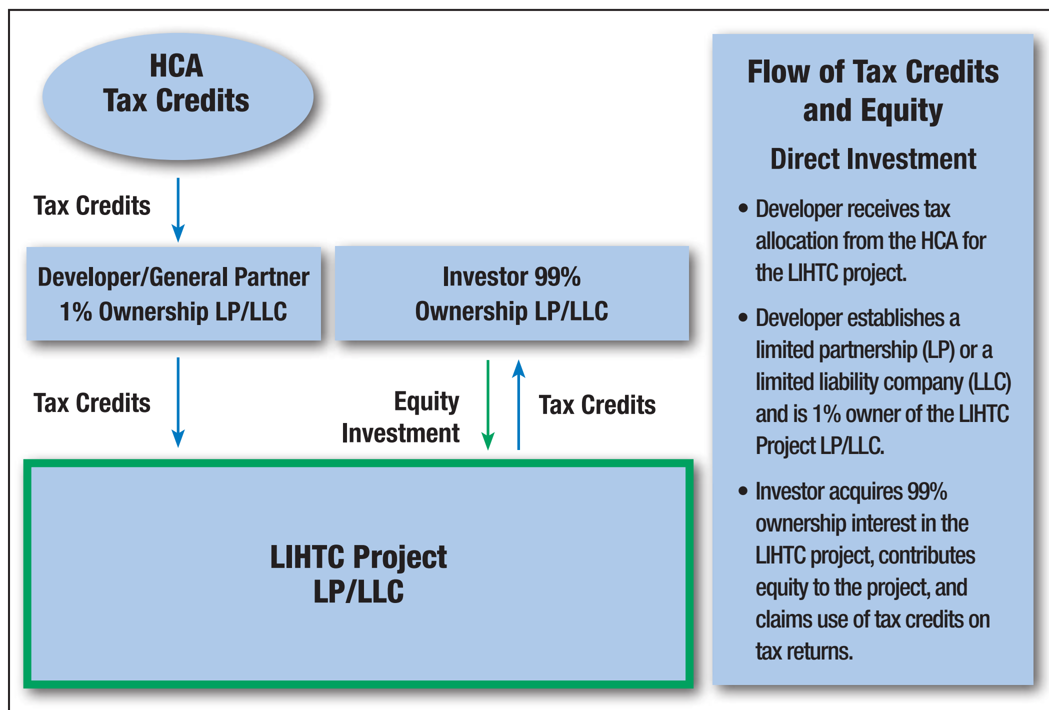
[1] Tax Reform Act of 1986, PL 99-514, 100 Stat 2085, HR 3838, 99th Congress, 2nd Session (October 22, 1986). The Internal Revenue Code (IRC) Section 42 contains the LIHTC provisions and is commonly referred to as "Section 42" of the IRC. Because LIHTCs are also commonly known as housing tax credits or tax credits, these terms are used interchangeably.

[2] Under IRC Section 42 (Section 42), state HCAs may delegate authority to local agencies. For ease of discussion, this article uses the 'HCA' convention when referring to these agencies. Together, 58 state and local agencies are authorized (subject to an annual per capita limit) to issue federal tax credits for the acquisition, rehabilitation, or construction of affordable rental housing. *See* "U.S. Housing Market Conditions Summary," U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Winter 2000.

Developers typically structure LIHTC projects as limited partnerships (LPs) or limited liability companies (LLCs), providing limited liability to bank investors. This structure allows banks to be investors that receive tax credit benefits and passive losses.[3] Banks can make direct investments in single LIHTC projects through LIHTC Project LP/LLCs as described in Figure 1 and LIHTC fund investments as shown in Figure 2.

Figure 1

Typical Legal Structure: Direct Investment



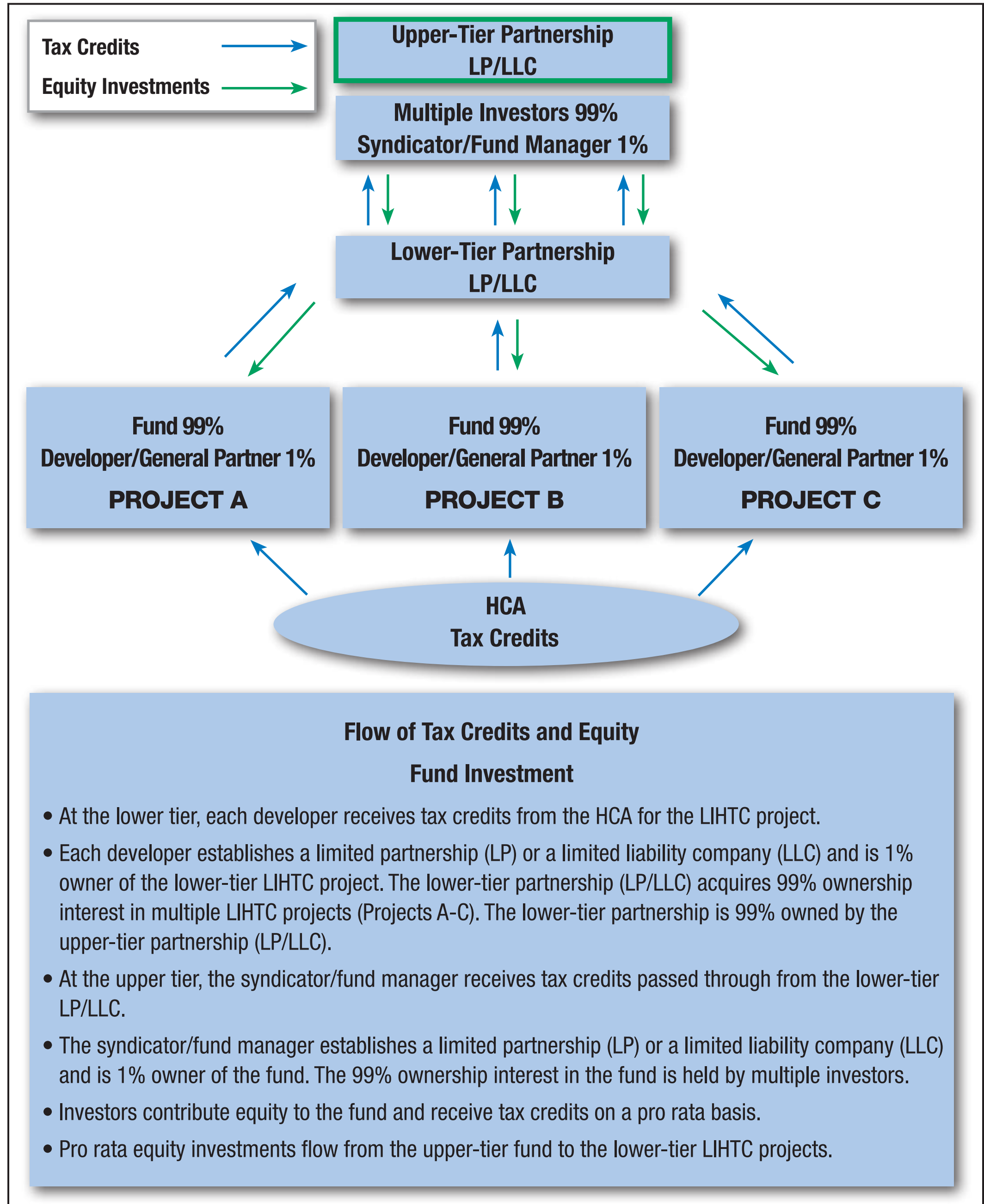
Larger banks make up the typical investor profile for LIHTC direct investments, which usually range between $2 million and $10 million.

Figure 2 represents the common legal structure for fund investments, which are typically comprised of multiple LIHTC projects. The upper-tier LP/LLC includes multiple investors that together account for 99 percent fund ownership and a syndicator/fund manager (fund) that has 1 percent fund ownership. The lower-tier partnerships are represented by separate LIHTC projects. The fund has 99 percent ownership in each project, and the developer/general partner of each project has 1 percent ownership. As with the direct investment structure, the HCA awards the tax credits to the developer/general partner. In this typical investment structure, the developer/general partner brings the tax credits to the lower-tier partnership and obtains equity through investments made by investors in the upper-tier fund. Investor equity contributions and tax credit distributions equate to the investor's share of ownership in the upper-tier investment fund.

[3] Under federal income tax law, LIHTCs may be taken only by property owners who have the benefits and burdens of ownership. This would include LPs, LLC owners, and other equity investors in the property. For example, if a bank is a 99 percent owner in a LP partnership, it will receive 99 percent of the tax credits and passive losses, which include, but are not limited to, depreciation and interest expenses.

Figure 2

Typical Legal Structure: Fund Investment



Syndicators usually set the minimum investment amount, with many allowing for investments of $1 million or less. Typically, syndicators hold investments in multiple affordable rental properties in several geographic areas and offer multi-investor funds. There are a number of national, state, and regional LIHTC funds around the country.[4] Fund investments may appeal to mid-size and community banks because of the greater investment flexibility in terms of lower investment amounts, greater portfolio diversity, and less bank administrative oversight.

[4] The National Equity Fund, for example, is a national syndicator of tax credits, including LIHTCs. Information about this fund is available at www.nefinc.org. In addition, at least 30 local and state equity funds provide equity capital for rental housing developments that qualify under the LIHTC program across the nation. More information about these local and state investment funds can be obtained from the National Association of State and Local Equity Funds at www.naslef.org.

II. Why Are Low-Income Housing Tax Credits of Interest to Banks?

Banks have chosen to participate in the LIHTC program for a number of reasons. These include:

- Earning attractive economic rates of return on investments.
- Contributing to revitalization in low-income areas, which frequently involves partnerships with community-based organizations.
- Gaining opportunities to diversify into other credit products and services.
- Receiving favorable CRA consideration.

Competitive Investment Yields

Depending on a bank's risk tolerance and tax credit appetite, the LIHTC program provides different investment methods to accommodate varied investor interests. The after-tax yields on LIHTC investments have consistently exceeded the blended municipal bond yields and the after-tax 10-year U.S. Treasury yields.[5] In recent years, the yields on tax credit investments have ranged between 5 percent and 7 percent.[6]

Additional Commercial Lending Opportunities

LIHTC projects are undertaken by developers who may have significant banking relationships with various financial institutions. The LIHTC program allows banks to expand their existing customer relationships and to develop new ones by offering additional products and services related to a developer's proposed tax credit project. Loan products that are often required in conjunction with the development of LIHTC projects include:

- Pre-development and acquisition loans.
- Bridge loans.[7]
- Construction loans.
- Permanent mortgage financing.
- Letters of credit.[8]
- Warehouse lines of credit.[9]

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[5] The blended municipal bond yield is a weighted average yield for bonds with varying risk ratings. *See Understanding the Dynamics IV, Housing Tax Credits Investment Performance*, Ernst & Young Tax Credit Investment Advisory Services, June 2007.

[6] This information is drawn from several interviews made with LIHTC investors.

[7] Bridge loans are short-term credit facilities provided by banks to tax credit investors to cover their capital contributions during the construction period. Also known as "subscription obligation financing," these credit facilities are typically secured by the unconditional commitment of investors. These credit facilities are often used by syndicators to generate higher internal rates of return required to attract investors as well as to better manage the capital contribution process.

[8] Banks can provide letters of credit on state HCA-issued tax-exempt bonds to enhance their credit ratings. Tax-exempt bonds are sometimes used to finance 4 percent LIHTC transactions.

[9] Banks can provide warehouse lines of credit to syndicators, allowing them to acquire LIHTC properties. The repayment source is equity capital from fund investors.

Platform for Leveraging Other Tax Credit Investments

Depending on the age and location of the property, LIHTC investments can be combined with historic rehabilitation tax credits (HTCs).[10] These projects, often referred to as "twinned" transactions, are popular with some developers and bank investors. Additionally, some states have established their own housing tax credit programs, which also can be twinned with the federal LIHTC program. The blend of federal LIHTCs with HTCs (and sometimes state housing tax credits) tends to improve the internal rates of return on these transactions for bank investors.

Favorable CRA Consideration

A 2003 study found that 43 percent of the LIHTC investors were subject to the CRA.[11] An important incentive for banks investing in LIHTCs is that they may receive favorable consideration under the CRA for this activity. Direct investments and loans made to LIHTC projects or investments made in syndicated funds (usually including numerous LIHTC projects) meet the definition of qualified activities under the CRA.[12] Banks will receive positive CRA consideration for such investments and loans when they benefit the bank's assessment area. In addition, investments and loans to LIHTC projects and funds that provide benefits to a broader statewide or regional area that includes the bank's assessment area(s) may receive positive CRA consideration, provided the bank has otherwise adequately addressed the community development needs of its assessment area(s), even if these activities will not directly benefit the institution's assessment area(s).[13]

Investments in state and municipal obligations, such as revenue bonds that specifically support affordable housing, also meet the definition of qualified investments under the CRA.[14] Community development loans for construction or permanent financing of LIHTC properties would receive positive CRA consideration too, provided the geographic requirements are met.

Revisions to the CRA regulation in 2005 expanded the definition of "community development" to include activities that revitalize or stabilize designated disaster areas and designated nonmetropolitan middle-income distressed/underserved areas. Typically, activities in these specially designated areas must benefit a bank's assessment area(s) or a broader statewide or regional area that includes a bank's assessment area(s) in order to receive CRA consideration.

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[10] The Federal Historic Preservation Tax Incentives program is jointly administered by the IRS and the National Park Service. Information about the federal tax incentives for historic preservation and rehabilitation is available from the IRS, http://www.irs.gov/businesses/small/industries/article/0,,id=97599,00.html; National Park Service, U.S. Department of the Interior, http://www.nps.gov/history/hps/tps/tax/brochure1.htm; and the National Trust for Historic Preservation, http://www.nationaltrust.org/rehab_tax_credits.

[11] "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," Ernst & Young report commissioned by the National Council of State Housing Agencies, February 2003, p. 4.

[12] The 2001 Interagency CRA Questions and Answers, __.12(s) & 563e.12(r)-4 provide examples of qualified investments, one of which describes projects eligible for low-income housing tax credits. Additional information about qualified direct and indirect (fund) investments is provided in the 2001 Interagency CRA Questions and Answers, __.23(a)-1 and __.12(s) & 563e.12(r)-4.

[13] *See* the 2001 Interagency CRA Questions and Answers, __.12(i) & 563e.12(h)-5 and the 2007 proposed Interagency CRA Question and Answers, __.23(a) – 2 that addresses the geographic requirements for qualified funds.

[14] IRC Section 265(b) states that banks may not deduct the carrying cost (the interest expense incurred to obtain or carry an inventory of securities) of tax-exempt municipal bonds. An exception, which allows banks to deduct 80 percent of the carrying cost of a "qualified tax-exempt obligation," requires that bonds be: (i) issued by a "qualified small issuer;" (ii) issued for public purposes; and (iii) designated as qualified tax-exempt obligations. A qualified small bond issuer is an entity that issues no more than $10 million of tax-exempt bonds during the calendar year. A discussion about bank qualified bonds is available at www.munibondadvisor.com/BQBonds.htm.

However, in 2006 the OCC issued Bulletin 2006-6, which made an exception to the geographic requirements for disaster areas related solely to hurricanes Katrina and Rita.[15] As a result, a bank located outside the designated disaster areas for hurricanes Katrina and Rita may receive positive CRA consideration for activities that revitalize or stabilize these areas, provided that the bank has otherwise adequately met the CRA-related needs of its local communities. This would include investment in projects eligible for LIHTCs that are related to disaster recovery.

III. How Does the Low-Income Housing Tax Credit Program Work?

The LIHTC program provides equity that is used by developers to subsidize the construction and rehabilitation costs of affordable rental housing. The HCA administers the program and creates a qualified allocation plan (QAP) that is used to evaluate tax credit applications submitted by developers seeking tax credits.[16] HCAs are located in each of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

Developers selected by HCAs to receive tax credits offer these credits to investors to obtain equity for their projects. Once a project is placed in service,[17] the tax credit compliance period for the investor extends for 15 years. However, the units must maintain affordable rent for at least 30 years. This additional 15 years is known as the extended use period.[18] Investors typically exit the investment at the completion of the 15-year compliance period, after which the risk of recapture ends.[19]

The 9 Percent Tax Credit

The 9 percent tax credit is designed to subsidize 70 percent of the eligible development costs for new construction and substantial rehabilitation of housing projects that are not otherwise subsidized by the federal government.[20] These tax credits are awarded by HCAs on a competitive basis to for-profit and nonprofit affordable housing developers who, in turn, offer the credits to investors.[21] The funds raised from the sale of tax credits are used as equity financing for the housing project. Figure 3 illustrates how a typical 9 percent LIHTC investment operates. In this example, developers submit project proposals to a HCA. Projects accepted are eligible for 9 percent tax credit allocations. Developers then obtain equity capital from bank investors. (Appendix A illustrates a 9 percent LIHTC case study.)

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[15] The OCC Bulletin 2006-6 – Hurricanes Katrina and Rita is available at http://www.occ.gov/ftp/bulletin/2006-6.doc.

[16] State HCAs may delegate authority to local agencies to issue tax credits, subject to the state's annual per capita cap.

[17] Generally, the placed in service date for a new or existing building to be used as residential rental property is the date on which the building is ready for occupancy (Section 42(e)(4)(A)).

[18] Developers seeking LIHTCs must follow Section 42(h)(6) which states that a building is eligible for tax credits if there is a long-term commitment to low-income housing. Section 42(h)(6)(D) describes the end of the extended use period as being the later of the date specified by the HCA or the date which is 15 years after the end of the compliance period. Typically, a developer's commitment to low-income housing is at least 30 years.

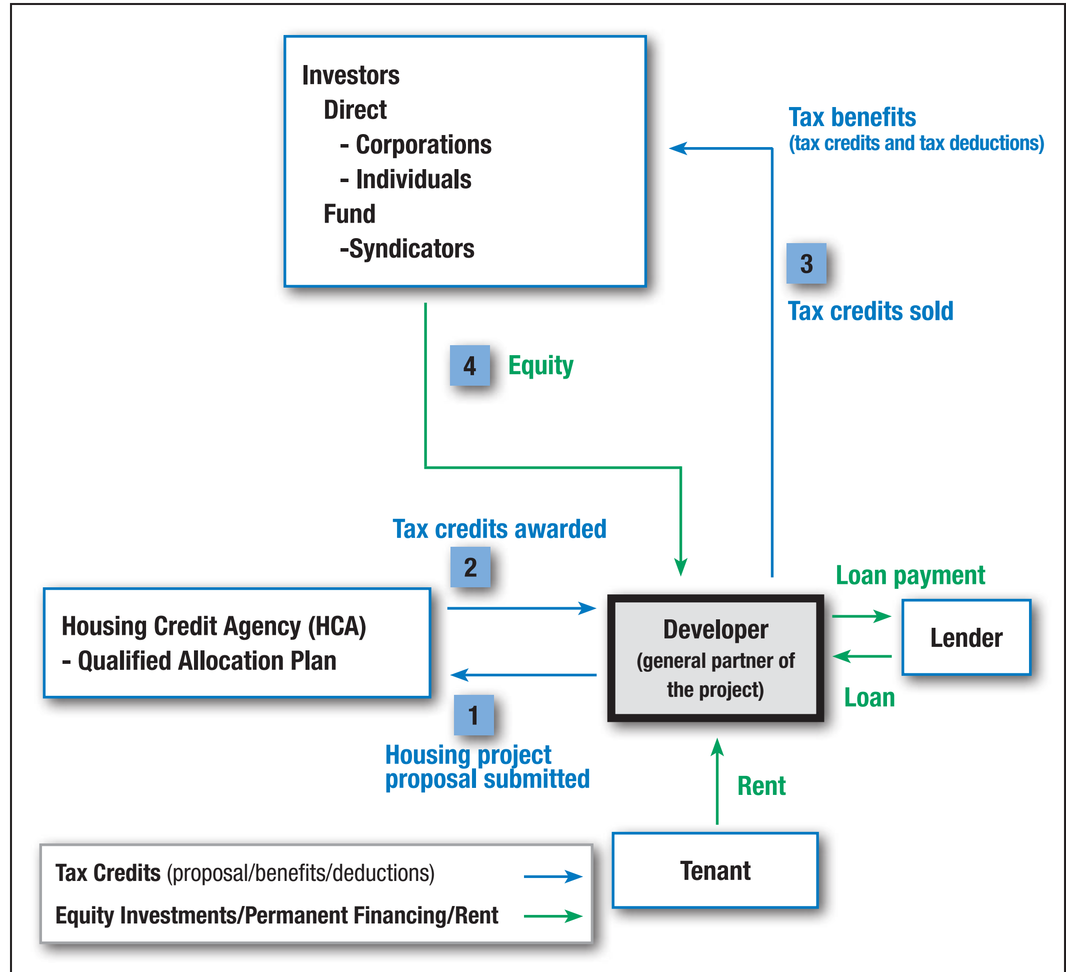
[19] A detailed description for noncompliance and possible recapture of tax credits is provided in Section 42(j)(1-3).

[20] The actual tax rate is not exactly 9 percent. This rate, commonly referred to as a monthly applicable federal rate (AFR), is indexed to 10-year U.S. Treasury note yields. Monthly AFRs are available in Table 4 at www.irs.gov/app/scripts/retriever.jsp. More information about the use of non-federal subsidies and the few allowable exceptions for 9 percent tax credit projects is available at http://www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/calculating/rates.cfm.

[21] On rare occasions, a project originally competing for 9 percent tax credits may become ineligible for reasons such as it is also using non-exempt federally-subsidized funds. Under these circumstances, a HCA may choose to allocate 4 percent credits from its volume cap for otherwise eligible projects.

Figure 3

Flow of 9 Percent Tax Credits and Equity Investments



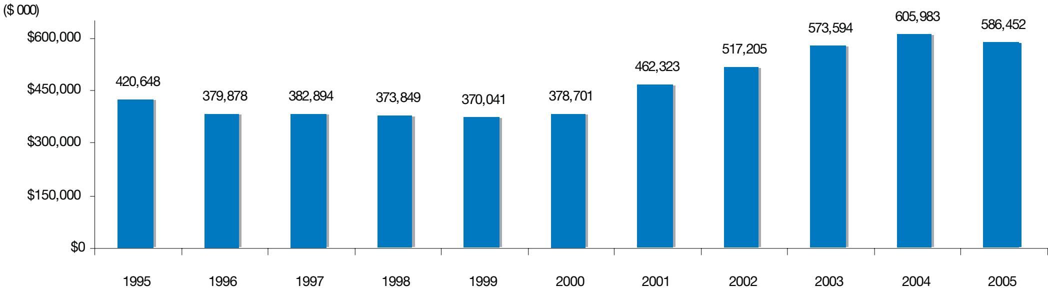
For each state, the annual 9 percent tax credit volume cap is measured as the product of a fixed per capita rate multiplied by a state's population.[22] Over the last two decades, nearly 1.5 million rental units have been financed with roughly $8 billion of 9 percent tax credits.

[22] In 2008, the fixed per capita rate is $2.00, with a minimum of $2,325,000 for less populated states. A state with a population size of 10 million people, for example, would have an annual 9 percent housing tax credit volume cap of $20,000,000 in 2008. From 1986 through 2000, the initial credit allocation amount was $1.25 per capita. The per capita allocation increased to $1.50 in 2001, $1.75 in 2002 and 2003, and indexed for inflation annually thereafter. The initial minimum tax credit volume cap for less populated states was $2 million and after 2003 was indexed annually for inflation. A state has two years to award housing tax credits to projects. If a state is unable to use its tax credits over a two-year period, they are returned to a national pool for re-allocation. If a state awards tax credits to a project that is not completed and the tax credits are returned, the state has an additional two years to award the tax credits to another project within the state. (More information is available at www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/basics/allocating.cfm).

Figure 4 reports the aggregate dollar amount of 9 percent LIHTC projects across the nation from 1995 to 2005, and Figure 5 shows the number of units created from this tax program over the same time frame.

Figure 4

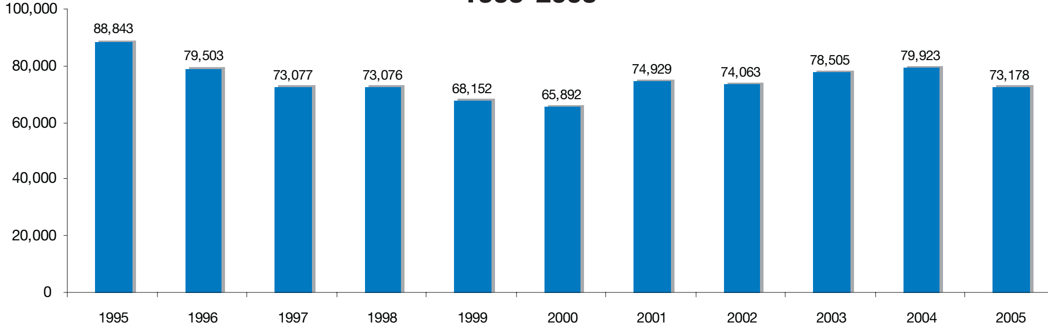
Aggregate Dollar Amount of 9 Percent LIHTCs 1995-2005



Source: *State HFA Factbook: 2005 NCSHA Annual Survey Results,* National Council of State Housing Agencies (NCSHA).

Figure 5

Number of 9 Percent LIHTC Units 1995-2005



Source: *State HFA Factbook: 2005 NCSHA Annual Survey Results,* National Council of State Housing Agencies (NCSHA).

The 4 Percent Tax Credit

When 50 percent or more of the project's eligible costs are financed with tax-exempt private activity bonds, project developers can receive 4 percent LIHTCs.[23] These tax credits, awarded to developers in a non-competitive application process, are designed to provide a 30 percent subsidy that is applied to the acquisition of existing buildings and to federally-subsidized new construction or rehabilitation.[24] As provided for in the LIHTC regulations, developers of 4 percent tax credit projects can seek additional funding through numerous sources, including but not limited to, federal programs, such as the HOME Investment Partnership Program, the Federal Home Loan Bank Program, and the Community Development Block Grant Program. Other sources may include state fund loans and private foundation grants. Since this program began, more than 500,000 rental units have been financed with 4 percent housing credits and tax-exempt private activity bonds.

Figure 6 illustrates the flow of 4 percent tax credits, equity investments, and permanent financing for a qualified affordable rental housing project. (Appendix B describes a 4 percent LIHTC case study.)

On the debt financing side, the HCA issues tax-exempt bonds that are sold to investors.[25] Proceeds of the bond sale are deposited with a trustee, typically a mortgage bank that functions as a financial intermediary and mortgage lender. The first mortgage financing on the project originates from the bond sale proceeds deposited with a trustee. In some transactions, developers may seek credit enhancement to obtain a higher grade bond rating.[26]

Passage of the LIHTC program made tax-exempt bonds subject to the private activity bond volume limits established by the IRS.[27] LIHTC projects financed with 4 percent tax credits are separate and distinct from a state's 9 percent tax credit volume cap and allocation. The benefit of combining tax-exempt bond financing with 4 percent LIHTCs is that these tax credits are not in competition with projects seeking the 9 percent tax credit allocations.

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[23] The actual tax credit rate is not exactly 4 percent. This rate, commonly referred to as a monthly applicable federal rate (AFR), is indexed to 10-year U.S. Treasury note yields. Monthly AFRs are available in Table 4 at www.irs.gov/app/scripts/retriever.jsp.

[24] State HCAs may delegate authority to local agencies to issue state tax-exempt private activity bonds or local agencies may issue local tax-exempt private activity bonds for financing eligible projects following the state HCA's underwriting criteria. The developer receiving the tax-exempt bond allocation would apply to the state HCA to receive 4 percent tax credits.

[25] Banks, like other investors, invest in municipal bonds to enjoy the benefit of earning tax-exempt interest income. After the passage of the Tax Reform Act of 1986, tax credit transactions do not qualify for bank-qualified bonds. To the extent that banks are substantial owners of bond debt, they cannot also hold tax credits for the same building. Similarly, as owners of tax credits, banks cannot own tax-exempt bonds for the same building. That is, banks cannot participate on both sides of the same tax credit transaction. However, banks play other important roles, such as underwriting the bond transaction.

[26] In addition to HUD's FHA multifamily mortgage insurance program, other types of credit enhancement programs are available through Fannie Mae, Freddie Mac, Ginnie Mae, and/or bank-provided letters of credit.

[27] *See Tax-Exempt Private Activity Bonds,* IRS, Tax Exempt and Government Entities, available at http://www.irs.gov/pub/irs-pdf/p4078.pdf. Private activity bond volume caps for U.S. possessions are determined under IRC Section 146 (d) (4). The volume cap for private activity bonds is calculated as the product of an area's population multiplied by a per capita rate, $85 in 2008, with a minimum of $262,095,000 for states with relatively lower populations. Beginning January 1, 2003, private activity bond volume caps became indexed for inflation. More information is available from the National Council of State Housing Agencies at www.ncsha.org.

Figure 6

Flow of 4 Percent Tax Credits, Equity Investments, and Permanent Financing

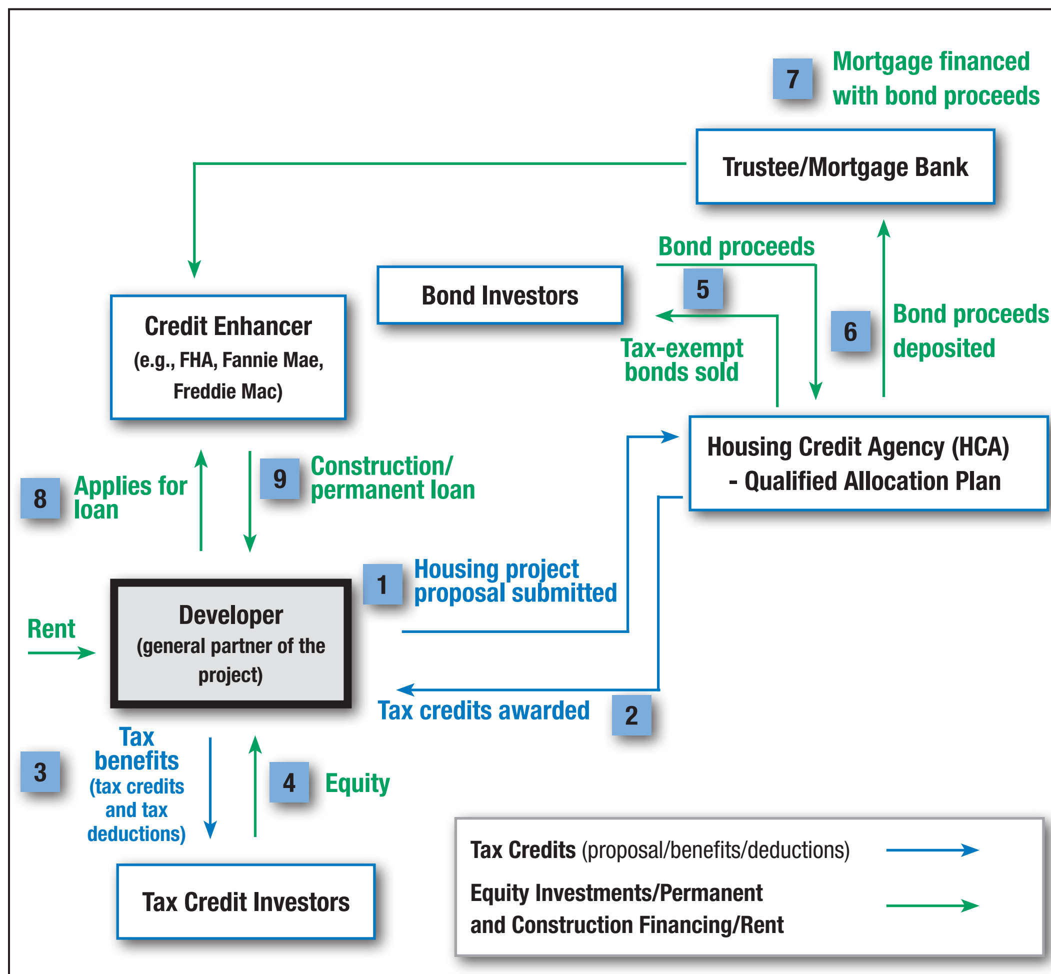
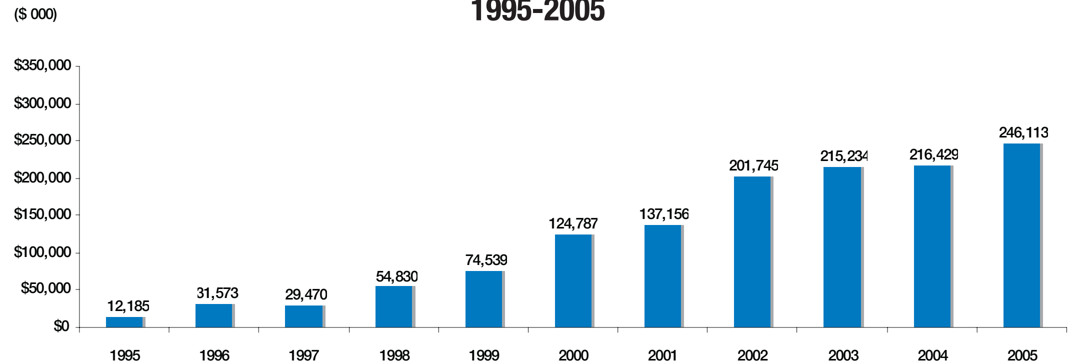


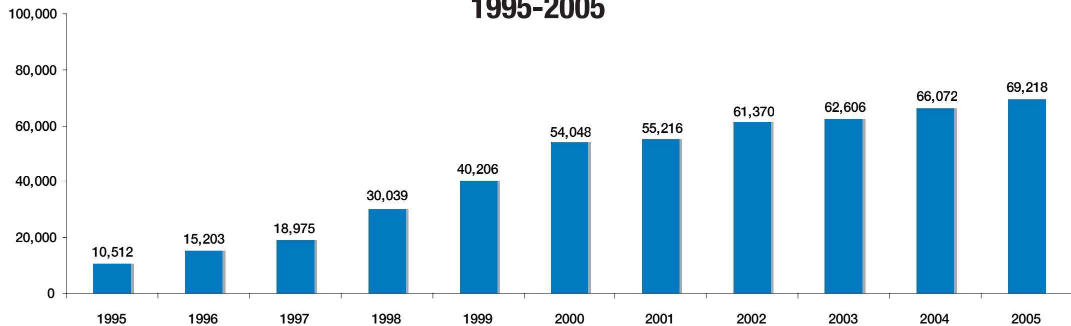
Figure 7 and Figure 8 illustrate the aggregate dollar amount and number of housing units produced by the 4 percent tax credit program between 1995 and 2005.

Figure 7



Source: *State HFA Factbook: 2005 NCSHA Annual Survey Results,* National Council of State Housing Agencies (NCSHA).

Figure 8



Source: *State HFA Factbook: 2005 NCSHA Annual Survey Results,* National Council of State Housing Agencies (NCSHA).

Income Eligibility and Rent Restrictions

The LIHTC program helps reduce rents in units made available to low-income households in projects that receive tax credit allocations. Under Section 42, LIHTC project developers must set aside either 40 percent of the units for residents that earn no more than 60 percent of the area's median income or 20 percent of the units for residents earning 50 percent or less of the area's median income. These units are subject to rent restrictions regarding the maximum gross rent that can be charged, including an allowance for utilities.[28] The law requires units to be rent-restricted and occupied by income-eligible households for at least 30 years.[29]

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[28] Detailed information about rent calculations for tax credit units is available at www.huduser.org/datasets/il/il06/faq.html, Income Limits page, Frequently Asked Questions.

[29] Some states require longer periods of compliance with low-income housing commitments of more than 30 years. Under these circumstances, states provide commensurate incentives for projects that voluntarily agree to longer compliance periods. For more information, see "Low Income Housing Tax Credit," National Low Income Housing Coalition, available at http://www.nlihc.org/detail/article.cfm?article_id=2790&id=46.

Guaranteed Funds

Some LIHTC funds offered by syndicators will guarantee a minimum yield to a bank investor. In this case, the syndicator, either directly or through a third-party, serves as the fund guarantor. Under this arrangement, the risk, which includes exposure to recapture risk on lower-tier projects the fund invests in, shifts to the guarantor and provides the investor with a guaranteed return. On a risk/return basis, guaranteed funds typically produce lower yields to investors than non-guaranteed funds.

Fifteen-Year Investment Period

A key economic benefit of a LIHTC investment is the opportunity to claim the federal tax credit over an accelerated 10-year time frame beginning in the taxable year in which the property is placed in service.[30] Although tax credits are claimed over 10 years, the investment compliance period continues until the end of the 15th year.[31] Investors will also benefit from the partnership's pass through of passive losses associated with income-producing real estate, such as depreciation and interest expense. We illustrate these combined benefits for a hypothetical 9 percent transaction in Figure 9 and a hypothetical 4 percent transaction in Figure 10.

As shown in Figure 9, if the qualified basis for a LIHTC project is $10,000,000, then 9 percent credits produce an annual tax credit $808,000, totaling $8,080,000 for the investor in 10 years.[32] Additionally, the sum of the other tax benefits is $3,000,000, creating a combined benefit of $11,080,000 over the life of the investment. Similarly, Figure 10 describes a hypothetical example when 4 percent tax credits are applied. With a qualified basis of $10,000,000, 4 percent tax credits produce for the investor a total of $3,460,000 in tax benefits over 10 years.[33] The sum of the other tax benefits is $1,285,000. Over the life of the investment the combined benefit is $4,745,000. At the end of the 15-year compliance period, bank investors typically exit the transaction (disposition in year 16) without triggering a recapture of tax credits.[34]

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[30] At the election of the taxpayer, the tax credit period may begin the succeeding taxable year. See Section 42(f)(1) and Section 42(h)(1)(B) for the conditions placed on this election.

[31] In addition, the unit rents must maintain affordability for at least 30 years.

[32] The annual 9 percent housing tax credit calculation is based on the July 2007 applicable federal rates.

[33] The annual 4 percent housing tax credit calculation is based on the July 2007 applicable federal rates.

[34] For more information about property disposition strategies, see *Understanding the Dynamics IV, Housing Tax Credits Investment Performance*, Ernst & Young Tax Credit Investment Advisory Services, June 2007, page 35.

Figure 9

Hypothetical LIHTC Project Benefit Schedule
9 Percent Tax Credits

	Tax Credit Benefit (AFR[1] = 8.08 %) ($)	**Other Tax Benefit[2]** (depreciation, interest expense, etc.) ($)	**Combined Benefit** ($)
Qualified basis[3]	10,000,000		
Annual Housing Tax Credits (Qualified basis multiplied by the applicable AFR)	808,000		
Year 1	808,000	180,000	988,000
Year 2	808,000	300,000	1,108,000
Year 3	808,000	250,000	1,058,000
Year 4	808,000	175,000	983,000
Year 5	808,000	170,000	978,000
Year 6	808,000	165,000	973,000
Year 7	808,000	160,000	968,000
Year 8	808,000	155,000	963,000
Year 9	808,000	150,000	958,000
Year 10	808,000	145,000	953,000
Year 11	0	140,000	140,000
Year 12	0	135,000	135,000
Year 13	0	130,000	130,000
Year 14	0	125,000	125,000
Year 15	0	120,000	120,000
Year 16 (Disposition)	0	500,000	500,000
Total	**$8,080,000**	**$3,000,000**	**$11,080,000**

Notes:

[1] Applicable federal rates (AFRs) represent the IRS method of calculating the present value of the credits to investors. In accordance with Section 42 (b)(2), the IRS publishes monthly AFRs for the LIHTC program. These rates are indexed to 10-year U.S. Treasury note yields. In this example, the AFRs were for November 2007. Monthly AFRs are available in Table 4 at http://www.irs.gov/taxpros/lists/0,,id=98042,00.html.

[2] For illustrative purposes only, the annual tax deduction is equal to the value of the estimated annual losses multiplied by the annual corporate tax rate, assumed here to be 35 percent. In this illustration, the year 1 tax deduction of $180,000 is equal to $514,286 (year 1 losses) multiplied by the corporate tax rate, 35 percent. The project becomes fully operational, creating a somewhat higher tax deduction in year 2. Accelerated depreciation of the underlying assets (principally, real property, site improvements, and personal property) results in a declining balance of tax deductions through year 15. At the point of disposition, year 16, it is assumed that the investor's remaining capital account is roughly $1.5 million. Given a 35 percent corporate tax rate, the investor realizes an additional tax deduction in the amount of $500,000. A zero residual property value is assumed in this hypothetical illustration.

[3] The qualified basis is defined as the product of the eligible basis multiplied by the proportion of the project's affordable housing units. The eligible basis, which is the amount of all depreciable development costs, includes all hard costs, such as construction costs and most depreciable soft costs such as architectural and engineering costs. Excluded from the eligible basis are non-depreciable costs, such as land acquisition, permanent financing costs, and initial deposits to reserves.

Figure 10

Hypothetical LIHTC Project Benefit Schedule
4 Percent Tax Credits

	Tax Credit Benefit (AFR[1] = 3.46 %) ($)	Other Tax Benefit[2] (depreciation, interest expense, etc.) ($)	Combined Benefit ($)
Qualified basis[3]	10,000,000		
Annual Housing Tax Credits (Qualified basis multiplied by the applicable AFR)	346,000		
Year 1	346,000	50,000	396,000
Year 2	346,000	125,000	471,000
Year 3	346,000	100,000	446,000
Year 4	346,000	95,000	441,000
Year 5	346,000	90,000	436,000
Year 6	346,000	85,000	431,000
Year 7	346,000	80,000	426,000
Year 8	346,000	75,000	421,000
Year 9	346,000	70,000	416,000
Year 10	346,000	65,000	411,000
Year 11	0	60,000	60,000
Year 12	0	55,000	55,000
Year 13	0	50,000	50,000
Year 14	0	45,000	45,000
Year 15	0	40,000	40,000
Year 16 (Disposition)	0	200,000	200,000

Notes:

[1] Applicable federal rates (AFRs) represent the IRS method of calculating the present value of the credits to investors. In accordance with Section 42 (b)(2), the IRS publishes monthly AFRs for the LIHTC program. These rates are indexed to 10-year U.S. Treasury note yields. In this example, the AFRs were for November 2007. Monthly AFRs are available in Table 4 at http://www.irs.gov/taxpros/lists/0,,id=98042,00.html.

[2] For illustrative purposes only, the annual tax deduction is equal to the value of the estimated annual losses multiplied by the annual corporate tax rate, assumed here to be 35 percent. In this illustration, the year 1 tax deduction of $50,000 is equal to $142,857 (year 1 losses) multiplied by the corporate tax rate, 35 percent. The project becomes fully operational, creating a somewhat higher tax deduction in year 2. Accelerated depreciation of the underlying assets (principally, real property, site improvements, and personal property) results in a declining balance of tax deductions through year 15. At the point of disposition, year 16, it is assumed that the investor's remaining capital account is roughly $142,857. Given a 35 percent corporate tax rate, the investor realizes an additional tax deduction in the amount of $200,000. A zero residual property value is assumed in this hypothetical illustration.

[3] The qualified basis is defined as the product of the eligible basis multiplied by the proportion of the project's affordable housing units. The eligible basis, which is the amount of all depreciable development costs, includes all hard costs, such as construction costs and most depreciable soft costs such as architectural and engineering costs. Excluded from the eligible basis are non-depreciable costs, such as land acquisition, permanent financing costs, and initial deposits to reserves.

State Allocation Process

The IRS requires each state HCA to have a qualified allocation plan (QAP), which sets out the state's priorities and eligibility criteria for awarding 9 percent tax credits as well as state tax-exempt private activity bonds.[35] The QAP gives preference to projects that:

- Serve the lowest income residents.
- Serve income-eligible residents for the longest time frame.
- Locate in qualified census tracts, tracts with a poverty rate of 25 percent, or in which 50 percent of the households have incomes below 60 percent of the area median income and contribute to a community's revitalization plan.

A state may design its QAP to give bonus points to projects with specific goals and set aside a percentage of credits (targeted tax credit allocations) for projects that serve specific populations or locations.[36]

A HCA awards the 9 percent housing tax credits on a competitive basis, with many states having two rounds of applications for tax credit allocations each year. Nationwide, this intense competition results in one application out of five receiving an allocation of the 9 percent tax credits.[37] Project "readiness" is a primary criteria used by HCAs in evaluating tax credit applications. Developers must comply with the requirement that at least 10 percent of the project costs be incurred by no later than six months after the date the allocation is made or by the close of the year in which the allocation is made.[38]

HCAs also administer the tax-exempt private activity bond program using their state's QAP priorities and eligibility criteria standards. Whenever tax-exempt bonds are used to finance affordable rental units, the project is eligible for a 4 percent LIHTC allocation as long as the bond proceeds finance more than 50 percent of the eligible low-income housing project costs. The combination of tax-exempt bonds and tax credits may be used to fund new construction or the acquisition and rehabilitation of existing housing stock.

Difficult Development Areas and Qualified Census Tracts

HCAs may award up to 30 percent additional LIHTCs to projects located in HUD-designated high cost areas. This additional award is commonly referred to as a basis boost.[39] These areas include difficult development areas (DDAs), locations where the living costs

[35] Section 42(m) sets forth the QAP requirements for HCAs. A detailed discussion about QAPs is also given by the National Low Income Housing Coalition, "Low Income Housing Tax Credit," available at www.nlihc.org/detail/article.cfm?article_id=2790&id=46 and Mark H. Shelburne, "An Analysis of Qualified Allocation Plan Section Criteria," *Journal of Tax Credit Housing,* Volume 1, Issue 1, January 2008, available at Novogradac & Company LLP, www.novoco.com/aom.pdf.

[36] The selection criteria established by the HCA must address the following eight items: location, housing needs, public housing waiting lists, individuals with children, special needs populations, whether a project includes the use of existing housing as part of the community revitalization plan, project sponsor characteristics, and projects intended for eventual tenant ownership. Because these criteria are minimums, states can adopt more rigorous criteria aimed at meeting specific housing needs in the state. A HCA may delegate authority to a local agency to issue tax credits.

[37] *See* Pamela J. Jackson, "The Low-Income Housing Tax Credit: A Framework for Evaluation," CRS Report for Congress, RL33904, March 7, 2007.

[38] *See* Section 42(h)(1)(E)(ii). For the Gulf Opportunity Zone (GO Zone) hurricane relief efforts, the IRS has provided guidance and temporary relief related to the carryover allocation, recapture, compliance monitoring, and emergency housing relief efforts under Section 42 (*See* IRS Revenue Procedure 2007-54). It also provided for an extension of time for the restoration of LIHTC projects located within the GO Zone that were damaged by Hurricane Katrina (*See* IRS Bulletin: 2007-34, Notice 2007-66).

[39] A basis boost increases by up to 30 percent the eligible basis (eligible project development costs) used to calculate the annual tax credit.

are far above the national average, and qualified census tracts (QCTs), tracts with a poverty rate of at least 25 percent, or tracts in which 50 percent of the households have incomes below 60 percent of the area median income.[40] (An example of a project located in a difficult development area receiving a 30 percent basis boost is illustrated in Appendix A.)

IV. What Are the Key Risks and Regulatory Issues Associated with Low-Income Housing Tax Credit Investments?

Banks active in the LIHTC business initially consider these investments in a way similar to commercial real estate transactions. Once a bank is satisfied with its normal due diligence of the transaction, it needs to be comfortable with this transaction as a long-term investment.

Tax Planning, Compliance, and Risk

LIHTCs are designed to reduce an investor's tax liability. Bank investors must be able to project taxable income over the term of the investment. Moreover, banks should evaluate their exposure to the alternative minimum tax (AMT) since the tax credits may be used to reduce ordinary tax liability, but not their AMT liability. As a result, banks that expect to be subject to the AMT during the 10-year LIHTC period should carefully evaluate to what extent they can use LIHTCs to reduce their overall tax liability when calculating their return on investment.

The potential loss of the tax credit and its recapture by the IRS represent a significant risk to a bank investor. For example, tax credits are generally recaptured if a project does not maintain its minimum set-aside of low-income rental units during the 15-year compliance period. The amount of the recapture is based on the prior LIHTC claimed by the bank investor and the time that has elapsed since the credit was first claimed.[41] Once the 15-year compliance period is over, the IRS cannot recapture the tax credits, and the bank investors typically exit the LP or LLC.

Owners of LIHTC properties must meet specific requirements during the planning, construction, and operation of the property to claim the tax credits. Noncompliance in meeting some of these requirements may not have an adverse impact on the property's tax credit status if quickly remedied. If certain requirements are not met, however, the property will lose all or a major portion of its potential tax credits. Examples of noncompliance that could generate lost tax credits would be that the LIHTC property failed to maintain the necessary minimum number of low-income units or did not maintain its low-income status for the 15-year compliance period.

Banks that invest in LIHTC syndicated funds rely on a syndicator to aggregate all of the tax information required to comply with IRS regulations governing the LIHTC program. Moreover, syndicators are responsible for monitoring the portfolio for compliance and managing the risk associated with the fund for bank investors. For these reasons, banks contemplating their first LIHTC investment may wish to consider a fund investment.

Banks making direct investments in LIHTC projects are primarily responsible for their own tax compliance activities. Tax compliance information is provided to a bank investor by the general or managing partner. A bank direct investor also relies on the general or

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[40] In 2004, HUD designated DDAs and QCTs for purposes of LIHTCs under Section 42. DDAs are geographies designated by HUD as places that have high construction, land, and utility costs relative to the area's median gross income. See U.S. Department of Housing and Urban Development, HUD User Policy Development and Research Information Service, September 2007, available at www.huduser.org/Datasets/QCT/DDA2007_Notice.pdf.

[41] Section 42(j)(1-3) provides detailed information about the calculation of recaptured tax credits plus interest for the 15-year period of compliance. Section 42(j)(6)(A) describes under what conditions there can be a discharge of liability through the posting of a bond.

managing partner to maintain the LIHTC property in a tax compliant manner. Banks with large portfolios of LIHTCs typically have established asset management units within their commercial real estate departments to oversee the maintenance of these properties and to mitigate the risk of recapture.

Liquidity Risk

The 15-year compliance period for LIHTCs requires that most investments be held to maturity. If a bank wants to sell its position prior to the end of the tax compliance period, it can turn to a secondary market where tax credits can be sold during the initial 10-year credit period. However, as previously described, the risk of recapture remains with the original investor. In the event a bank's interest is transferred, a bank investor may avoid this risk prior to the end of the compliance period by posting a bond with the U. S. Treasury Department, and the property continues to be operated under the LIHTC program.[42]

Underwriting and Credit Risk

Management

Whichever investment approach is used, a bank investor must perform front-end due diligence to determine the financial capacity, performance, management capacity, and expertise of the project developer and general or managing partner. Evaluations must be made on the project developer and the organization that will operate the property as the general partner, or, in the case of multiple properties in a LIHTC fund, the syndicator responsible for overseeing different property managers at multiple locations. The strength of these development partners is measured by their proven track records, management skills, and pipeline of future projects. A bank investor should ensure that these development partners have adequate financial, management, and compliance monitoring resources to support the long-term viability and success of its investment. Confidence in the development partner's ability to accurately execute the tasks associated with direct investments in LIHTC projects, and syndicators in the case of LIHTC fund investments, is needed to minimize uncertainties about whether the investment will meet the bank's targeted rate of return.

Real Estate Underwriting

Banks initially underwrite LIHTC investments as commercial real estate transactions, specifically as multifamily construction and permanent loans. Once a transaction meets a bank's underwriting criteria, a bank can then evaluate it from an investment perspective. For example, during the construction and lease-up phase (which typically lasts one to three years), a bank considers all of the sources and uses of construction financing and calculates the expected costs to be included in the eligible basis. Since all LIHTC projects involve new construction or rehabilitation, a bank investor will also need to evaluate the experience, strength, and reputation of the general contractor who will be responsible for completing the project on-time and on-budget. Other typical underwriting elements include such items as site location within a neighborhood, market demand, rents and expenses, and project financing rates and terms. Additionally, as a multifamily property operating for a minimum of 15 years, a bank must be comfortable with project reserves, debt service coverage, and guarantees. Developers and general partners typically provide investors with completion, operating, and tax credit delivery guarantees to mitigate the risk associated with this type of real estate investment. An unconditional guarantee of construction completion is the most important factor since an unfinished project will never produce tax credits.

Portfolio diversity is an important underwriting consideration when a bank is deciding whether to invest directly or through a syndicated fund. Direct investments carry the risk of individual defaults which may or may not be significant based on the bank's overall

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[42] *See* Section 42(j)(6).

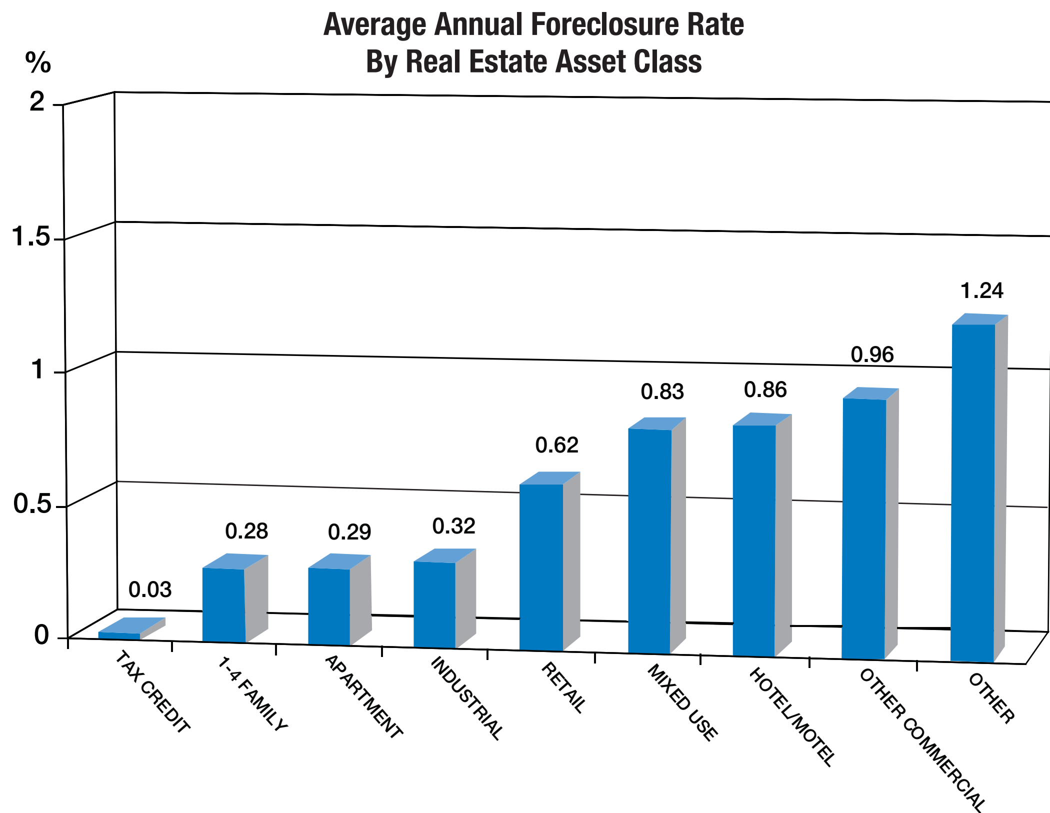
exposure to one development partner. Banks investing in LIHTC syndicated funds must have confidence that the syndicator is able to balance the fund portfolio with properties from different geographic markets and general partners. Mid-size and community banks may want to consider that by investing in funds they will have less exposure to single-project risk based on the geographic diversity of the fund portfolio.

Collateral Risk

A bank investor places its equity investment at risk in a LIHTC transaction. This is because the equity investor cedes first lien position on the real estate to the permanent mortgage lender. As a limited partner in a real estate partnership, a bank typically has a 99 percent ownership interest in the underlying real estate assets of the partnership. Therefore, a bank relies on the performance of these underlying properties to cash flow as projected and to perform as proposed.

As the LIHTC business has progressed over the years, the performance of LIHTC properties has remained stable, with relatively low foreclosure rates and high physical occupancy levels.[43] As shown in Figure 11, loans to housing tax credit properties continue to operate with a relatively low foreclosure rate of 0.03 percent. By comparison, loans to non-tax credit apartment real estate have a foreclosure rate of 0.29 percent. However, some real estate markets may be subject to rapid change.

Figure 11



Note: The average rates were calculated from the American Council of Life Insurers Mortgage Loan Portfolio Profile, 1993-2005 and 1996-2005, except tax credit data.

Source: *Understanding the Dynamics IV, Housing Tax Credits Investment Performance,* Ernst & Young Tax Credit Investment Advisory Services, June 2007, page 49.

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[43] *See Understanding the Dynamics IV: Housing Tax Credit Investment Performance*, Ernst & Young Tax Credit Investment Advisory Services, June 2007.

Operational and Reputation Risk

LIHTC investments can be fairly complex transactions, requiring compliance with numerous rules and regulations. A project development team or fund syndicator involves many different players, including, but not limited to, developers, contractors, architects, lawyers, accountants, and property managers. To reduce a bank investor's risk in all aspects of the business, it is important to have a team of experienced and independent third-party consultants, such as real estate lawyers, tax accountants, housing finance consultants, appraisers, real estate management companies, and regulatory compliance experts.

Part 24

On the regulatory side, national banks may make investments primarily to promote the public welfare under the community development investment authority in 12 USC 24 (Eleventh) and its implementing regulation, 12 CFR 24 (Part 24). Part 24 rules implementing that section of the act enable national banks to make equity investments in LIHTCs under the Part 24 public welfare investment authority. Recent changes to the statute require that these investments primarily benefit low- and moderate-income (LMI) persons or LMI areas. National banks seeking to make Part 24 LIHTC investments must either request prior OCC approval or submit an after-the-fact notice to the OCC, depending on the bank's safety and soundness profile and the nature of the investment.[44]

Accounting Considerations

Direct investments or syndicated fund investments made with a conduit LP or LLC could be accounted for under the cost or equity method of accounting, or may result in consolidation depending on the level of control the bank exercises over these entities.[45]

V. Who Is in the Low-Income Housing Tax Credit Business Today?

There are numerous interested parties involved in the production of affordable rental housing units under the LIHTC program.

State Housing Credit Agencies (HCAs)

The IRS requires that HCAs publish annually their housing priorities and eligibility criteria for awarding housing tax credits. QAPs must give priority to projects that serve the lowest income households and that remain affordable for the longest period of time. HCAs allocate the 9 percent housing tax credit program through competitive applications from affordable housing developers. HCAs also allocate 4 percent tax credits to affordable housing projects that are financed with tax-exempt private activity bond program funds.

Developers

Real estate developers may be for-profit or nonprofit organizations, joint ventures, partnerships, limited partnerships, trusts, corporations, and limited liability companies. Some developers will remain in the LIHTC transaction as the general partner (in a LP) or managing partner (in a LLC). Alternatively, some developers will joint venture with a nonprofit housing developer who manages the LIHTC property after the project has been placed in service. In this case the developer and nonprofit are co-general partners. Under

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[44] *See* 12 CFR 24.5. Information about Part 24 Community Development Investments is available at the OCC Community Affairs Web page at www.occ.gov/cdd/pt24toppage.htm.

[45] *See* Financial Accounting Standards Board (FASB) Interpretation No. 46 (R) Consolidation of Variable Interest Entities, EITF 03-16 Accounting for Investments in Limited Liability Companies, and AICPA Statement of Position 78-9 Accounting for Investments in Real Estate Ventures.

many state QAPs, tax credits are set aside for nonprofit developers, resulting in many successful joint ventures between for-profit real estate developers and nonprofit housing corporations. Once a HCA awards the tax credits, developers raise equity capital by offering the tax credits to bank investors. Recently, some public housing authorities have begun to act as developers and use the LIHTC program as a method to build low-income units replaced under the HOPE VI program.[46]

Investors

LIHTC investors can be either individuals or corporations, although most tax credit investors are corporations. While exact data on industry participation is not available, a recent industry study reported that 43 percent of LIHTC investors are subject to CRA.[47]

Syndicators

Syndicators are an important conduit between bank investors and developers of LIHTC transactions. Syndicators identify investors interested in purchasing tax credits and affordable housing developers who require the funds from the sale of the tax credits to help finance their projects. Syndicators invest in multiple LIHTC projects using pooled funds. They perform the preliminary due diligence to identify affordable housing investment opportunities and manage the construction and on-going compliance of the properties once the projects are placed in service.

Banks

Banks, as credit providers in LIHTC transactions, offer numerous types of financing to affordable housing developers. Among the types of credit facilities provided are: pre-development and acquisition loans, bridge financing, and construction and permanent mortgage loans. Banks also are actively involved as providers of letters of credit to enhance the creditworthiness of tax-exempt private activity bonds used with 4 percent LIHTC transactions. Some banks may also underwrite and market the tax-exempt private activity bond issues used in the financing of 4 percent projects.

Third-party Experts

Investing in LIHTCs is a fairly complex real estate transaction. Real estate lawyers, tax accountants, housing finance consultants, appraisers, real estate management companies, regulatory compliance experts, among others, bring important expertise and experience in organizing, financing, and managing LIHTC projects.

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[46] Public Housing Authorities (PHAs) also have started to apply to HCAs for 9 percent and 4 percent LIHTCs to increase the supply of affordable housing in their communities and to revitalize existing distressed housing developments. To further increase PHA participation, HCAs and HUD are reaching out collaboratively to PHAs to provide them with training in LIHTC financing.

[47] "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," Ernst & Young report commissioned by the National Council of State Housing Agencies, February 2003, p. 4.

VI. How Does the Cost/Pricing Structure of Low-Income Housing Tax Credits Work?

To compare the risk-adjusted return on a transaction offered to them, most bank investors have established an internal hurdle rate for LIHTC investments that is above the 10-year U.S. Treasury note. Understanding that investments in U.S. Treasury securities preserve principal plus earn a low-risk rate of return, a bank investor will expect to obtain a return in excess of the current yield on a 10-year note.[48]

Bank investors use a number of variables to determine the returns associated with proposed LIHTC transactions. These variables include, but are not limited to:

- Price paid per dollar of tax credit, and the timing and percentage of when the bank's equity is disbursed into the project.
- Time frame that the LIHTC project is placed in service.
- Typical risk factors associated with commercial real estate development, such as guarantees, operations, cash flow, and asset management (previously discussed in Section IV).

Ideally, a bank would invest in a LIHTC transaction with an experienced developer who has a strong balance sheet and a well-regarded general contractor who has a proven track record. They would pay on the low end of prices for the tax credits and disburse the majority of funds into the project as close as possible to the project's completion date. An illustrative example of a pay-in schedule for equity in a LIHTC project is shown in Appendix C. Variations on this type of investment are negotiated between a bank (as a limited partner) investor and the general or managing partner. Banks providing the construction and permanent financing to LIHTC developers, along with equity investments, may obtain higher "all in" returns from the transactions.

Prices and Yields

In the early years of the LIHTC program, the average value or price per dollar of tax credits was approximately fifty cents. This was a time when investors were unsure whether the LIHTC program would be made permanent by Congress (which it was in 1993) and demand for tax credits was low. With the changes made to the CRA in 1995, which included a new investment test for large banks, and the gradual reduction in federal housing subsidies, the LIHTC program took on new significance. As illustrated in Figure 12, the gross equity raised and the tax credits allocated have steadily risen in recent years. The average value or price paid per dollar of tax credit was $1.07 in 2005 and declined somewhat in 2006 and 2007.[49]

The calculation of estimated yields on LIHTC investments involves sophisticated modeling of cash flows and differs for each transaction and investor. Each transaction represents different financing elements and basis. Likewise, each investor has its own tax liability profile and risk-adjusted return expectations. For example, some investors will prefer higher yields with later capital contributions, while other investors may sacrifice higher yields for a lower guaranteed return. The primary elements in the calculation of estimated returns from LIHTC investments include: a bank investor's federal income tax rate, the price paid for tax credits, the 10-year stream of tax credits, and the timing of capital contributions. Additionally, passive losses, such as depreciation and interest expenses, are considered in the yield projections. To maintain the projected yields on LIHTC investments, investors typically negotiate what are commonly referred to as tax credit adjusters with general or managing partners. These tax credit adjusters help LIHTC investors achieve their projected yields.

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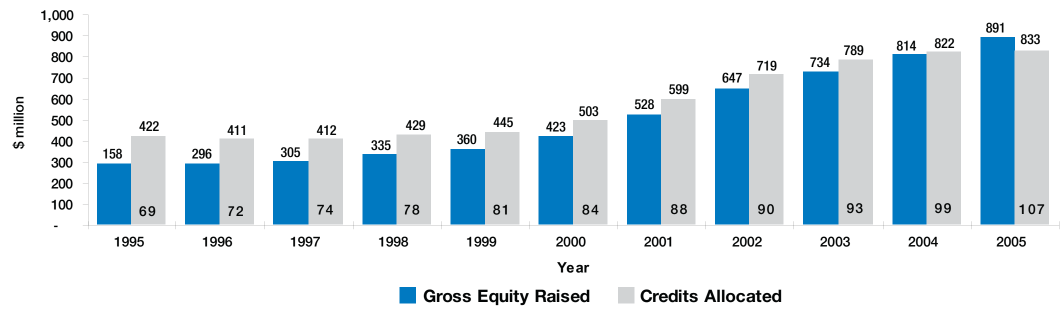
[48] More information about U.S.Treasury securities is available at http://treasurydirect.gov/tdhome.htm.

[49] The latest information about LIHTC allocations, prices, and units is documented in the *State HFA Factbook: 2005 NCSHA Annual Survey Results*, published by the National Council of State Housing Agencies, August 2007.

Figure 12

Credits Allocated and Equity Raised



Note: The credits allocated and the equity raised includes both 9 percent and 4 percent tax credits. The bolded figures inserted in the "credits allocated" columns are the average price (in cents) paid per dollar of tax credits each year.

Sources: National Council of State Housing Agencies (NCSHA) and Richard Floreani, Ernst & Young, LLP.

Fees

The LIHTC investment business involves many interested parties and service providers. For example, syndication fees, which are negotiated between developers and a syndicator, are included in the agreed upon price paid for tax credits. Annual asset management fees paid to a syndicator are also negotiated between developers and a syndicator. Fees for items, such as market and environmental analyses, appraisals, tax accountants, legal services, and property managers, can involve substantial initial costs and ongoing expenses. They are typical to bank-financed commercial real estate transactions and are traditionally funded from development budgets and operating cash flows.

Property Management

Large banks actively involved in LIHTC direct investments have found it useful to establish asset management units within their real estate departments. Asset management units work with LIHTC project owners to ensure the properties are well managed, operate as proposed, and comply with all LIHTC program requirements. Banks with large portfolios of both direct and fund investments also use these asset management units to monitor property management activities of the funds in which they invest. Alternatively, banks with smaller LIHTC fund portfolios typically rely on the asset management expertise of the fund manager to provide this oversight.

VII. What Barriers Have Constrained the Growth of Low-Income Housing Tax Credits?

Availability of Tax Credits

An increase in the supply of tax credits is constrained by the growth in the 9 percent tax credit volume cap and the private activity bond volume cap that determines the availability of 4 percent tax credits. Growth in each of these volume cap measures is tied to the rate of inflation and population growth.

Long-term Commitments

LIHTCs require a long-term, 15-year commitment by investors. Some bank investors may be reluctant to enter this business if there is a need to maintain shorter term liquidity.[50]

Complex Industry

The LIHTC marketplace has been viewed by some to be complex with substantial regulatory, financial, and tax reporting issues. As first time investors, mid-size and community banks may wish to consider investing in the LIHTC funds. Over time, as these banks become more experienced in LIHTC investments, they may prefer to make direct investments in individual projects with well qualified for-profit and nonprofit affordable housing developers.

VIII. Conclusion

Since 1987, when the LIHTC program began, HCAs have approved 2 million rental units with tax credits. This program allows banks to expand existing customer relationships and establish new ones by offering additional products and services related to 9 percent and 4 percent tax credit projects. Banks that make real estate investments in LIHTC projects can earn attractive rates of return and can receive favorable CRA consideration.

Each year the LIHTC program induces several billion dollars of private investment to produce nearly 130,000 apartments that are affordable to low-income families, the elderly, and other special needs populations.[51] Through participation in LIHTC projects, bank investors can form partnerships with community-based organizations and other developers to sponsor community revitalization activities. Moreover, tax credit projects undertaken in "difficult development areas" can result in greater community economic stability and tax credit benefits to investor banks. When carefully executed, investments in LIHTC properties can provide banks with economic and regulatory benefits, while helping to revitalize and strengthen the communities in which they do business.

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[50] A bank investor can divest from the partnership by selling its LIHTCs to a secondary market prior to the end of the 10-year period.

[51] *See* National Council on State Housing Agencies, available at www.ncsha.org/section.cfm/3/34/35.

Appendix A

Case Study: 9 Percent LIHTC Project In a Difficult Development Area

Project Size: Total project development cost was $ 15,220,000.

Project Overview: The project is an example of a direct investment by a national bank in a 9 percent LIHTC project located in a major city's difficult development area (DDA). Because the project was located in a DDA, the qualified basis, which is the basis for calculating the tax credits, was boosted by 30 percent. The project was new construction of 100 units of affordable rental housing. The units were allocated to renters according to a household's income relative to the area median income (AMI). The project also committed to a 24-unit set aside for homeless veterans, using Section 8 subsidies.

	Household Description
10	Households with income under 60 % AMI
20	Households with income under 50 % AMI
34	Households with income under 40 % AMI
36	Households with income under 30 % AMI
100	Total

Tax credit project financing: A national bank was a direct investor with 99.99 percent ownership interest in a limited partnership. The 9 percent LIHTCs created $9,618,700 in equity financing, while a state housing trust fund program provided the permanent financing of $2,200,000. The balance of financing needed to complete the project was made available by other state housing programs. Repayment on the second and third mortgages is required only upon transfer of the property or 30 years, whichever comes first.

Sources of Funds	
Equity (sale of 9 % LIHTCs)	$ 9,618,700
Permanent Loan (State Housing Trust Fund Program)	2,200,000
Second Mortgage (State Housing Program Loan)	2,000,000
Third Mortgage (State Housing Development Corporation)	1,400,000
General Partner Equity	1,300
Total Sources of Funds	**$15,220,000**
Uses of Funds	
Land Costs	$ 400,000
Construction Costs	10,411,178
Soft Costs	2,852,008
Developer's Fee	1,556,814
Total Development Costs	**$ 15,220,000**

Equity Calculation	
Qualified Basis with Basis Boost † (Eligible Basis X 130 % (100 % affordable units plus 30 % basis boost))	$12,823,238
Annual Housing Tax Credits (Qualified Basis with Basis Boost multiplied by the actual tax credit rate applied to this project, 8.05)	1,032,271
Total Housing Tax Credits (Annual Housing Tax Credits X 10 years)	10,322,710
Net Equity (Total credits X $.9318 (price per tax dollar))	**$ 9,618,700**

†The qualified basis is defined as the product of the eligible basis multiplied by the proportion of the project's affordable housing units. The eligible basis, which is the amount of all depreciable development costs, includes all hard costs, such as construction costs and most depreciable soft costs such as architectural and engineering costs. Excluded from the eligible basis are non-depreciable costs, such as land acquisition, permanent financing costs, and initial deposits to reserves.

Note: The facts described in the case study are drawn from an actual LIHTC investment made by a national bank; however, some figures and geographic markers have been modified to preserve anonymity.

Appendix B

Case Study: 4 Percent LIHTC Direct Investment

Project Size: Total project development cost is $16,207,635.

Project Overview: The project is an example of a direct investment by a national bank in a 4 percent LIHTC project financed with tax-exempt private activity bonds in a moderate-sized city in the West. The project was new construction and created 128 new affordable rental units. The project committed to set aside 40 percent of the units at or below 60 percent of the area median income (AMI), but 100 percent of the units are affordable to those at or below 60 percent of AMI.

Tax credit project financing: A national bank was the direct investor in a limited partnership that used 4 percent LIHTC allocations to provide $3,963,359 in equity financing for the construction of this low-income housing project. Roughly two-thirds of the financing of the project, $11,355,000, was from the sale of tax-exempt private activity bonds.

Sources of Funds:	
Equity (Sale of 4 % LIHTCs)	$3,963,359
Permanent Debt (Bond was 67 % of total project costs)	11,355,000
Developer Fee Note	889,276
Total Sources of Funds	**$16,207,635**
Uses of Funds:	
Land Costs	$2,600,000
Construction Costs	9,312,000
Soft Costs	2,934,255
Developer Fee	1,361,380
Total Development Costs	**$16,207,635**

Equity Calculation	
Qualified Basis[†] (Eligible Basis X 100 % (100 % affordable units)	$12,803,265
Annual Housing Tax Credits (Qualified Basis multiplied by the actual tax credit rate applied to this project, 3.47 %)	444,273
Total Housing Tax Credits (Annual Housing Tax Credits X 10 years)	4,442,730
Net Equity (Total Housing Tax Credits X $.8921 (price per tax dollar))	**$3,963,359**

[†]The qualified basis is defined as the product of the eligible basis multiplied by the proportion of the project's affordable housing units. The eligible basis, which is the amount of all depreciable development costs, includes all hard costs, such as construction costs and most depreciable soft costs such as architectural and engineering costs. Excluded from the eligible basis are non-depreciable costs, such as land acquisition, permanent financing costs, and initial deposits to reserves.

Note: The facts described in the case study are drawn from an actual LIHTC investment made by a national bank; however, some figures and geographic markers have been modified to preserve anonymity.

Appendix C

Sample of a Pay-in Schedule for Equity (For Illustrative Purposes Only)

This schedule illustrates how equity, $10,000,000 in this direct investment example, may be disbursed into a LIHTC project. The milestones and percent of equity funding required are always negotiated between the investor and the general or managing partner. Pay-in schedules for a LIHTC fund are typically established by the general or managing partner in a public offering statement (POS) for all potential investors to consider and subscribe. Pay-in schedules reflect the unique circumstances of each project, the requirements of investors (as limited partners), and the needs of the general or managing partner.

Equity Pay-In (%)	Milestone	Amount ($)
30	Date of closing	3,000,000
40	Placed in service (completion of occupancy certification)	4,000,000
20	Occupancy at 90% and cost certification completed	2,000,000
10	Federal tax return and Schedule K-1[†] submitted	1,000,000
100%	**Equity**	**$10,000,000**

[†] The IRS Schedule K-1 (Form 1065) describes the partner's share of income, deductions, credits, etc.

Appendix D

Resource Directory

Office of the Comptroller of the Currency

Community Developments Investments E-zine
"Investing in Low-Income Housing Tax Credits: A Sound Opportunity for Community Banks"
http://www.occ.treas.gov/cdd/Spring06

Community Affairs Fact Sheets
Low-Income Housing Tax Credits Fact Sheet
http://www.occ.treas.gov/cdd/fact_sheet_LIHTC.pdf

Part 24 Community Development Investments Web Resource Directory
www.occ.gov/cdd/pt24toppage.htm

Affordable Housing Investors Council
http://www.ahic.org/ahicportal/DesktopDefault.aspx

Ernst & Young
http://ey.com/us/taxcreditadvisory

Internal Revenue Service
http://www.irs.gov/taxexemptbond/index.html

National Association of Local Housing Finance Agencies
http://www.nalhfa.org

National Association of State and Local Equity Funds
http://www.naslef.org/bestpractices.html

National Council of State Housing Agencies
www.ncsha.org

National Equity Fund
http://www.nefinc.org

National Low Income Housing Coalition
http://www.nlihc.org/advocates/lihtc.htm

Novogradac & Company, LLP
http://www.novoco.com/resource.shtml

Reznick Group
http://www.reznickgroup.com/index.php

U.S. Department of Housing and Urban Development (HUD)
www.huduser.org/datasets/lihtc.html
www.huduser.org/periodicals/pdrperio.html

Sherrie L.W. Rhine was the primary author of this report. Also contributing were William Reeves, E. Matthew Quigley, Barry Wides, and Julie L. Williams. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Office of the Comptroller of the Currency.