Frequently Asked Questions of Investors
In the Low Income Housing Tax Credit

Introduction

The Low Income Housing Tax Credit (LIHTC) program is the largest and most successful catalyst for the development and rehabilitation of affordable housing in the United States. While administered at the state level, it is a federal program that must be in compliance with Section 42 of the Internal Revenue Code. The LIHTC program addresses the increasing demand for affordable housing while also providing: (i) Community Reinvestment Act (CRA) benefits for financial institutions, (ii) economic benefits for investors, (iii) tax revenues for state and local governments, and (iv) construction and permanent jobs. The LIHTC program has stimulated the creation of more than 2.5 million affordable multifamily units since it began in 1986.

1. **What is the role of the LIHTC investor?**
    a. Answer: The role of the investor is to partner with the developer of a project (the general partner) by providing equity to help finance its construction or rehabilitation. The relationship between the developer and the investor is a true partnership, in that both partners share economic value and risk in the transaction. While the LIHTC investor is a limited partner, it typically provides 99% of the equity. In return, tax benefits (defined in question #4) flow between the investor and general partner in proportion to their equity interest.

       There are two main types of LIHTC investors currently in the market:
        i. *Financial Institutions:* LIHTC investing compliments the familiarity banks have with real estate underwriting and can also help meet their goals under the Community Reinvestment Act (CRA). CRA is a federal law designed to encourage banks to help meet the needs of borrowers in all segments of their communities, including low and moderate-income neighborhoods. Most banks have goals to deploy capital in projects that primarily benefit low to moderate-income individuals and/or communities to meet their CRA objectives. As federal deposit shares increase among a bank's locations, it is more likely to invest in these areas to meet its CRA needs. CRA considerations can affect a LIHTC investor's demand and return thresholds. Some CRA investors also invest as economic investors.

ii. *Economic Investors:* Many LIHTC investors are not financial institutions and thus have no CRA need. In addition, there are banks that have met their CRA objectives or invest for other reasons beyond CRA. These companies invest primarily for the tax benefits and are known as economic investors. As a result, they are much less focused on the location of the projects in which they invest.

b. Because LIHTC investors take substantial financial risk as partners, they also assist the projects by:
   i. Ensuring projects are well maintained and in tax credit compliance
   ii. Encouraging innovation and efficiencies
   iii. Supporting projects as needed through the 15-year compliance period.

2. What is the difference between a LIHTC syndicator and a LIHTC investor?

a. Answer: Investors provide capital and bear the economic risk of the transaction. Syndicators are intermediaries that assist investors in sourcing, underwriting and asset managing LIHTC investments for a fee.

b. An investor can invest in LIHTC projects in several ways:
   i. *Direct Investments/No Syndicator Involvement:* In these investments, the investor enters the partnership directly as a limited partner or investor member. These are singular investments where all benefits and risks lie solely between the investor, the general partner or managing member of the LIHTC project and the investment's guarantor.
   ii. *Syndicated Funds*: Investments are also made via LIHTC syndicators who serve as intermediary institutions between the investor and the project. Syndicators are not the end recipients of the tax benefits and they do not hold economic risk in the transaction. There are generally two types of investments made through syndicators:
      1. *Multi-Fund Investments*: These are pooled investments, similar to mutual funds, with multiple investors and multiple projects. The tax benefits roll up into a fund from which each investor receives a proportional share. The syndicator is the manager of the fund, and decisions are made primarily by the syndicator, with varying levels of participation from investors.
      2. *Single Investor/Proprietary Investments*: These are also pooled investments; however, there is only one investor in the fund. The syndicator is the manager of the fund, but major decisions during the course of the investment often lie in the hands of the investor.

As manager of a fund, the syndicator will:

   i. Source potential investments based on an investor's needs (CRA or economic motivations)
   ii. Complete underwriting and analysis for the investor (this varies by syndicator and investor)
   iii. Handle asset management and reporting.

3. When looking at a potential investment, what factors does a LIHTC investor consider?

  a. Answer: The Affordable Housing Investors Council (AHIC) has developed underwriting guidelines to profile investment risk. The metrics include:
     i. Operational Trends over 15 Years
        1. Debt Service Coverage (DSC): The DSC for each year is analyzed to review the trends and study the project's ability to maintain healthy operations.
        2. Size and Use of Reserves
           a. As mitigation against operating deficits, many investors use guidelines developed by AHIC for sizing operating reserves. If the project is shown to have declining DSC over the 15-year period, the requirement for reserves may be larger.
           b. To assist with capital needs throughout the 15-year period, investors have guidelines for replacement reserves. Lenders often set replacement reserve requirements as well.
     ii. Investors tend to sensitize the metrics above based on:
        1. Market dynamics such as income and rent growth
        2. Increases in operating expenses
        3. Loss or fluctuation in rental or operational subsidy funding
     iii. Other matters important to LIHTC investors include:
        1. GP/developer experience and sustainability
        2. Guarantor financial strength
        3. Market strength and demand
        4. Area median income (AMI) trends
        5. Leverage/foreclosure risk
        6. Construction risk
        7. Availability of and competition for housing within the local market
        8. Strength and experience of the syndicator (If applicable)
        9. Community impact/support
        10. Tax considerations
        11. Real estate feasibility
        12. Tax credit compliance

4. **What tax benefits do LIHTC investors receive?**
    a. Answer: The LIHTC is a reduction of the investor's federal income tax over a 10-year period. Investors also receive tax losses associated with their investment in real property assets as well as deductions on accrued subordinate financing. The LIHTC, tax losses, and deductions are collectively called the tax benefits.

5. **How is LIHTC pricing determined?**
    a. Answer: While LIHTC investment pricing is generally market driven, every investor uses a somewhat different mechanism to determine pricing. Many investments are priced off an internal rate of return (IRR). The acceptable target IRR varies by different geographic markets throughout the country, but often CRA-motivated investors accept a lower target IRR in markets where they have high CRA needs.

       In addition, capital proceeds from many institutions come at a cost from the parent entity that must be factored in. Most institutions use internal metrics to value the investment from a cost of capital perspective, because the tax benefits to the investor are largely realized not when equity is disbursed into the project during construction, but over a 15-year period following qualified lease up of the project. (Even though the credit period is 10 years, the LIHTC compliance period is 15 years. As a result, most investors look at the value of the investment over this longer time horizon.)

       The LIHTC investment market overall regulates pricing and IRR thresholds among investors. The factors listed in #3 above play a large role in determining pricing and acceptable yields.

       Other items that influence pricing and are collectively used in determining the IRR include:
        i. Timing of capital contributions from the investor
        ii. Timing of the receipt of tax credits by the investor
        iii. Amounts and amortization periods of tax losses ultimately received by the investor as a result of investment in real property assets
        iv. Amount of other tax deductions from subordinate financing

For more information about LIHTC, the Affordable Housing Investors Council and our guidelines for the underwriting and asset management of LIHTC investments, see www.ahic.org or contact our Executive Director, Julie Hertzog, at 347.392.9983 or jhertzog@ahic.org.