

Affordable Rental Housing Funding

Affordable housing developments are funded by combining a variety of federal, state and local funds that require no loan repayments unless a project demonstrates positive cash flow. These special funds require little to no debt service, and therefore allow project rents to be lower than market rate rents, or “affordable.” The projects also include developer equity and a small construction loan that does require debt service. Projects typically begin when the City, through [The Long Beach Community Investment Company](#), makes funding available through a competitive Notice of Funding Availability, or NOFA. Developers then identify a potential project and identify all the funding needed to finance the project.

There are two main government funding mechanisms that fund affordable housing, the Low-Income Housing Tax Credit Program and the Tax-Exempt Housing Revenue Bond Program.

Low-Income Housing Tax Credits

Created in 1986 and made permanent in 1993, the Low-Income Housing Tax Credit (LIHTC) is an indirect federal subsidy used to finance the construction and rehabilitation of low-income housing. Without tax credits, policymakers believed private developers and investors would not provide enough low-income housing because these projects usually do not generate enough profit to warrant the investment.

LIHTCs give investors a dollar-for-dollar reduction in their federal tax liability in exchange for providing funds to develop affordable rental housing. Investors’ equity contribution subsidizes low-income housing development, allowing some units to rent at below-market rates. In return, investors receive tax credits paid in annual allotments generally over 10 years. LIHTC-financed projects must meet eligibility requirements for at least 30 years after project completion, meaning that owners must keep the units rent restricted and available to low-income tenants. At the end of this period, the properties remain under the control of the owner.

The credit, which is claimed pro rata over 10 years, can be used in connection with both newly constructed and renovated rental buildings. The LIHTC is designed to subsidize either 30 percent or 70 percent of the low-income unit costs in a project. The 30 percent subsidy (known as the automatic 4 percent LIHTC that is often combined with tax-exempt bonds) covers new construction that taps additional subsidies or the acquisition cost of existing buildings. The 70 percent subsidy (or 9 percent LIHTC) supports new construction without any additional federal subsidies. New construction includes the cost of rehabilitating an existing building if a minimum per-unit expenditure threshold is satisfied. The minimum threshold amount varies by state.

Tax-Exempt Housing Revenue Bonds

The Internal Revenue Code (IRC) of 1986 restated that interest income on any state or local bond is excluded from federal income tax. State and local governments sell tax-exempt housing bonds and pass on the interest savings for the construction of low-income apartments. Each state’s annual supply



of housing bonds is included in an annual limit for a laundry list of projects including industrial development, public-private partnerships for municipal services, redeveloped or blighted areas and student loans. Tax exemption allows bondholders to retain more of their investment income. The higher the marginal tax rates that an individual or entity experiences, the greater the economic benefits of municipal bond ownership. As a result, tax-exempt bonds are issued at below-market interest rates and are less expensive for bond issuers.

To reap the economic benefits of tax-exempt bond financing, developers must adhere to technical requirements. For example, developers must use at least 95 percent of bond proceeds toward land and construction costs. In addition, under the IRC, bond-financed apartment owners must earmark either 40 percent of the units for residents earning 60 percent or less of the area's median income or 20 percent of the units for residents earning 50 percent or less. Bond-financed apartments must maintain these rent restrictions for at least 15 years.

Bond transactions are not cheap. Taking into account legal and professional fees, affordable housing developers typically pay 5 to 6 percent of project costs toward professional services such as underwriting and legal fees. Due to the high cost of bond issuance, projects with less than \$5 million in tax-exempt bonds generally do not make sense economically. The City has no obligation to repay these bonds, as they are repaid from project cash flow (rents).

Combining LIHTCs and Bonds

Whenever tax-exempt housing bonds are used to finance a multi-family project, the owner automatically qualifies for a 4 percent LIHTC allocation as long as the investor follows certain state requirements. The combination of tax-exempt bonds and tax credits can be used to fund both new construction and the acquisition and rehabilitation of existing stock.

A key benefit to combining tax-exempt bonds and LIHTCs is the exemption from the volume cap limitation, which is the total LIHTC allocation each state receives each year based on its population. Only 9 percent of LIHTC allocations are deducted from a state's volume cap, not the automatic 4 percent LIHTC allocations. If 50 percent or more of the aggregate basis in land and building is financed with tax-exempt bonds, then the entire project is eligible for credits without reducing the state's LIHTC volume cap.

Developers use tax-exempt bonds to provide both a lower interest rate on permanent financing and a source of substantial equity capital. If a developer chooses to couple the bonds with 4 percent LIHTCs, the owner may have to earmark additional units to low-income use and/or lower the rents of the existing low-income units. If an investor is considering purchasing an existing building using the LIHTC and bond program, the previous owner generally must have held the property for a minimum of 10 years in order for the purchaser to claim credits on the acquisition costs. In addition, there are a variety of state and county funding programs that may be combined with the tax credit and/or bond financing and are needed to make a project financially feasible. The financing of affordable housing is very complex and funding programs are extremely competitive.

