CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE

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DESCRIPTION OF CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE PROGRAMS

The California Tax Credit Allocation Committee ("Committee" or "TCAC") administers two low-income housing tax credit programs – a federal program and a state program. Both programs were authorized to encourage private investment in affordable rental housing for households meeting certain income requirements.

The Committee

The Committee has seven members, including three voting members and four advisors. The voting members include the State Treasurer, who serves as chairman, the State Controller, and the Governor, who may choose to designate the Director of the Department of Finance as his representative. The non-voting members are the Executive Director of the California Housing Finance Agency, the Director of the Department of Housing and Community Development, and two representatives of local governments. One local representative must be associated with a city and is appointed by the Speaker of the Assembly. The other member is a county representative appointed by the Senate Rules Committee.

FEDERAL AND STATE HOUSING TAX CREDIT PROGRAMS

The Federal Program

Congress created the federal Low Income Housing Tax Credit Program in 1986. It replaced traditional housing tax incentives, such as accelerated depreciation, with a tax credit that enables low-income housing sponsors and developers to raise project equity through the sale of tax benefits to investors. Two types of federal tax credits are available and are generally referred to

as nine percent (9%) and four percent (4%) credits. These terms refer to the approximate percentage of a project's "qualified basis" a taxpayer may deduct from their annual federal tax liability in each of ten years. (See "How Credit Amounts are Calculated" below).

The program is regulated through Internal Revenue Code Section 42, and is administered by the Internal Revenue Service, which is part of the U.S. Treasury Department. Section 42 specifies that each state must designate a "housing credit agency" to administer the Credit program. In California, responsibility for administering the program was assigned to the California Tax Credit Allocation Committee (TCAC), first by a February 1987 gubernatorial proclamation, and later by enactment of SB 113, Chapter 658, statutes of 1987. The federal tax credit program was granted permanent status with passage of the Omnibus Budget Reconciliation Act of 1993.

The State Program

Recognizing the extremely high cost of developing housing in California, the state legislature authorized a state low income housing tax credit program to augment the federal tax credit program. Authorized by Chapter 1138, Statutes of 1987, the state credit is only available to a project which has previously received, or is concurrently receiving, an allocation of federal credits. Thus the state program does not stand alone, but instead, supplements the federal tax credit program.

Annual Federal Credits Available

For 2015, each state has an annual housing credit ceiling of $2.30 per capita for 9% Low Income Housing Tax Credits. In addition, States may qualify for a pro rata share of credits available annually in a national pool comprised of states' unused credits. Also, any credits returned to a state from a credit recipient may be allocated to new projects. From the total ceiling amount available to California, the Committee allocates credit amounts based upon assessments of eligible project costs, as defined by IRC Section 42. The housing sponsor uses or sells ten times the allocation amount, since investors can take the annual credit each year for a ten-year period. Although the credit is taken over a ten-year period, the Internal Revenue Code requires that the project remain in compliance for at least 30 years.

Annual State Credits Available

The state credit ceiling for 2015 is approximately $94 million and would be increased by any unused or returned credits from previous years. Investors claim the state credit over a four-year period, rather than the ten-year federal allocation period. The full four-year state credit allocated to a project is deducted from the state ceiling, while only the annual federal credit allocated to a project is deducted from the federal ceiling.

Tax-Exempt Bond Financed Projects

Developments financed with the proceeds of tax-exempt bonds may also receive federal tax credit. In this instance, the developer/owner of a tax-exempt development must apply to the Committee and must meet both the federal and state statutory and regulatory requirements. The tax credits available are tied to the private activity bond cap limits, but are not deducted from the state's annual tax credit ceiling. The annual credit available is based on approximately 4% (instead of 9%) of the "qualified basis" of the development. Qualified basis consists of the costs attributable to the units that will be income and rent restricted for a minimum of 30 years.

Eligible Projects

Only rental housing projects are eligible for tax credits in both the federal and state programs. Credits can be allocated to new construction projects or existing properties undergoing rehabilitation. Nine percent credits are allocated on a competitive basis so that those meeting the highest housing priorities and public policy objectives, as determined by the Committee, have first access to credits. Those utilizing tax credits must own the project for which the credits are awarded.

Rent and Income Restrictions

The programs have both rent and income restrictions. Rents on tax credit units cannot exceed 30% of an imputed income based on 1.5 persons per bedroom (i.e., in a two-bedroom unit, the income of a three-person household is used to calculate rent, regardless of the actual family size of the household). Federal law requires that the initial incomes of households in tax credit units not exceed either 60% or 50% of the area median income, adjusted for household size. When a project developer or sponsor applies for tax credits, he or she irrevocably elects one of the following minimum federal set-aside requirements:

- a minimum of 40% of the units must be both rent-restricted and occupied by households whose incomes are 60% or less of the area median gross income, adjusted for family size, or
- a minimum of 20% of the units must be both rent-restricted and occupied by households whose incomes are 50% or less of the area median gross income, adjusted for family size.

Despite this minimum set-aside election, most project sponsors designate all of the units in a project for occupancy by low-income households, since credits are allocated only for restricted units. For instance, if a developer builds a project in which half of the units are market-rate and half are affordable, only half of the eligible project costs would be considered when determining how much credit may be allocated. Additionally, as described below, sponsors generally target a

certain number of units to tenants with incomes below 60% or 50% of median to compete successfully.

Long Term Affordability

Under federal law, credit projects must remain affordable for at least 30 years; however, California law generally requires a 55-year extended use period for 9% tax credit projects. Also, 4% tax credit recipients frequently access significant boosts to their basis limits by agreeing to 55-year extended use restrictions. Regulatory agreements are recorded against each tax credit project to ensure compliance.

Determination of Credit Need

As required by federal law, the Committee performs feasibility analyses on every project to ensure that allocations do not exceed the amount required for project feasibility. While a project's qualified basis determines a maximum credit allocation, only the amount needed to fill the financing shortfall may be allocated. The Committee must consider the sources and uses of funds and the total financing planned for the development, including the projected proceeds to be generated by the sale of tax credits. The Committee must also determine the reasonableness of estimated development, operational and intermediary costs. For each project, the amount of credits needed must be determined at least three times: at application, 180 days after award, and at placed-in-service.

How Credit Amounts Are Calculated

In determining the amount of credit for which a project may be eligible, first, total project cost is calculated. Secondly, "eligible basis" is determined by subtracting non-depreciable costs, such as land, permanent financing costs, rent reserves and marketing costs. The project developer may also voluntarily reduce the requested eligible basis in order to gain a competitive advantage. If the development is located in a HUD-designated Difficult to Develop Area (DDA) or Qualified Census Tract (QCT), the eligible basis receives a 130% adjustment. Next, the eligible basis is multiplied by the "applicable fraction", which is the smaller of (1) the percentage of low-income units to total units, or, (2) the percentage of square footage of the low-income units to the square footage of the total units. This figure is known as the "qualified basis" of the project.

The qualified basis is multiplied by the federal tax credit rate, published monthly by the IRS, to determine the maximum allowable tax credit allocation. For projects that are new construction or rehabilitation, which are not financed with a federal subsidy, the rate is summarized as nine percent (9%). For projects involving a federal subsidy (including projects financed more than

50% with tax exempt bonds), the rate is summarized as four percent (4%). Due to the fluctuating federal tax credit rate published monthly by the IRS, TCAC currently uses a 7.69% and 3.30% rate to determine a project's initial tax credit reservation. A project's final (placed-in-service) tax credit allocation is based on actual project sources and uses of funds, the financing shortfall and the actual applicable federal rate. The rate applicable to a project is the rate published for the month each building is placed in service or in an earlier month elected by the sponsor. The allocation cannot exceed the initial reservation amount and may be reduced if an analysis determines that the maximum allowable amount would generate excess equity proceeds to the project.

Raising Equity Investment

Most credits are sold to corporate or individual investors through public or private syndication. Investors benefit from the tax credit by purchasing an ownership interest in one or more tax credit housing projects. In turn, investors claim a dollar-for-dollar credit against their tax liability over a ten-year period. Partnership equity contributed to the project in exchange for the credit typically finances 30-60% of the capital costs of project construction.

The net amount of equity proceeds contributed to a project is based on investor contributions (the present value of the ten-year credit) less syndicator overhead and fees and other syndication-related costs. The Committee uses the net tax credit factor (net proceeds divided by the total 10-year tax credit allocation) to determine the credit amount needed.

Differences Between the State and Federal Programs

California's tax credit program was structured to mirror the federal program with certain exceptions. In addition to the state credit only being available to projects, which also receive a federal credit, other differences include:

- The applicable percentage to be applied to the qualified basis for determining the amount of state credits is 30% for projects which are not federally subsidized, and 13% for projects which are federally subsidized, in contrast to 9% and 4% for the federal credit.
- State credits are not available for acquisition costs, except for previously subsidized projects that qualify as "at-risk" of being converted to market rate.

Federal Preference and Selection Criteria

Each state agency is responsible for designing and implementing its housing tax credit program in accordance with requirements of the Internal Revenue Code and its own particular state housing needs. The Internal Revenue Code sets broad parameters that must be considered by each state in its "Qualified Allocation Plan" (QAP), adopted after public hearings and input that sets forth the state's program.

Section 42, for example, requires that each state give preference to projects that serve the lowest income tenants, projects obligated to serve qualified low income tenants for the longest period of time, and projects located in qualified census tracts that contribute to a concerted community revitalization plan.

Additionally, the following selection criteria must be considered by each state in awarding credit: project location, housing needs characteristics, project characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, and projects intended for eventual tenant ownership.

California's Program

In California, the demand for housing tax credit has recently exceeded the supply by approximately two to one (2:1). This means, of course, many good, worthwhile projects are unable to be awarded credit. It also means a rather elaborate set of legal and regulatory rules for determining what projects are awarded credit has been established. State and federal law require at least 10% of the annual federal credit be awarded to projects that materially involve non-profits. State law also requires 20% of the annual federal credit be awarded to projects located in rural areas of the state. Additionally, to assure geographic distribution of the tax credit, a certain percentage of credit is awarded each year to projects located in eleven geographic regions of the state.

Public policies encouraging smart growth principles, energy efficiencies, and the like are part of California's housing tax credit program. In its competitive scoring system, points are awarded for a variety of items, ranging from serving lower income tenants, to achieving energy efficiencies, to the degree that the project will contribute to revitalization efforts in the area where it will be located.

Threshold criteria require that the applicant show the following:

- the type of housing proposed is needed and affordable to the targeted population within the community in which it is to be located;

- enforceable financing commitments of at least 50% of the total estimated financing need;
- control of the site;
- compliance with all applicable local land use and zoning ordinances;
- development team experience and financial capacity to ensure project completion and operation for the extended use period;
- financial viability throughout the compliance period of the project;
- minimum construction standards;
- all deferred-payment financing, grants, and subsidies be "committed" at application; and
- new construction projects using 9% tax credits are limited to no more than 150 units for non-rural set-aside applications, and 80 units for rural set-aside applications.

In addition, targeted projects must meet additional threshold requirements applicable to the targeted populations they are intended to serve. These additional threshold requirements can be found in the TCAC Regulations.

Application Cycles and TCAC Review Process

State law requires the Committee to hold two or more application cycles each year for awarding 9% tax credits, unless circumstances warrant a reduction in the number of cycles. The 2014 funding schedule is as follows:

Round	Application Due Date	Committee Awards
First	March 4, 2015	June 10, 2015
Second	July 1, 2015	September 23, 2015

Application Process

TCAC has prepared an application package to help applicants to present clearly their project's characteristics. Staff reviews the application to determine the reasonableness of project costs, the maximum allowable tax credit allocation, and the amount of credit needed for financial feasibility. The application review process generally takes about sixty days to complete.

Point System for Ranking and Scoring Applications

TCAC receives far more applications for tax credit than it has authority to award. Generally, the demand is roughly twice the supply of available credit. For that reason, the Committee, in 1999, implemented a point system by which to rank applications. Although it is somewhat complicated by the overlay of statutory set-asides and geographical apportionments, the basic point structure advantages applications that show evidence of leveraging public and some private funds, projects for which the owner and management company have previous affordable housing experience, projects that have location amenities (for example, being located by a public transit stop), projects that will offer tenants various service amenities (for example, after school computer classes), projects serving the lowest income tenants, "mixed income" projects that have a non-tax credit component of renters, projects that are ready to proceed, projects that attain energy efficiencies, and projects that contribute to neighborhood revitalization. (See the TCAC Regulations for a fuller explanation.)

Stages of Tax Credit Reservation

Federal law has stringent requirements for making allocations and placing projects in service. A slip in timing could cause the state to lose credits and not be able to access unused credits from other states. It is for this reason that the Committee has established progress requirements that ensure California is in compliance with federal law.

- Preliminary Reservation: Generally, when applications are submitted to TCAC, projects are not yet ready to begin construction and the applicant seeks a Preliminary Reservation.

- Carryover Allocation: Federal law requires that a Carryover Allocation be obtained if a project will not be placed-in-service in the same year the project receives a reservation. Once a Carryover Allocation is made, project owners have until December 31 of the second calendar year after the year in which the Carryover Allocation is made to place the project in service.

- Issuance of Tax Forms: This is accomplished when conditions of the Preliminary Reservation have been met, the project is "placed in service" or ready for occupancy, and the owner submits various documentation to TCAC for review. TCAC issues IRS Form 8609 (and the state Form FTB 3521A, if applicable) after performing a final feasibility and cost reasonableness analysis to determine the requisite amount of tax credits needed. The final analysis is based on an audited cost certification prepared by a certified public accountant. One tax form is issued for each residential building in a project.

Before the tax forms are issued, the owner must enter into a regulatory agreement with TCAC. This agreement is recorded against the land and holds the project owner to the specifications and characteristics of the project on which the tax credit reservation was awarded (rent and income restrictions, selection criteria, preference points and other requirements).

Compliance Monitoring

The Committee administers a compliance monitoring program involving all projects with an allocation of federal or state housing tax credits. Projects are monitored according to the requirements of Section 42, IRS regulations, and the terms of the regulatory agreement entered into between the owner and the Committee. Each project will have a site visit from TCAC staff or its agent every three years. During this visit, tenant files and rent rolls will be examined to assure that the incomes and rents are properly restricted. Other items to be inspected include promised amenities as well as the physical conditions of the development and its units.