



# The Low-Income Housing Tax Credits Issue



### Celebrating the LIHTC on Native Nation Lands in California

*Nine years into the California LIHTC set-aside for affordable housing on Native lands, more than \$130 million in tax credits have been awarded to build or rehabilitate nearly 350 homes, but demand still far outpaces the limited set-aside.*

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### Partnering with a Nonprofit for a LIHTC Development

*What are the benefits and challenges of private for-profit affordable housing developers partnering with a nonprofit?*

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### Temporary Regulations Provide Details to Assist in Complying with Final AIT Guidance

*Temporary regulations provide context for the practical application of final average income test regulations.*

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### 45L Credit Extension Expands Clean Energy Possibilities for LIHTC Developers

*The Inflation Reduction Act includes a 10-year extension of the Section 45L Energy Efficiency Home Credit, providing a long runway for an incentive that previously was renewed on short-term bases.*

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# Partnering with a Nonprofit for a LIHTC Development

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As many state low-income housing tax credit (LIHTC) allocating agencies have increased set-asides for nonprofit developers and/or have strengthened the scoring benefit of having nonprofit participation in the development team, private for-profit affordable housing developers increasingly need to look at forming partnerships with nonprofit developers.

Tax credit allocations aside, there are a number of other strong benefits from partnering with a nonprofit. However, there are also significant drawbacks and many detailed considerations that need to be taken into account when creating such a partnership. In this article, those drawbacks and considerations will be addressed, with steps that can be taken to mitigate the drawbacks.

## Benefits to Partnering with a Nonprofit Developer

First, it is important to understand all the benefits that come from partnering with a nonprofit developer.

The major benefit to the for-profit affordable housing developer to partner with a nonprofit is of course increased competitiveness to obtain a LIHTC award. Most states give points for nonprofit involvement in the developer and owner, with more points awarded as the level of ownership interest and level of material participation by the nonprofit increases. Allocation scoring also often gives points for a strong resident services plan, for which having a nonprofit member of the ownership team with that expertise improves the chances of obtaining the maximum points. Some agencies give points if there is a Year 15 right of first refusal (ROFR) to a participating nonprofit. In the extremely competitive world of LIHTC allocation awards—where the difference between winning an award and going home empty can be a little as one or

two points or even a fractional point—having the added points from a partnership with a nonprofit can make all the difference.

There are also additional benefits to consider.

Nonprofit participation can be critical to obtaining state and local gap subsidy funding that enables a project to achieve financial feasibility and, therefore, enable it to secure 4% credits through tax-exempt bond financing. In Washington, D.C., a 100% tax exemption is provided for a property that is subject to LIHTC regulatory requirements and which has a general partner or managing member controlled by a nonprofit, enabling the development to reduce its gap by leveraging more first mortgage debt. In that case, control is defined as having a 51% ownership interest and material participation in operations. Maryland provides a payment in lieu of taxes benefit for affordable housing developments, the general partner of which is a nonprofit or wholly owned by a nonprofit. Funding programs from most cities and states, including CDBG, HOME, housing trust funds, etc., have set asides or priorities for nonprofit involvement in the developer or owner.

Many nonprofit organizations have substantial development experience that they bring to the partnership, including expertise in areas such as construction administration. Many have strength

in the provision of resident services or case work for permanent supportive housing—essential for successful affordable housing (as well as securing points in the competitive LIHTC allocation process). Many bring strong relations with the local community, which can be critical to securing entitlements or funding support. And many own or are a conduit to land and buildings for affordable housing development.

The nature of these partnerships, the legal structure and the economic splits can be varied, depending on the capacity, expertise and experience of the nonprofit and the state and local government regulations around tax credit and funding programs. At Somerset, we have undertaken numerous developments with nonprofit partners. In some cases, the involvement of the nonprofit was limited to ensuring a robust program of resident services (their expertise), and in other cases the partnership was a full joint venture with substantive divisions of responsibility throughout the development and operating phases. The structure of these partnerships is often a critical mechanism by which the disadvantages of partnering with a nonprofit are mitigated.

### Challenges to Partnering with a Nonprofit Developer, Solutions

These disadvantages include complicating and slowing decision-making; sharing the economic benefits of the development; typically needing to provide a year 15 ROFR to the nonprofit partner with a minimum sale price in accordance with Internal Revenue Code (IRC) Section 42(i)(7)(B), impacting the likelihood of having residual economic benefits at sale or resyndication; and having some element of project control outside of the hands of the guarantor.

What can be done to mitigate these disadvantages and to structure around the various issues that need to be addressed? First, given the skepticism that nonprofits sometime have for for-profit developers, even mission-driven companies, it is very important to have open and fully transparent negotiations to set the terms of the partnership. Those terms should be emblazoned early on in a memorandum of agreement (MOA),

which can be later referred to as the nitty gritty details of the legal documents get worked out—much like the term sheet from a syndicator. The MOA should deal with outlining the vision of the development to ensure a common understanding. It should define the roles and responsibilities of the partners during the predevelopment, construction and operation phases; and outline the decision making, e.g., what decisions are “major decisions” which require unanimous consent. The MOA needs to define the economic splits of the developer fee, cash flow distributions (regardless of whether they are characterized as deferred fee, incentive management fee, partnership administration fee, other fees or distributions) and residuals; including a mechanism, perhaps a side-letter agreement, to reconcile the actual amounts received through the project waterfall with the intended splits. It should define capital contributions and staff allocations and define recourse liability of the partners, which are often heavily weighted to the for-profit partner. And the MOA should define how the Year 15 exit will work in the context of a possible general partner (GP) option and/or a nonprofit ROFR.

Other considerations for the MOA include setting the preclosing term of the agreement in order to accommodate the possible need for multiple state LIHTC funding rounds; defining methods of resolving disputes; outlining the anticipated organizational structure which meets legal and funding requirements while at the same time achieving the agreed to economic splits, roles and responsibilities and protections for the guarantor.

The for-profit developer, who typically shares an identity of interest with the guarantor, needs to pay particularly careful attention to the organizational structuring and decision-making rights and process. This is essential to protect the interests of the guarantor, while the requirements of funders and the expectations of the nonprofit partner are also met. The guarantor might want to be an administrative limited partner or administrative GP with consent rights on

certain material decisions. Carefully incorporating these provisions into the partnership operating agreement and the LIHTC ownership agreement has been successful in balancing the needs of the private developer and guarantor and those of the funding agencies which require some degree of nonprofit control of the GP.

Having conversations with prospective tax credit investors is also helpful in determining the right organizational structure. The tax credit investor may want to take bonus depreciation (helping to maximize tax credit pricing) which requires a for-profit GP. To address this and meet the nonprofit control requirements of other funding, the nonprofit partner could establish a wholly owned for-profit entity. If appropriately structured, the tax credit investor may also be able to take IRC Section 45L credits available under the Inflation Reduction Act, which can be very significant if the project also meets prevailing wage requirements, but which require a nonprofit GP. One other arcane factor to address is that when the

nonprofit brings existing property to the development which qualifies for acquisition basis, there may be need for the disaffiliation of the nonprofit seller from the developer buyer. An additional nonprofit organization, acceptable to both the for-profit and the nonprofit partners, may need to be brought into the partnership to take a 21% interest in the GP entity. All said, a good tax lawyer and tax credit accountant are critical at the early stages.

The organizational structuring of a partnership between a for-profit developer and a nonprofit developer can be challenging and sometimes feel like pretzel making. But the partnership, the relationships created and the ultimate delivery of critically needed affordable housing can be extremely rewarding. ❖

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