# The Life Cycle of Low-Income Housing Tax Credits (LIHTC)

## *Part 2 – Development*

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The LIHTC credits are awarded based on the eligible cost basis of the residential property which has been designated for the set aside. That said, the entire project need not be just "affordable housing." In urban areas, such as New York City, mixed use and mixed income are increasingly popular avenues of development.

Incorporating both affordable and market rate residential as well as commercial space is allowed. The key is understanding and documenting the allocation of costs between the different uses.

### *The Four C's*

Once construction is done – it is time for the four C's:

- Certificate of Occupancy
- Cost Certification
- Credit Calculation
- Conversion

When a Certificate of Occupancy is obtained for the development, tenants are allowed to move in and the day-to-day operations of the property begin. The initial occupancy of the units begins the tax credit clock, but, before we get to that, the costs of the development need to be certified.

A cost certification is just what it sounds like – a certification of development costs. The cost certification process is considered an audit and, therefore, all of the standard audit requirements still apply. The scope of this reporting is limited to the costs of the development and the related sources of funding the development. This is commonly referred to as the "Sources and Uses."

The cost certification schedules can vary based on the funding sources, HPD and HDC both have specific schedules they prefer to receive as well additional forms outside the cost certification they each require to be submitted. The basic cost certification schedules include:

- Total Cost and Eligible Basis
- Permanent Financing
- Calculation of Tax Credits

The Schedule of Total Costs and Eligible Basis is similar to a schedule of functional expenses. The costs are broken down by budget line and then by eligibility for tax credits.

Eligible basis can be defined as residential development costs which are subject to depreciation. Eligible basis includes the cost of common areas of a building.

Land and certain land-related costs are not subject to depreciation and, therefore, not includable in eligible basis.

Standard capitalization rules apply in that there are other costs that are required and should be considered part of the building – for example, you buy a piece of machinery, pay for shipping and installation. You don't just capitalize the purchase price as it took more than that to get it "ready for its intended use."

If the development includes commercial or market rate units, construction costs related to those areas are still capitalizable but not part of Eligible Basis when it comes to the tax credits.

### *Direct Costs*

Direct costs are always included in basis as they exist because of the development. These costs include items such as Architect, Engineering, Developer Fee and Building Permits. Contractor costs are subject to depreciation; therefore, any of those costs (allocable to the residential units) would also be eligible basis.

### *Indirect and Other Costs*

Indirect costs are sometimes included as they can exist before, during and after the construction period. The portion incurred during construction is capitalized; after the property is in service, these costs are expensed. Examples of these costs are Interest/Letter of Credit, Real Estate Taxes and Insurance. As they are subject to depreciation only during the construction period, these costs may not be fully eligible.

Other costs are NEVER eligible for tax credits. These are not directly related to construction, whether incurred during the construction period or not. Marketing costs are a prime example of a necessary development cost which is not subject to depreciation and, thus, not includable in eligible basis.

The Schedule of Permanent Financing includes not only the permanent debt of the project but all sources of funding for the development:

- Bonds and mortgages payable
- Interest accrued during development
- Equity payments and
- Any deferred developer fees.

Total sources on this schedule must be equal to the total costs on the Schedule of Permanent Financing.

### Contact Us

The third and final part of this three-part series on the LIHTC tax credit program will follow shortly and will deal with calculating the tax credits. If you have any questions, feel free to contact the partner in charge of your account or Jennifer Galasso, Partner, at jgalasso@pkfod.com.