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Avoiding the "Lock"-ness Monster

by Johan Graham

If you are a developer, the beast is easy to recognize. You may have observed it when you placed your project in service and discovered that the applicable monthly low-income housing tax credit rate had fallen dramatically from the rate at which the project was underwritten by the state and negotiated with your equity provider. This quandary has befallen seasoned developers as well as newcomers to the housing tax credit program in the past few years. Understanding the way the credit rate fluctuates will help you elect the time for locking the credit rate on your project and keeping the "Lock"-ness Monster at bay.

The Rate and the Lock

The credit rate, published by the Treasury Department, changes monthly and is used to calculate the amount of annual tax credits permissible from the qualified basis. The Treasury Department gives two credit rates that are based upon the discounted, after-tax averages of Treasury's mid-term and long-term obligations.

The first rate is recalculated monthly to provide developers with a present value on tax credits equal to 30 percent over the ten-year period for those project costs associated with acquisition of existing buildings or with federally subsidized financing (i.e., tax-exempt bonds).

The second rate is also recalculated monthly to provide developers with the present value on tax credits equal to 70 percent over the ten-year period for costs associated with both new construction and rehabilitation.

The acquisition credit has been nicknamed the "four percent credit" because it was pegged when the rate was around four percent, while the rehabilitation and new construction credit, doing business as the "nine percent credit," was set around nine percent. A historical record of the past monthly credit rates can be found at *www.ncsha.org.*

There are two times when the monthly credit can be locked to a project. The Internal Revenue Code section 42(b)(2)(A) states:

> *In the case of any qualified low-income building placed in service by the taxpayer after 1987, the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the earlier of (i) the month in which such building is placed in service, or (ii) at the election of the taxpayer—the month in which the taxpayer and the housing credit agency enter into an agreement with respect to such building (which is binding on such agency, the taxpayer, and all successors in interest) as to the housing credit dollar amount to be allocated to such building. . . .*

The election option specified in section 42(b)(2)(A)(ii) can be invoked only if the election is made no later than the 5th day after the close of the month in which the binding agreement is made. In the case of tax-exempt bonds, the rate is locked in the month in which the tax-exempt obligations are issued.

Each state adheres to the IRS guidelines; however, each state's housing finance agency interprets the "agreement" to enter into an election differently. Many consider the lock-in month to be the month of the reservation of credits, but some consider it the month in which the credits are actually allocated.

Therefore, it is extremely important that you contact your state agency or look for additional instructions in your state's qualified allocation plan. When you lock in this applicable credit percentage, this is the official rate that will be used to

Other Lock-in Considerations

Gross Rent Floor Election

The gross rent floor constitutes the minimum amount of rent that the owner of a rent-restricted building can charge, even if the area median gross income (AMGI) decreases. If an owner does nothing, the gross rent floor will be based on the AMGI at the time when the buildings are initially allocated credits. However, it may be beneficial for an owner to elect instead the placed-in-service date in case the AMGI rises, thereby creating a higher gross rent floor. Although the owner can wait to make this election (at any time between the allocation date and the placed-in-service date), the election must be made no later than the placed-in-service date, or the gross rent floor will be based on the project's allocation date.

Community Affordable Housing Equity Corp. (CAHEC) was created in 1992. CAHEC's mission is "to raise and invest equity capital in low-income housing tax credit projects, to empower residents living in developments CAHEC helps finance, and to promote home ownership."

CAHEC publishes *TechNotes* for its constituents in the affordable housing industry.

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calculate the amount of your credits. Until that point, the credit rate used in the underwriting analysis is only an estimate.

Problem Identification

Equity in a deal is based on a building's qualified basis multiplied by its applicable fraction, the credit rate, ownership interest, and a price. If you consider that the price, ownership interest, and applicable fraction are known quantities, then the rate and costs are the variable items.

Developers, in an attempt to maximize their equity, want to see the rate as high as possible in order to generate more dollars. So the quandary becomes whether to lock the rate at reservation/allocation or to wait until the placed-in-service date to lock the rate (that is, "float" the rate) in hopes that the rate might rise in the meantime.

Another variable could come into play in those states where floating the rate until the placed-in-service date can allow developers to maintain the option of maximizing their allocation. In these states, the locking of the rate coincides with the locking of the annual allocation, so this can be an additional incentive to float the rate and generate additional equity.

The problem lies in the fact that the credit rate generally ebbs and flows along with interest rates, but not in strict concordance. Additionally, as interest rates rise, the amount of permanent debt a project is able to secure shrinks because of the need to maintain a specific debt coverage ratio. This rise in rates can also generate more equity due to a higher credit percentage.

Likewise, as interest rates fall, a project should be able to handle less equity because it could obtain additional permanent financing. In theory, this is the way interest rates, permanent financing, and the credit percentage interact.

However, predicting the month-to-month rate has been an elusive challenge to even the most skilled developers. Why? Imagine that you were awarded credit in April of 2004 when the credit rate was a low 7.91%. Would you lock the rate and secure your future, or would you decide to float the rate until the buildings were placed in service?

Think carefully—you may not place your buildings in service for another two years, and you have already negotiated your permanent financing commitments and your equity amount. What do you think the rate will be in 2006 when you place your buildings in service? Ah . . . the dilemma.

"Lock"-ness Attack

Figure 1 illustrates the dilemma with hard numbers. Suppose a project that could have locked in at the rehabilitation and new construction rate of 8.41% in October of 2000 passed on that because the developer believed that rates would go up. What if the project placed in service in October 2002? The developer got burned because the rate had actually fallen to 7.97%.

Calculation of Credits	New Construction (9% Credit)	
	Oct. 00	Oct. 02
Total Adjusted Eligible Basis	5,000,000	5,000,000
x Applicable Fraction	100%	100%
Total Qualified Basis	5,361,389	5,361,389
x Credit Rates	8.41%	7.97%
Total Ten-Year Credit Amount	4,205,000	3,985,000
x Price Per Credit	0.78	0.78
x Ownership Percentage	99.99%	99.99%
Equity Generated	$ 3,279,572	$ 3,107,989

Figure 1

Notice that on this project with $5,000,000 in qualified costs, the rate change caused a $171,583 decrease in equity. This would certainly be a bitter pill for the developer to swallow. So why risk it? Why not lock the rate at reservation?

Developers don't lock because of the upside. The previous scenario pointed out the downside, but the rates could have gone up, a move that would have generated more equity. Many developers argue that with the record lows in the credit percentage over the last 18 months, the rates can't go down much more—surely they are bound to climb upward and generate more equity if the project doesn't lock until placed in service.

Risk vs. Reward

Savvy developers always balance their risks versus their rewards, and the question "When do I lock?" calls for thoughtful analysis. The question can be addressed with the answers to several other questions: Am I risk averse? Do I have liquid net worth to back up my decision? If my project has a large gap, can it easily be filled by other sources? Am I a for-profit organization or a nonprofit organization?

For-profit organizations with high net worth, liquidity, and adequate, available external funding sources may be more willing to take on the risk of floating the credit. The upside of increased equity in the deal can be a real plus if the organization can handle a "Lock"-ness attack occasionally.

On the other hand, a small nonprofit organization with low liquidity and net worth usually can't afford the risks of a surprise attack no matter what the potential upside could be. If the nonprofit gets burnt, the project may fail and the organization may cease to operate.

In analyzing these questions, look at your funding sources. Are your projects well funded with little or no deferred development fee and with an easily obtainable price per credit from your syndicator? If yes, locking with the reservation/allocation may be the better option. Eliminating the down side in this transaction may be more important than the upside if the rate happens to rise. Besides, your financing is secure and your development fee is seemingly in hand. Why jeopardize that?

Losing credits is painful. Your equity will be adjusted downward based upon what you did not deliver to your investors. During the reservation season, it's important to weigh your ability to handle the risks of floating versus the rewards of locking. If you choose to lock, you must do so in accordance with your state's binding credit election policy. If you choose not to lock, realize that you're risking an encounter with the "Lock"-ness Monster.

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