NOVOGRADAC
Journal of Tax Credits™

April 2024 • Volume XV • Issue IV
Published by Novogradac

The Low-Income Housing Tax Credits *Issue*

The Many Meanings of 'Mixed-Income' and How they Affect Policymakers
The term "mixed-income" can describe six different circumstances in the LIHTC context, each with important implications.
Page 10

Stop Locking the LIHTC Rate
Filling out an election to lock the LIHTC rate is currently not necessary and has the theoretical potential to hurt a LIHTC development.
Page 12

Reauthorizing, Increasing Funding for NAHASDA Could Help Provide Crucial Funding for Native Housing
Reauthorizing and properly funding Native American Housing Assistance and Self Determination Act could help tribally designated housing entities better access LIHTC.
Page 16

Underwriting for Impact: A New Tool from Urban Institute
The Capital for Communities Scorecard assesses various impacts of a proposed real estate development or operating business investment.
Page 18

Stop Locking the LIHTC Credit Rate

GLENN A. GRAFF, ESQ., APPLEGATE & THORNE-THOMSEN

My Uncle Sam likes to tell the tale that once upon a time the low-income housing tax credit (LIHTC) rates would float every month. They were not locked at 4% and 9%. One could choose to lock the floating rate when a binding commitment was issued (or tax-exempt bonds were issued) or let it float until placement in service.

The story goes that the all-wise and powerful Congress used the power of a "bill" to change the law and locked the rates at 4% and 9%. Is this tale true? As explained below, they myth is not quite reality. Rates are not "locked;" instead, there is a "floor" so that rates can never be lower than 4% and 9%, although they could be higher. So, should projects still be filling out a rate lock form? Probably not. Filling out an election to lock the LIHTC rate is currently not necessary and has the theoretical potential to hurt a project. So, this author recommends sponsors stop locking the LIHTC tax credit rate.

How Are Floating Tax Credit Rates Determined

To calculate a project's supportable credit amount, the project's qualified basis is multiplied by the LIHTC tax credit rate, called the "applicable percentage." As originally enacted in 1986, in Internal Revenue Code (IRC) Section 42, the applicable percentage was a floating monthly rate that was meant to do the following: for new construction and rehabilitation costs for projects that were not federally subsidized, the rate was computed so that the 10-year credit stream would have a present value equaling 70% of the project's qualified basis under IRC Section 42 (b)(1)(B)(i). For projects that were federally financed (which now means they have tax-exempt bonds) or for costs of acquiring an existing building, the floating rate was set at a rate that results in the 10-year credit stream equaling 30% of the qualified basis under IRC Section 42 (b)(1)(B)(ii).

The applicable percentage that a project received under IRC Section 42(b)(1)(A) was the appropriate rate for the earlier of (i) when a rate lock was elected, or (ii) the month the project was placed in service. For projects receiving an allocation of LIHTC from a credit agency, the rate could be locked at the time that there was binding commitment between the credit agency and the taxpayer for the credit agency to allocate an amount of credits This was most often the time of a reservation or a carryover, depending on how it was structured by the credit agency. For projects getting their LIHTC from the issuance of tax-exempt bonds, the rate could be locked at the time of bond issuance. If the rate was not locked, then the applicable percentage would be the rate in effect when the building was placed in service.

Congress Never 'Locked' the Applicable Percentages

In response to the 2008 financial crisis, Congress passed the Housing and Economic Recovery Act of 2008 (HERA) which retained the 70% credit computation but provided that the applicable percentage established under IRC Section 42(b)(2) would have a floor so that the rate would not be less than 9%. Because the floating applicable percentage at that time was less than 8%, this resulted in projects being eligible for almost 20% more LIHTCs. Projects with financing gaps are now able to request more credits from their credit agencies so that the projects become financially viable.

Due to budget limitations at the time, HERA did not include a 4% floor for the 30% credit rate. However, in 2020 Congress passed the Consolidated Appropriations Act of 2021 as part of the response to impacts of the COVID-19 pandemic. That law kept the 30% present value computation under IRC Section 42(b)(3), but added a floor so that the rate would be no less than 4%. This was a very significant improvement as it permanently increased the amount of LIHTCs that bond-financed projects could receive and is leading to the construction of significantly more affordable housing.

Correcting the Mythology

The applicable percentages are not "locked" at 4% and 9%. Instead, Congress set a "floor" on such rates at 4% and 9%. Specifically, IRC Section 42(b)(2) provides that the rate for new construction and acquisition costs not financed with tax-exempt bonds *shall be no less than 9%*. For projects with tax-exempt bonds or for projects with eligible acquisition costs, IRC Section 42(b)(3) provides that the applicable percentage is *no less than 4%*. As a result, rates are not "locked" at 4% and 9%. Instead, the rates just have "floors" of 4% and 9%. The IRS continues to publish the monthly floating rates, with the March 2024 rates published in Revenue Ruling 2024-04 as being 3.42% and 7.99%.

Recommendation

The author recommends currently not electing to lock the applicable percentage (and not doing so provided the floating applicable percentages remain below 4% and 9%). The reason for this is that if interest rates go up very significantly, it is possible that the floating applicable percentages in effect at the time of placement in service could exceed the 4% and 9% floors. In fact, this happened in 1988 when the applicable percentage was above 9.00% for nine months of the year, with a high of 9.22%.

It is a true that for decades, interest rates have been significantly below what is needed for the floating applicable percentages to exceed 4% and 9%. However, given the country's recent bout of inflation and higher interest rates, it is conceivable that rates could someday exceed 4% and 9%. If a project locks its rate while the floating rates are less than 4% and 9%, then it would forego the opportunity to use a higher rate in effect at the time of placement in service.

Importantly, there is no current downside to not electing to lock the applicable percentage because the rates cannot be lower than 4% and 9%. Here is an example:

Example 1–Don't Rate Lock

A new construction project will be financed by tax-exempt bonds issued in March 2025 when the floating rate is 3.42%. Placement in service occurs in March 2027, but due to high inflation and interest rates the floating rate has risen to 4.05%. The general rule is the applicable percentage is the rate in effect at the earlier of a rate lock election or the rate at placement in service. If the project had filled out a rate lock election in March 2026, then the rate under the general rule would be that 3.42% and the 4.05% rate would be unavailable. However, the IRC Section 42(b)(3) floor would come into play and provide that the rate is no less than 4%. Conversely, if no rate lock election had been made, then the applicable percentage would be the rate in effect at placement in service, which is the 4.05% rate. That higher rate will support more LIHTCs. If the March 2027 rate was less than 4%, then the 4% floor would come into play and the applicable percentage would be 4%. Thus, not locking the rate created no additional risk as the rate would never be lower than 4%. But in a conceivable higher-rate environment, not locking the rate could allow an applicable percentage higher than 4%.

Could there ever be a time to lock the applicable percentage? Yes, if interest rates go up significantly, then the floating rates may go above 9% or 4%. While interest rates would have to rise very substantially–Treasury rates of say 8%-10% or higher–in such an environment locking the rate could be considered.

Example 2–Skyrocketing Rates Mean a Rate Lock Can Be Considered

Same basic facts as Example 1, except the March 2025 rate when bonds are issued is 4.02%. Now there is a judgment call to make. If a rate lock election is made, then the project will lock in the 4.02% rate, which is higher than the 4.00% floor and this will guarantee a higher amount of credits using the 4.02% rate. However, if a rate lock election is not made and the applicable percentage is 4.05% in March 2027 when building is placed in service, then the project could support even more LIHTCs. However, if rates dropped and the March 2027 rate was 3.95%, then the 4% floor would come into play and the rate would only drop to 4%. The 4% floor therefore provides some protection, but that rate is still lower than the 4.02% rate that was available at the time a rate lock could have been made. Therefore, the developer has a judgment call to make: lock a for-sure 4.02% rate or roll the dice for a higher rate, but knowing the rate can never be less than 4%.

While there is a theoretically possible high-rate situation where locking the rate makes sense, in the current economic climate there is no value in electing to lock the rate.

Moral of the Story

If a credit agency sends you a LIHTC rate lock election form now, don't sign it. If current floating rates ever exceed 4% or 9%, then you can think about locking that higher fixed rate.

Glenn Graff is a partner at the law firm of Applegate & Thorne-Thomsen where he chairs the Tax Group. He previously served on the Governing Committee of the American Bar Association's Forum on Affordable Housing and Community Development Law, is its current budget chair, and is a former chair of its Tax Credit and Equity Financing Practice Group.

NOVOGRADAC®

CONTACT

CORRESPONDENCE AND EDITORIAL SUBMISSIONS
Teresa Garcia
teresa.garcia@novoco.com
925.949.4232

ADVERTISING INQUIRIES
Christianna Cohen
christianna.cohen@novoco.com
925.949.4216

ISSN 2152-646X