Starting Up Your Hybrid:
Combining 4% and 9% Tax Credit Projects

2019 Housing California Conference

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STARTING UP YOUR HYBRID: COMBINING 4% AND 9% TAX CREDIT PROJECTS

Housing California
Sacramento, California
April 17, 2019

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Checking you’re not a bot

How many puppies do you see?

3  4  5  6
Checking you’re not a bot

How many puppies do you see?

3 4 5 6
Checking you’re not a bot

How many buildings do you see?

1
2
3
4
Checking you’re not a bot

How many buildings do you see?

3
What is a Hybrid Tax Credit Transaction?

A Tax Credit Transaction that could have been structured as a single 9% tax credit project which is structured as two related, but independently financed, projects using 9% tax credits on one portion of the project and 4% tax credits of the other.
What is are advantages of a Hybrid Tax Credit Transaction?

- Provides a mechanism to monetize eligible basis which would have been lost due to voluntary exclusion or credit cap
- May have a tie-breaker advantage
- May reduce overall project subsidy
### Pre-Hybrid Structure

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
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<tbody>
<tr>
<td>Gross Project Eligible Basis</td>
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<tr>
<td>Voluntary Excluded Basis</td>
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<tr>
<td>Net Project Eligible Basis</td>
<td>$21,000,000</td>
</tr>
<tr>
<td>Basis Boost</td>
<td>130%</td>
</tr>
<tr>
<td>Qualified Basis</td>
<td>$27,300,000</td>
</tr>
<tr>
<td>Credit Rate</td>
<td>9%</td>
</tr>
<tr>
<td>Annual Credits</td>
<td>$2,457,000</td>
</tr>
<tr>
<td>Total Credits</td>
<td>$24,570,000</td>
</tr>
<tr>
<td>Credit Price</td>
<td>$0.95</td>
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<tr>
<td>Total Equity</td>
<td>$23,341,500</td>
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## Post Hybrid Structure

<table>
<thead>
<tr>
<th></th>
<th>9% Deal</th>
<th>4% Deal</th>
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<tbody>
<tr>
<td>Gross Project Eligible Basis</td>
<td>$21,000,000</td>
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<tr>
<td>Credit Rate</td>
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<td>Total Equity</td>
<td>$23,341,500</td>
<td>$7,719,985</td>
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</table>
More Money and a Better Tie-Breaker…
Why isn’t EVERY deal a Hybrid?

• Tax Challenges

• Land Use Challenges

• Logistical Challenges
• IRC Section 42(i)(2) – “A new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under Section 103 the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.”

• IRC Section 42(b)(1)(B)(ii) – “Method of prescribing Credit percentages. The percentages prescribed by the Secretary for any month shall be percentages which will yield over a 10-year period amounts of credit . . . which have a present value equal to 30% of the qualified basis [of a federally subsidized building].”
Direct or Indirect Use of Bond Proceeds

- No direct guidance from the IRS on a hybrid deals specifically designed as such
- Cross collateralization of debt is prohibited (TAM 9528002)
- Projects need “Separate Plan of Financing” (PLR 200035016)
- Commonality of Ownership (i.e. same GPs and LPs for each project) is OK
- Disagreement about how to handle common areas
## Substantial Downside for Being Wrong

<table>
<thead>
<tr>
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<th>9% Credits</th>
<th>4% Credits</th>
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<td>Total Equity</td>
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**Price For Being Wrong**

$14,808,885
What is a Building

• Separate Structures are ALMOST always separate buildings
• A Single Structure can be multiple buildings for Tax Purposes
• IRS Notice 88-91 – “qualified low-income building” includes residential rental property that is either an apartment building, a single family dwelling, a townhouse, a row-house, a duplex, or a condominium.
Never Let Tax Lawyers Name Things
The Physical Layout of Your Project Dictates the Nature of Your Hybrid Transaction

• “Side-by-Side Hybrid” - Multiple Physical Buildings on separate legal lots in which one (or more) building(s) are financed with 9% Tax Credits and the other(s) are financed with 4% Tax Credits.

• “Integrated Hybrid” - Single physical structure which is treated as multiple buildings for tax purposes with 4% and 9% units in the same structure.
How far can we take IRS Notice 88-91

- Multiple condominiums within the same structure clearly works
- Air-rights parcels within the same structure not explicitly allowed by IRS Notice 88-91 but have been accepted as being functional equivalent
- Long Term Lease -
Land Use Challenges
Subdivision Map Act

• Property can not be sold or financed unless the parcel is created in accordance with the Subdivision Map Act

• Map Act allows for both horizontal and vertical subdivision of land

• Vertical subdivisions can be accomplished by Air Rights Subdivision or Condominium
Land Use Challenges
Time and Risk

• Vertical Subdivision and Condominiums typically require discretionary public approvals which can be time consuming and politically risky

• Vertical Subdivision and Condominiums may trigger additional fees and conditions including Quimby Fees
Logistical Challenges

• Splitting a single deal into two deals means splitting all soft financing into two loans.
• Going from one deal to two deals means twice the paper and more expenses.
• Some lenders and equity investors don’t want to be bothered with the hassle.
• You will probably need to use the same lender and equity investor for both deals which may limit your pool of financing partners.
• Lots of moving pieces with the TCAC Readiness deadline looming large.
BOCARSLEY EMDEN
Bocarsly Emden Cowan Esmail & Arndt LLP

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Los Angeles, CA 90071
Starting Up Your Hybrid – Combining 4% and 9% Tax Credit Projects

Housing California
April 17, 2019

Anthony Zeto, Deputy Executive Director
California Tax Credit Allocation Committee
Hybrid Project Qualifications

- 4% application submitted to CTCAC and CDLAC by the 9% application deadline;
- 4% and 9% projects are simultaneous phases, as defined in §10327(c)(2)(C);
- 4% project is eligible for maximum points in housing needs, service amenities, sustainability, and lowest income, except housing needs and lowest income categories can be met across the combined project;
- Developer fee limit requirements pursuant to §10327(c)(2)(A) using combined Tax Credit Units and eligible basis; high-cost test applies to 9% project only.
Hybrid Tie Breaker Benefits

- Qualified “hybrid” project 9% tie breaker benefits:
  - Tax Credit Units from combined project are included in the project size factor
  - First tie breaker ratio shall utilize the combined amount of leveraged soft resources defraying residential costs and the combined total residential project development costs
  - Second tie breaker ratio shall also utilize the combined total residential project development costs
Hybrid Projects to Date

- TCAC approved the conversion of two 2016 projects to hybrid 9% and 4% projects in 2017.
- In 2018, TCAC approved four hybrid 9% and 4% tax credit project applications.
- The average size of the combined approved projects has been 104 total units.
- In the first round of 2019, TCAC received two 9% and 4% tax credit project applications.
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EDEN HYBRID DEALS

Mission Court Senior Apartments
Warm Springs TOD Village Affordable #1 & #2

Elizabeth Kuwada, Eden Housing
Housing CA
April 17, 2019
EDEN HOUSING

• One of CA’s oldest nonprofit affordable housing developers – since 1968
• Based in Hayward, CA
• Develops, preserves, and manages affordable housing statewide for families, seniors and people with disabilities:
  10,000+ affordable units / 140+ properties
  (develop and/or owned and acquired)

• Property Management: Eden Housing Management, Inc.
• Resident Services: Eden Housing Resident Services, Inc.
PROJECT OVERVIEWS

1. Mission Court:
   - Fremont
     - 1 mi south of Warm Springs BART
   - Inclusionary
     - Part of 500-unit, 23.5 acre senior-focused master development with housing & community center

2. Warm Springs:
   - Fremont
     - Across street from Warm Springs BART
   - Inclusionary
     - Part of 1,001-unit, 35 acre Warm Springs Station Master Plan with housing, retail, & recreation amenities
PROJECT OVERVIEWS

1. Mission Court:
   • 2016 Round 2 Deal
   • Senior housing
   • 1 building: 90 units

2. Warm Springs:
   • 2018 Round 2 Deal
   • Family housing
   • 2 buildings: 132 units (61 & 71 units)
MISSION COURT: FINANCING

Financing:

• Tax credit equity

• $8.5M City of Fremont loan

• 30 PBS8 vouchers from Housing Authority of the County of Alameda

• Inclusionary land donation
MISSION COURT: FINANCING

- Structured as regular 9% deal
- Received Round Two 9% tax credit award Fall 2016
- Tax Credit Pricing Drop after Nov. 2016 Election: $1.18 to $1.00
- Financing Gap:
  $3M (tax credit pricing ↓) + $3M (construction pricing ↑) = $6M gap
- Solved for $3M of gap through increased perm loan (PBS8 rent and term increase) & design changes = $3M gap remaining
- Leveraged $3M in additional equity by going hybrid
MISSION COURT: HYBRID APPROACH

1. Project structure: Simple
   • Big enough: 90 units, $36M TDC, $17M of unused basis
   • Simple enough: limited restrictions, straightforward site plan

2. Project team: Motivated
   • Investor: Enterprise (upper tier: Morgan Stanley)
   • Construction & Perm Lender: JP Morgan Chase Bank
   • Housing Authority of County of Alameda
   • City of Fremont
   • Attorney: Kyle Arndt (Bocarsly Emden)
   • Financial Consultant: Diana Downton (CEI)

3. Project financing: Back-stop of new gap funds
   • County A1 funds and AHP award
**MISSION COURT: HYBRID APPROACH**

**9%: Mission Court Nine LP**
- Floors 1-2: 46 units,
- Includes site and common space
- $19M TDC, $3M Soft Loan

**4%: Mission Court Four LP**
- Floors 3-4: 44 units
- $17M TDC, $5.5M Soft Loan

→ Constructs entire building with 1 building permit & 1 construction contract (closed June 2017)

→ Purchases 4% portion prior to placing in service (closed Oct. 2018)
MISSION COURT: 4% PURCHASE

• Set up mechanics and most documents for 4% purchase during construction closing

• 4% LP purchased 4% project from 9% LP prior to placing in service (Temporary Certificate of Occupancy), prior to completing “mandatory post-closing work”

• Did mini cost certification to confirm that we satisfied 50% test prior to purchase

• Closing Process:
  • Day 1: Bond Draw Down
  • Day 2: Purchase: money transferred from 9% to 4% LP
WARM SPRINGS: FINANCING

Financing:

• Master developer contribution
• Inclusionary land donation
WARM SPRINGS: FINANCING

- Structured as two standalone 9% deals; goal was to finance one project first, followed by second project. If unsuccessful, ultimate fallback option would be standalone 4% deals.

- All soft funding to be contributed by master developer.

- Applied Round 1 2018 for the 71-unit project, did not receive award.

- Due to master developer timing requirements, running out of time to successfully get awards in Rd 2 2018 and Rd 1 2019 for separate 9% deals. Plus facing escalating construction costs.

- To minimize total master developer contribution, maximize tie breaker, and most efficiently get both projects completed, best to go hybrid.
# WARM SPRINGS: HYBRID APPROACH

<table>
<thead>
<tr>
<th>STANDALONE 9% DEALS</th>
<th>Tiebreaker</th>
<th>Gap Financing</th>
<th>Credit Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>71-unit deal</td>
<td>55%</td>
<td>$10 Million</td>
<td>$2,147,963</td>
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<tr>
<td>61-unit deal</td>
<td>55%</td>
<td>$11.8 Million</td>
<td>$2,023,251</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$21.8 Million</td>
<td>$4,171,214</td>
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<table>
<thead>
<tr>
<th>HYBRID DEAL</th>
<th>Tiebreaker</th>
<th>Gap Financing</th>
<th>Credit Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>132-unit hybrid</td>
<td>77%</td>
<td>$21.8 Million</td>
<td>$2,500,000</td>
</tr>
</tbody>
</table>
1. **Tiebreaker advantage**
   - Due to large size of project, as hybrid had 22% tiebreaker advantage assuming same amount of gap financing

2. **Project structure**
   - Two separate parcels already created: no need to go through parcel split process under time pressure
   - Simple, flexible financing
     - Large Project: 132 units, $83M TDC
     - Master development contribution only: flexible splitting funding between 9% and 4% portions of project
     - One tax credit investor, one construction/perm lender team
WARM SPRINGS: HYBRID APPROACH

4%:
- 71 units
- $40M TDC
- $15M Soft Loan

9%:
- 61 units
- $43M TDC
- $6.8M Soft Loan
LESSONS LEARNED

1. Make sure your soft lender(s) is comfortable with the hybrid structure.
   
   • Need flexibility to shift funds between the two hybrid parts of the project.
   
   • For projects with Project-Based Section 8 or other subsidy, this will require long-term tracking with separate contracts, waiting lists, etc.
LESSONS LEARNED

2. Work through the parcel subdivision carefully.

- Air Rights Subdivision vs. Condominium
- Significant collaboration with City housing, engineering, survey, fire, police, planning, building departments.

Parcel 1 (9%)
Parcel 2 (4%)
LESSONS LEARNED

3. The Reciprocal Easement Agreement (REA) is key to long-term success.
   - Air Rights Parcel Subdivision and REA senior to all project financing
   - City, Investor, Lender requirements
   - In coordination with Property Management Plan
LESSONS LEARNED

4. You get in the weeds working through the financial split.

- Developer Fee: changed to split 50-50
- Excluding common space from basis
- Splitting costs:
  - By square footage: construction-related hard and soft costs
  - Actual costs: TCAC fees, cost of issuance
  - 50-50: legal fees, investor costs, market study, audit, title
LESSONS LEARNED

5. You need to build consensus upfront and throughout.

- Financing team
- City: Council, Community Development, Building, Fire, etc.
- In house: Property Management, Accounting, Asset Management
Brooklyn Basin Hybrid Project

Housing California Conference
April 17, 2019
The Project

- 465 affordable units on two parcels as part of a 3,100 unit master planned community on the Oakland Estuary.
- First parcel has two projects, a 110 unit senior project and a 101 unit family project - two buildings built on one podium.
- Goal was to start construction on both projects at the same time for efficiencies.
Brooklyn Basin, Projects 1 and 2
Original Financing Plan

• Originally conceived of as a 110 unit senior 9% project next to a 101 unit Family 4% project to built at the same time. Other financing included Project Based Section 8, AHP, City funds, free land.

• 9% project had around $11 million in unused basis.

• Increased construction costs, combined with lower equity pricing and higher interest rates produced about a $14 million combined gap between the two projects.

• Both the Senior and Family project already met all of the additional scoring requirements (housing type, affordability, services, etc).

• After analyzing it multiple ways, we decided to turn the senior project into a 4% deal, and the family project into a 9%/4% hybrid.

• By raising more equity on the family project, we were able to move public subsidy to the senior project to make it feasible as a 4% project.
Not this kind of hybrid
More like this
Brooklyn Basin Hybrid Family Project

- Approximately $62 million in total basis.
- 9% credit was limited by the project size cap ($2.5 million federal credit).
- Total basis needed to support a 9% $2.5 million credit request = about $24 million = 41 units
- Total basis remaining for 4% = about $38 million = $1.6 million annual credit allocation = 60 units
- Basis prorated based on total square footage of units
Additional Equity Raised with the Hybrid

- **Just 9%**: $2.5 million annual credit allocation = $23.75 million (at 95 cents)

- **Just 4%**: about $2.6 million annual credit = $25 million (at 95 cents)

- **Hybrid**: $2.5 million 9% credit plus $1.6 million 4% credit = $39 million (at 95 cents)

- About $14 million in additional equity as a hybrid
Brooklyn Basin family tiebreaker

• In order to maximize total credit to the combined project, the 9% component was sized to maximize credit, resulting in equity contributing 80% of the total project financing, very little public subsidy.

• Public subsidy is loaded onto the 4% project.

• Tiebreaker calculated based on combined public subsidy, so not a problem.

• If we had done it as a single 9% project, tiebreaker would be higher – but only because we would have needed to substitute the additional $14 million in equity with public funds.
Ownership Issues

• To be eligible for 4% credits, project must be financed with tax exempt bonds
• To be eligible for 9% credits, project CANNOT be financed with tax exempt bonds
• In order to achieve this, the two projects must be owned by separate partnerships with separate financing.
• Need to create separate legal parcels.
Brooklyn Basin ownership

- Projects are on leased land owned jointly by the City of Oakland and the Oakland Housing Authority.
- Map Act allows land owned by public agencies to create parcels through a Plat Map and Legal Description. So didn’t need to go through the whole parcel map process. Instead separate parcels created through the Ground Leases.
- Have Joint Use Agreement between the two sides of the hybrid to address joint maintenance and operating issues.
FAMILY HYBRID UNITS
Project [1A] 3%: 41 units
Project [1B] 4%: 60 units
TOTAL: 101 units

FAMILY HYBRID PARKING
Family 1st Floor: 52 (5 Accessible)
Family 2nd Floor: 56 (7 Accessible)
TOTAL: 108
Project [1A] 3%: 45 spaces
Project [1B] 4%: 64 spaces

SENIOR UNITS
110 units

SENIOR PARKING
Senior 1st Floor: 38 (5 Accessible)
Senior 2nd Floor: 45 (4 Accessible)
TOTAL: 83

ARCHITECTURAL DATUM = D. 0" = 00'0" ABOVE SEA LEVEL
SEE CIVIL DRAWING
FAMILY HYBRID UNITS
Project [1A] 3%: 41 units
Project [1B] 4%: 60 units
TOTAL: 101 units

FAMILY HYBRID PARKING
Family 1st Floor: 55 (5 Accessible)
Family 2nd Floor: 56 (7 Accessible)
TOTAL: 104
Project [1A] 3%: 45 spaces
Project [1B] 4%: 64 spaces

LEVEL 1
LEVEL 2

FAMILY HYBRID

Should allocate 11 spaces from Level 2 to Project [1B] 4% LP

SENIOR PROJECT 2

FAMILY HYBRID PROJECT

101 units

(1 Manager unit)
Debt and Equity structure

- Goal was to minimize the number of financial partners
- Wells Fargo provided equity and construction debt on all three partnerships. Also was the AHP lender.
- Wells Fargo provided permanent loans through the Freddie TEL program on all three partnerships. Freddie will purchase the perm loans at conversion, thus no substantial user issue.
- Still three different sets of attorneys!
- Closed on December 20, 2018- (a few days before readiness deadline)
Hybrid Issues during closing

• Biggest concern was keeping the bonds from tainting the 9% credits. Needed to as much as possible separate the 4% from 9%.

• The two project were separated by stack, not floor, and cost of all common areas was pro-rated between 4% and 9%, causing concern for tax counsel.

• They required that we use a “tracing method” to clearly demonstrate that tax exempt bonds weren’t paying for the common areas.
  – Separate GC contracts for 4% and 9%
  – 4% Schedule of Values further broken out into Unit vs. Common Area costs.
  – Each draw requires that the Common Area costs be paid for by non-bond sources
  – Needed to have enough non-bond sources during construction to do this
Hybrid Issues during closing

• Needed to separate our consultant contracts between the 4% and 9% owner.
  – Architecture, civil both had separate contracts
  – Others pro-rated and separated through assignment and assumption agreement

• Scrutiny on the operating expense allocations.
  – Joint Use Agreement governed the operations
  – Expenses allocated pro-rata
  – One component is the lead, the other reimburses
The One Building Hybrid- lessons learned

• Design the building to separate the 4% from 9% as much as possible
  – Separate by floor as much as possible
  – Minimize need to access the 9% by going through the 4%

• It’s all about the common areas
  – Allocate common areas to the 9% if possible

• All costs must be consistently allocated
  – Allocation of paid developer fee should be pro-rata
  – Don’t count on any gamesmanship on basis to maximize the credit
More Lessons Learned: Prepare well ahead of time

- Make sure you have an investor who is willing to do it. Don’t go too far down the road before talking to investors and their counsel.
- Bring investor and their counsel in before design is final and before tax credit application is submitted.
- Set up your systems and proforma to easily allocate costs.
- Use a GC who is prepared to help you with cost allocations.
- Include your auditor in the planning
More Considerations

• Application was extra work. Complicated financial modelling plus three applications are due at the same time – two TCAC and one CDLAC.
• Make sure soft lenders are OK with being on only one side of the transaction- (if possible, apply for the funds as only one side of the transaction)
• Minimize the number of financial partners
• Be prepared for a very complicated closing.
  – Organization is key!
• Don’t rename your project in the middle of the closing!
When does it make sense?

- 9% project that has significant unused basis:
  - Large Voluntary Reduction to boost tiebreaker
  - Project that exceeds the project size cap or the credit amount available in the region
  - Basis that is unused in order to be within the basis limits is not as helpful
- 4% project with a gap and that can meet the additional requirements
- Projects where there are not significant barriers to separate ownership – talk to your city
- Project where design is compatible with separate ownership