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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
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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?

✗	✗	5	✗

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

Gross Project Eligible Basis		$40,000,000
Voluntary Excluded Basis		($19,000,000)
Net Project Eligible Basis		$21,000,000
Basis Boost		130%
Qualified Basis		$27,300,000
Credit Rate		9%
Annual Credits		$2,457,000
Total Credits		$24,570,000
Credit Price		$0.95
Total Equity		$23,341,500

Post Hybrid Structure

	9% Deal	4% Deal
Gross Project Eligible Basis	$21,000,000	$19,000,000
Voluntarily Excluded Basis	$0	$0
Net Project Eligible Basis	$21,000,000	$19,000,000
Basis Boost	130%	130%
Qualified Basis	$27,300,000	$24,700,000
Credit Rate	9%	3.29%
Annual Credits	$2,457,000	$812,630
Total Credits	$24,570,000	$8,126,300
Credit Price	$0.95	$0.95
Total Equity	$23,341,500	$7,719,985

More Money and a Better Tie-Breaker… Why isn't EVERY deal a Hybrid?

- Tax Challenges
- Land Use Challenges
- Logistical Challenges

Tax Challenge
Bond Taint of 9% Credits

- 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

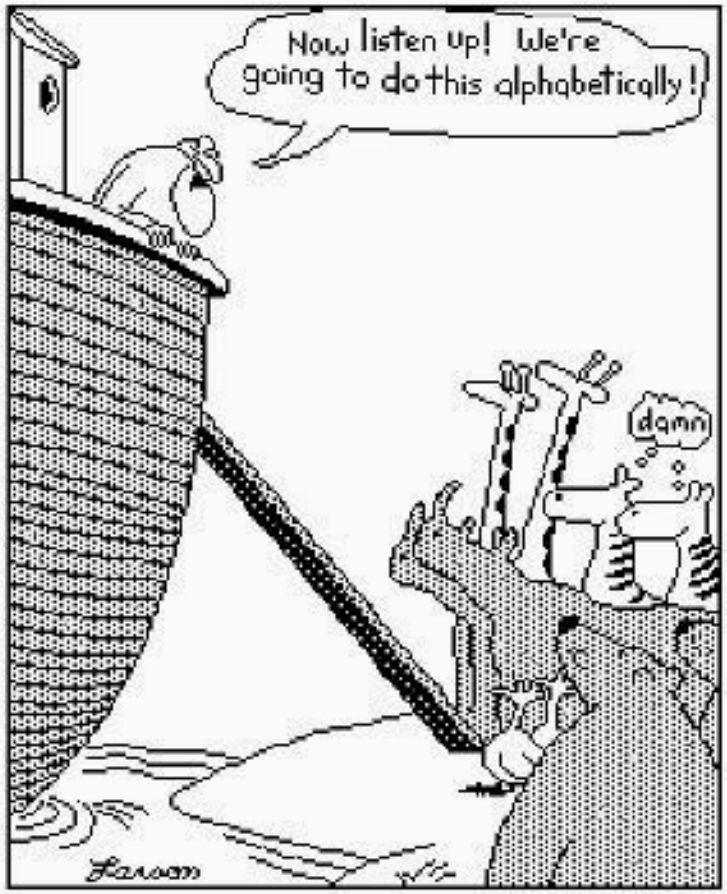
Substantial Downside for Being Wrong

	9% Credits	4% Credits
Eligible Basis	$21,000,000	$21,000,000
Basis Boost	130%	130%
Qualified Basis	$27,300,000	$27,300,000
Credit Rate	9%	3.29%
Annual Credits	$2,457.000	$898,170
Total Credits	$24,570,000	$8,981,700
Credit Price	$0.95	$0.95
Total Equity	$23,341,500	$8,532,615
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.

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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:

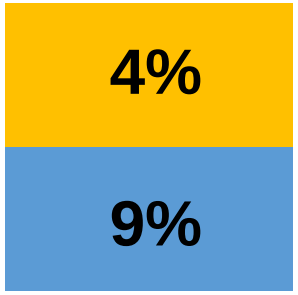
- Fremont
  - Across street from Warm Springs BART
- Inclusionary
  - Part of 1,001-unit, 35 acre Warm Springs Station Master Plan with housing, retail, & recreation amenities

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

➔ **Constructs entire building with 1 building permit & 1 construction contract**

(closed June 2017)

4%: Mission Court Four LP

- Floors 3-4: 44 units
- $17M TDC, $5.5M Soft Loan

➔ **Purchases 4% portion prior to placing in service**

(closed Oct. 2018)

MISSION COURT: 4% PURCHASE

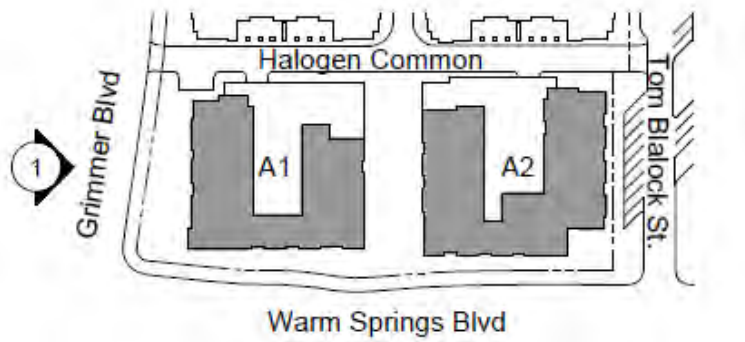
- Set up mechanics and most documents for 4% purchase during construction closing
- 4% LP purchased 4% project from 9% LP prior to placing in service (Temporary Certificate of Occupancy), prior to completing “mandatory post-closing work”
- Did mini cost certification to confirm that we satisfied 50% test prior to purchase
- Closing Process:
  - Day 1: Bond Draw Down
  - Day 2: Purchase: money transferred from 9% to 4% LP

PAULINE WEAVER
SENIOR APARTMENTS
47003
EDEN
HOUSING
47003

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

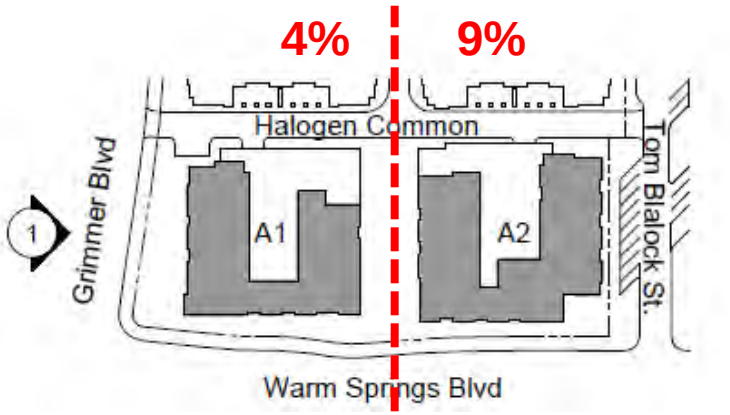
STANDALONE 9% DEALS	Tiebreaker	Gap Financing	Credit Ask
71-unit deal	55%	$10 Million	$2,147,963
61-unit deal	55%	$11.8 Million	$2,023,251
Total		**$21.8 Million**	**$4,171,214**

HYBRID DEAL	Tiebreaker	Gap Financing	Credit Ask
132-unit hybrid	**77%**	**$21.8 Million**	**$2,500,000**

WARM SPRINGS: HYBRID APPROACH

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

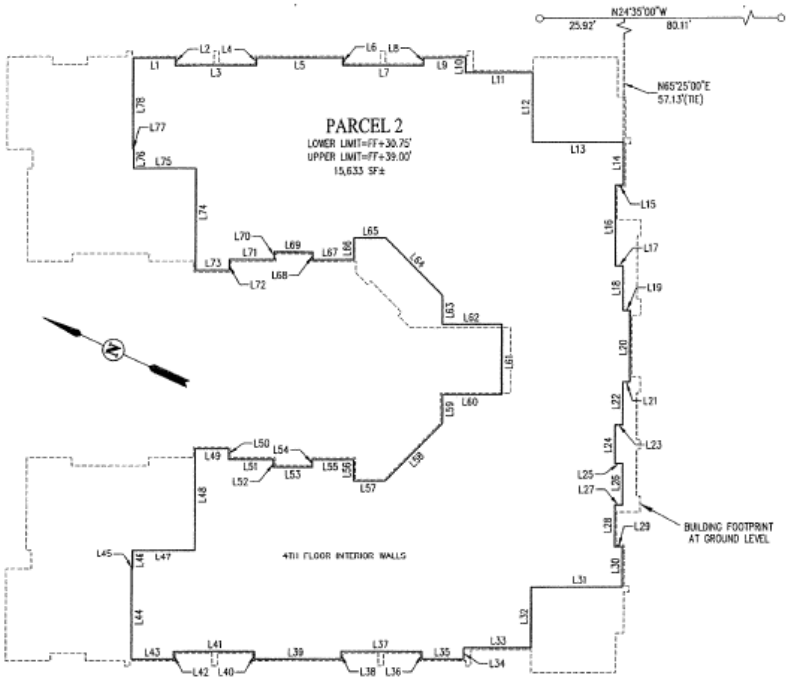
1. Make sure your soft lender(s) is comfortable with the hybrid structure.

- 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

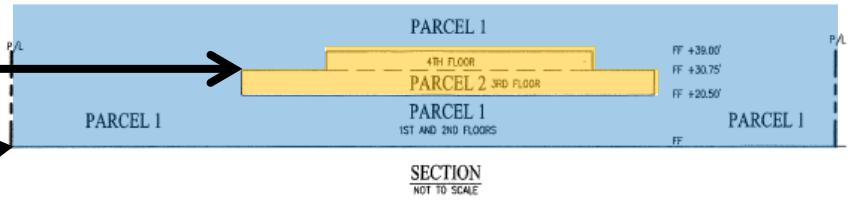
2. Work through the parcel subdivision carefully.

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



Parcel 2 (4%)

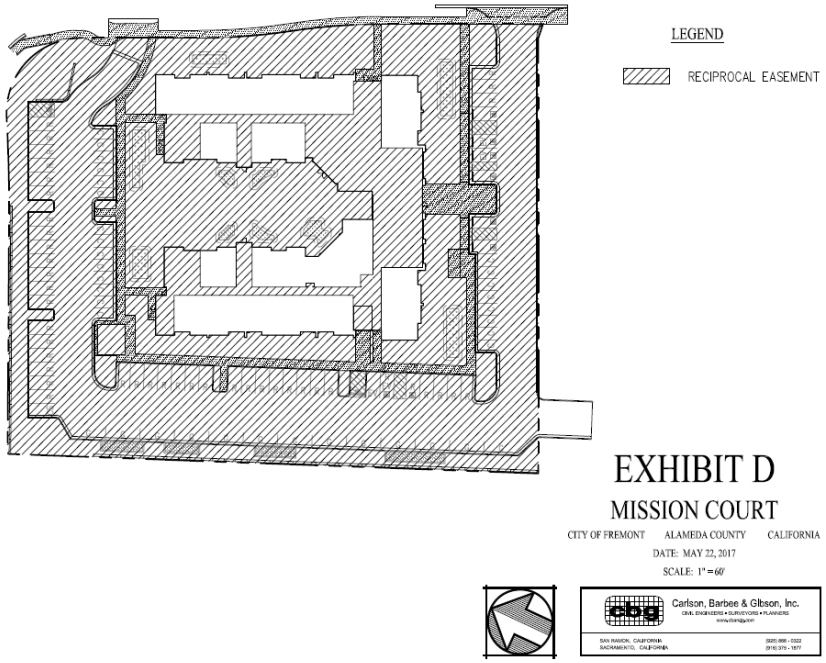
Parcel 1 (9%)



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

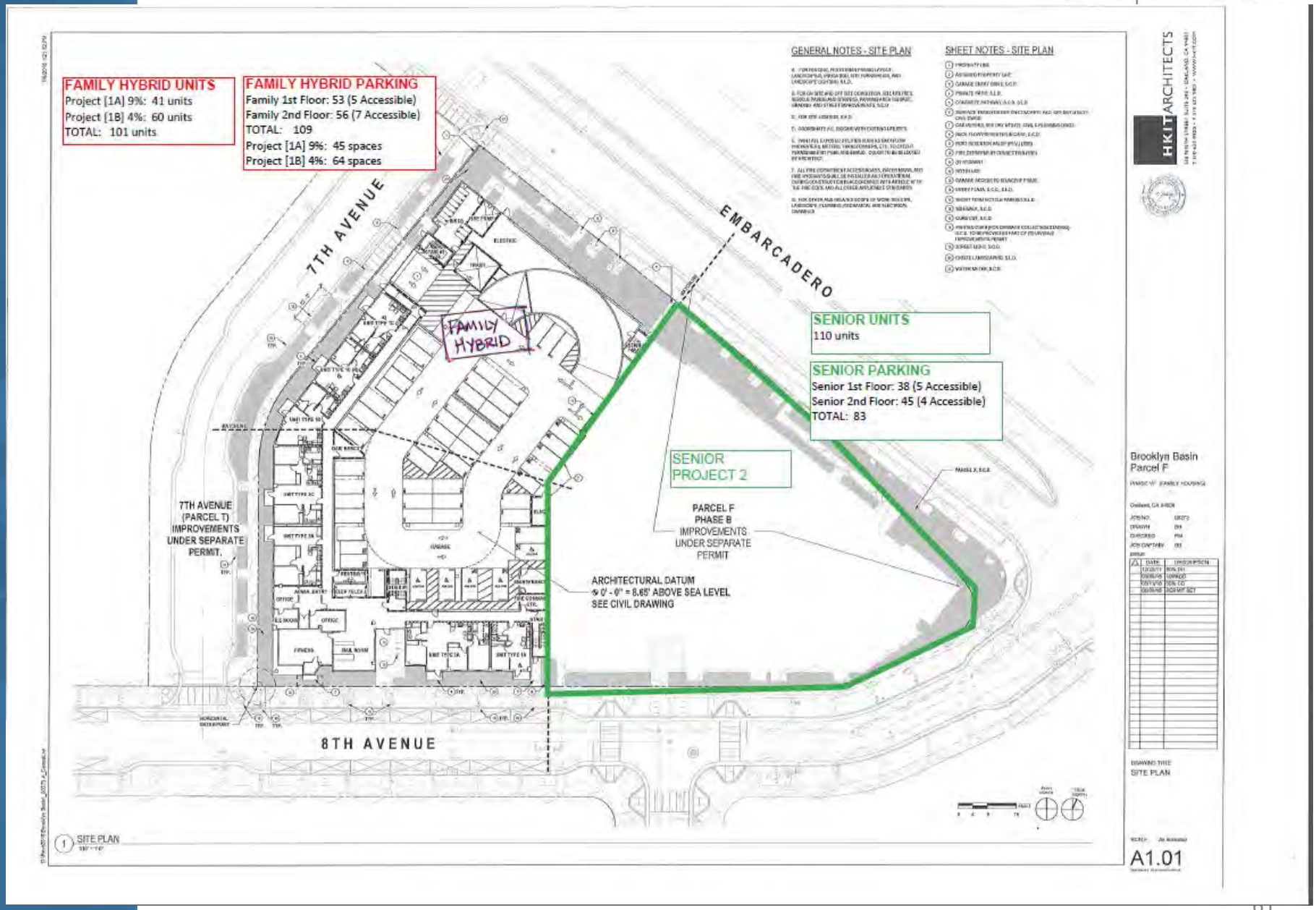
- In order to maximize total credit to the combined project, the 9% component was sized to maximize credit, resulting in equity contributing 80% of the total project financing, very little public subsidy.
- Public subsidy is loaded onto the 4% project.
- Tiebreaker calculated based on combined public 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

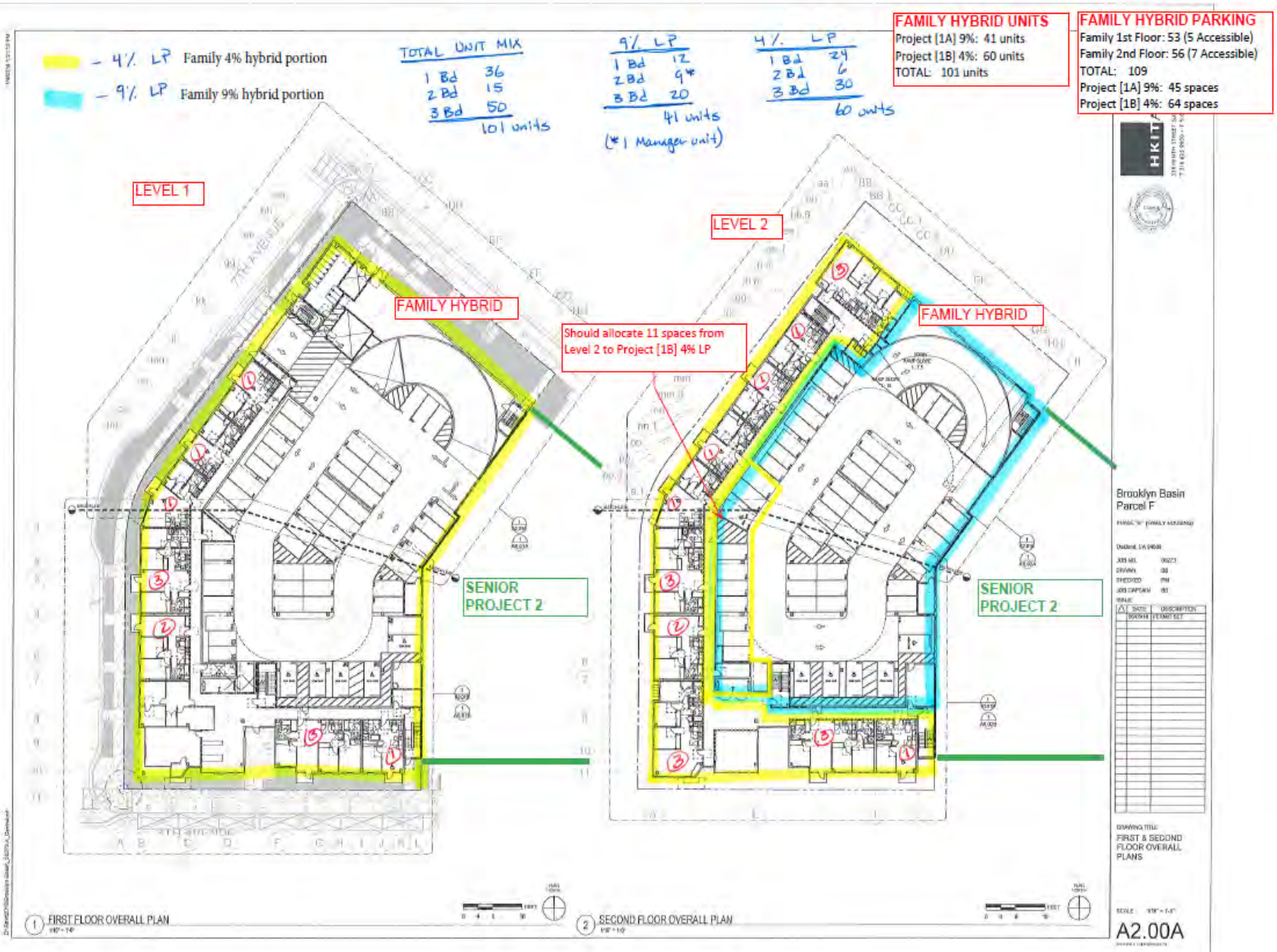
- To be eligible for 4% credits, project must be financed with tax exempt bonds
- To be eligible for 9% credits, project CANNOT be financed with tax exempt bonds
- In order to achieve this, the two projects must be owned by separate partnerships with separate financing.
- Need to create separate legal 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] 9%: 41 units
Project [1B] 4%: 60 units
TOTAL: 101 units
FAMILY HYBRID PARKING
Family 1st Floor: 53 (5 Accessible)
Family 2nd Floor: 56 (7 Accessible)
TOTAL: 109
Project [1A] 9%: 45 spaces
Project [1B] 4%: 64 spaces
GENERAL NOTES - SITE PLAN
SHEET NOTES - SITE PLAN
7TH AVENUE
EMBARCADERO
FAMILY HYBRID
SENIOR UNITS
110 units
SENIOR PARKING
Senior 1st Floor: 38 (5 Accessible)
Senior 2nd Floor: 45 (4 Accessible)
TOTAL: 83
SENIOR PROJECT 2
7TH AVENUE (PARCEL T) IMPROVEMENTS UNDER SEPARATE PERMIT.
PARCEL F PHASE B IMPROVEMENTS UNDER SEPARATE PERMIT
ARCHITECTURAL DATUM
0' - 0" = 8.65' ABOVE SEA LEVEL
SEE CIVIL DRAWING
8TH AVENUE
1 SITE PLAN
HKIT ARCHITECTS
Brooklyn Basin
Parcel F
DRAWING TITLE
SITE PLAN
A1.01

MidPen HOUSING



- 4% LP
- 9% LP
LEVEL 3
FAMILY HYBRID
SENIOR PROJECT 2
LEVEL 4
FAMILY HYBRID
OPEN TO TERRACE BELOW
SENIOR PROJECT 2
HKIT ARCHITECTS
Brooklyn Basin Parcel F
THIRD & FOURTH FLOOR OVERALL PLANS
A2.00B
1 THIRD FLOOR OVERALL PLAN
2 FOURTH FLOOR OVERALL PLAN

~4% LP
~9% LP
LEVEL 5
FAMILY HYBRID
OPEN TO TERRACE BELOW
SENIOR PROJECT 2
LEVEL 6
FAMILY HYBRID
OPEN TO TERRACE BELOW
SENIOR PROJECT 2
1 FIFTH FLOOR OVERALL PLAN
2 SIXTH FLOOR OVERALL PLAN
HKIT ARCHITECTS
Brooklyn Basin
Parcel F
FIFTH & SIXTH FLOOR OVERALL PLANS
A2.00C

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