[LIHTC Decoded: The Investor Lens Series]

Differences in Underwriting Tax Credit and Market Rate Properties

The Low-Income Housing Tax Credit (LIHTC) and market-rate apartments share fundamental construction and operational elements, but the LIHTC program introduces unique complexities that can challenge even seasoned commercial real estate professionals. **This Explainer identifies key differences between LIHTC and traditional market rate development.**

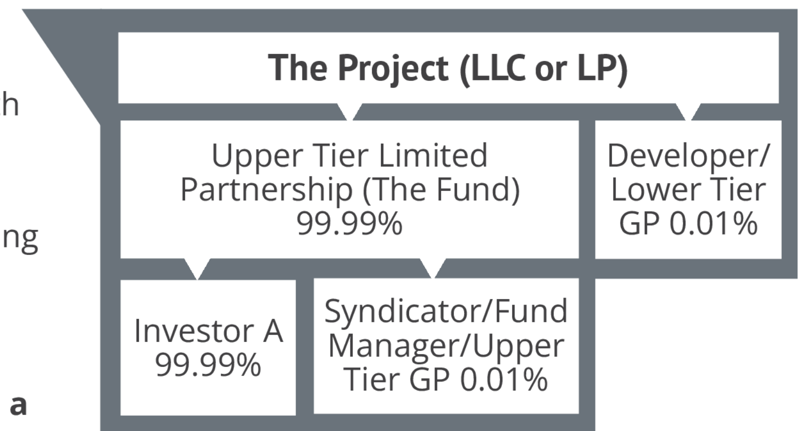
EQUITY STRUCTURE

In LIHTC deals, the sponsor typically does not contribute equity - at least not directly. This can be a difficult shift for professionals coming from the market rate side, where sponsors often "fill the gap" by bringing more capital to closing.

Instead, equity in a LIHTC transaction comes from a third-party investor, whose return is primarily driven by the value of the tax credits and any usable losses and depreciation. Because most LIHTC properties are structured to operate near breakeven after debt service, the potential for upside from operations is limited. While exit proceeds can contribute meaningfully to overall return, they're difficult to underwrite at closing due to the long hold period (typically 15+ years).

The standard deal structure involves a limited partnership (LP) or limited liability company (LLC), with the sponsor serving as general partner (GP), typically holding a 0.01% interest, and the investor—either directly or through a syndicator—holding the remaining 99.99% as the limited partner (LP).

It is important to note that while sponsors have limited ownership in the properties, they do have a meaningful financial stake via deferred developer fees.



Indicative Org Chart for Proprietary Fund
(Note: Direct investment structure or a multi-investor fund structure may also be utilized)

EQUITY INVESTORS

Regulated banks with Community Reinvestment Act (CRA) obligations account for **over 80%** of the LIHTC equity market. In recent years, Fannie Mae and Freddie Mac have also re-entered the market in a significant way. **Economic investors—such as insurance companies—participate when the risk-return profile compares favorably to other tax-advantaged opportunities.**

EQUITY: LOWER TIER VS UPPER TIER

In LIHTC transactions, investors often refer to lower-tier and upper-tier pricing and returns. The lower tier price per credit applies at the property level—it's the amount paid to the sponsor. This figure is often widely known, as it's visible to multiple deal participants and tends to circulate among sponsors in a local market.

The upper tier price per credit is what the investor ultimately pays. It's higher than the lower tier price, with the difference covering syndicator fees (if applicable), fund-level expenses, and upper tier reserves. The internal rate of return (IRR) an investor receives is based on this upper tier pricing and also reflects the value of tax losses, fund structure, and the projected exit—factors that are typically considered proprietary. Because of this, upper tier pricing, IRRs, and investor underwriting models are not shared with developers without explicit consent.

Syndicated Fund Uses	
Upper Tier Price/Credit	$0.97
Upper Tier Investment	$9,700,000
Syndication/Acquisition Fee (4%)	$388,000
Working Capital/Upper Tier Reserves (2%)	$194,000
Asset Management Reserve (1.25%)	$121,250
Amount to Lower Tier	$8,996,750
Lower Tier Price/Credit	$0.8997

CONSTRUCTION LOANS

LIHTC construction loans are almost always recourse to the borrower and include a guarantor. If the perm lender enters the deal during construction, it may not be possible for the bank loan to have a mortgage. While a lender may treat these loans like construction loans, its security is the future equity pay-ins or the receipt of governmental grant.

LIHTC Construction Loans	VS	Market Rate Developments
Recourse to the borrower; include a guarantor		Lower LTV can lead to partial or non-recourse loans

PERMANENT DEBT MARKET

The permanent debt structure is often more straightforward than in market rate deals. **All permanent loans in LIHTC transactions are forward committed and rate locked at closing, with maturities that match or exceed the 15-year compliance period.** This eliminates interest rate risk during construction and lease-up and refinance risk during the tax credit and recapture period.

Investors run Debt Service Coverage Ratio calculations on actual forward-locked rates and amortizations schedule, not indicative terms.

DSCR are generally lower than for market rate deals and investors require operating reserves at the lower tier. Perm loans do not have guarantors (except for bad act carveouts) and rarely have covenants.

DEVELOPER FEES

Developer fees in LIHTC projects are typically higher than those in market-rate developments. These fees are shaped by the requirements of the allocating agency and reflect the complexity of structuring LIHTC deals, which offer limited upside from residual cash flows, property sales, or refinancing. As a result, developers earn most of their profit during the construction phase.

Unlike market-rate deals, where developer fees are paid proportionally with each construction draw, LIHTC fees are disbursed in stages—commonly at closing, completion, stabilization, and upon receipt of IRS Form 8609. Developer fees payable at completion and stabilization are often viewed by investors as additional contingency, helping to absorb unexpected cost increases or adjust the size of the permanent loan if rents or operating costs deviate from expectations.

A portion of the LIHTC developer fee is frequently deferred and paid out over time from the property's cash flow. This structure helps align the interests of sponsors, investors, and permanent lenders, though there are limits on how much can be deferred.

> **Developer Fees payable at completion and stabilization serves as additional contingency.**

SPONSOR REVIEW

Sponsor quality reviews generally follow the same process as those for market rate developers. However, the Real Estate Owned (REO) and contingent liability schedules are not standardized across the industry and can vary materially from market rate schedules.

LTVs are not a good indicator of balance sheet quality as the metric is complicated by subordinate debt which may not be hard pay. General partners are not entitled to all the cash the property generates, but REO schedules frequently conflate property performance with cash to the sponsor. The schedule should also be viewed in the context of the remaining compliance period and available reserves.

Contingent liability schedules for LIHTC developers include not just construction completion/construction loan repayment guarantees, but also operating deficit and tax credit guarantees. Consequently, contingent liabilities may look exceptionally high to a market-rate credit officer when they are actually standard for an affordable housing sponsor. Given the long time that operating deficit and tax credit guarantees remain in place, some investors consider these as separate categories with different risk profiles than traditional construction guarantees. LIHTC guarantees may also be offset by specific property-level reserves.

> **Construction loan guarantees**
> **+ Operating deficit and tax credit guarantees**
> **Contingent Liability Schedules**

DEVELOPMENT TIMELINE

The development timeline for LIHTC projects is typically longer and more complex than for market-rate developments. This begins with the challenge of identifying sites that are both market-feasible and competitive enough to score well in the LIHTC award process. States frequently require multiple third-party reports prior as a part of the application adding time and expense. **A market-rate garden-style apartment might take 18-24 months from site control to construction loan closing, while a similar LIHTC development often take 30-36+ months given application cycles and layering of subordinate debt.**

Beyond the tax credit award itself, LIHTC projects require multiple layers of financing, including a permanent loan, one or more sources of gap financing, and a construction loan. Because sponsors cannot simply contribute additional equity if costs rise, any increase in construction expenses or interest rates can pause the project until new funding sources are secured.

Gap financing programs vary widely in structure and requirements. The majority of the gap fillers are structured as extremely low-interest rate debt (vs market rate mezz loans in the mid-teens), and some may be cash flow only, meaning the borrower is only obligated to pay if there is property level cash flow available.

Layers of Financing

- Permanent Loan
- Gap Financing
- Construction loan

Investors must understand how and when funds are committed, when they are disbursed at the property level, whether they need to be bridged during construction, and what conditions must be met for the funds to be available.

RENTAL ASSISTANCE

Rental assistance in LIHTC developments introduces a range of underwriting and operational complexities. When assistance is tied to individual tenants, it is typically excluded from underwriting considerations as the benefit will not remain with the unit if the tenant moves out.

In contrast, rental assistance tied directly to the unit is often factored into underwriting, though not always fully by investors. The terms of the rental assistance contract, including rental amount and duration, play a significant role in assessing long-term viability.

> **Rental Assistance tied to units is considered in underwriting. Rental Assistance to individuals is ignored.**

EXIT STRATEGIES

Near the end of the tax credit compliance period, investors look to exit the investment. **The process of the exit is spelled out in the Limited Partnership Agreement signed at closing.** The tax code drives a significant part of the unwind process. The extended use period (typically 15+ years) limits the ability to convert the tenant base to market rates and leads to a cap on the value of the property.

NEXT STEPS
Learn more about LIHTC program from the investor's perspective with AHIC's suite of underwriting and asset management best practices at bit.ly/LIHTCKnowledge.

About the Series: *AHIC's LIHTC Decoded series helps educate industry participants and stakeholders about the investor's perspective of this public-private partnership.*

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