

Maximizing Capitalized Interest Costs in Housing Credit Rehabilitation Projects: Effective Strategies for Developers

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Employing strategies to boost capitalized interest costs in a low-income housing tax credit project is a way to increase the amount of eligible basis. Doing so will increase the amount of housing tax credits generated that can be channeled to investors or used to pay for project costs, including the developer's fee.

These strategies, and the importance of maximizing capitalized interest costs, are often overlooked, however. This article will detail three strategies for maximizing capitalized interest costs, particularly in rehabilitation tax credit projects.

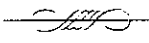
In general, interest payments on permanent mortgage debt used to finance a tax credit project are claimed as tax deductions by a taxpayer. Conversely, interest on debt related to the construction of a project generally is capitalized (rather than deducted) and added to the basis (cost) of the project.

The kinds of interest costs that can be capitalized are interest payments made on eligible debt (e.g., construction loan, other non-permanent mortgage debt) during the "production period" (construction period) of a project.

Naturally, there are trade-offs. Increasing the capitalized interest costs in a tax credit project will increase the amount of eligible basis and housing credits, but reduce the size of interest deductions and losses. Conversely, less capitalized interest will result in greater interest deductions and losses.

The "uniform capitalization rules" in the Internal Revenue Code and companion IRS regulations¹ specify the requirements

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INCREASING THE CAPITALIZED INTEREST COSTS IN A TAX CREDIT PROJECT WILL INCREASE THE AMOUNT OF ELIGIBLE BASIS AND HOUSING CREDITS, BUT REDUCE THE SIZE OF INTEREST DEDUCTIONS AND LOSSES.

Freddie Mac Invests in Initial Single-Investor Fund

Freddie Mac, the large national mortgage corporation, has invested in its first-ever single-investor low-income housing tax credit fund.

The \$50 million fund, Freddie Mac Equity Plus I - ESIC, L.P., was established and will be operated by the Enterprise Social Investment Corporation, an affiliate of The Enterprise Foundation (Columbia, MD). ESIC has organized numerous low-income housing tax credit funds over the years, aimed at raising equity for nonprofit sponsors, dating back to 1987.

Until now, McLean, VA-based Freddie Mac has invested in housing tax credits through multi-investor corporate tax credit funds.

In an interview with *The Tax Credit Advisor* on 11/30/01, Christine Hobbs, Director of Freddie Mac's Community Development and Investment Group, Multifamily Division, said the single-investor approach is just an additional avenue by which the company will be investing in housing credits.

"We do a lot of investing through multi-investor funds," she said. "But the size of some of the multi-investor funds and frequency has decreased as other investors have done single-investor funds. Doing a single-investor fund gives us another vehicle to use as we invest. But we will continue to do

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¹ Internal Revenue Code Section 263A(f), IRS Regs. 1.263A-8 through 1.263A-15. Also see Regs. 1.266-1.

and restrictions governing the capitalization of interest costs, including the definition of production period and other key terms. While the rules are fairly understandable, they weren't written specifically to address the rehabilitation of a multifamily housing project. So, in some instances, one must "fill in the gaps" to apply the tax rules to the rehabilitation arena.

The other inherent complication is that all rehabilitation projects are different, in regard to the specific physical changes, timetable for work, and resident issues. Some projects encompass the complete "gutting" of an existing structure that will have no tenants during rehabilitation period. Others involve more cosmetic updating of existing residential units where the residents will be only minimally disturbed.

Following are three strategies for maximizing the amount of capitalized interest in a housing credit project:

Expanding Your Construction Period

Expanding the construction period for a housing tax credit rehabilitation project can be accomplished by the proper scheduling of development activities.

The beginning of the construction period starts with the first physical alterations of the apartment units. One way to move up the start of the construction period for all of the apartment units is to start physical alteration of some "common area feature" of the property that benefits all of the units. Beginning the construction or rehabilitation of a common area feature, therefore, is a great tool to get your construction period for all units underway.

On the other end of the construction spectrum is the completion of construction. In this regard, the uniform capitalization rules are writ-

ten in such a way that we can't use common area features to our advantage. What we can do, however, is to delay one aspect of the construction – the installation of appliances, for example – until the very end of the rehabilitation process. Since appliances will be installed in all of the units in the project, this step will keep the construction period for all of the units "open" until very close to the completion of the entire rehabilitation process.

If, by the preceding tactics, we can increase the average construction period of each apartment unit by 50 percent, the result is that we can qualify 50 percent more interest carrying costs in eligible basis, generate more tax credits, and raise more equity from investors.

Expanding Your Production Expenditures

A huge way to expand your production expenditures (and therefore the factor on which interest carrying costs are computed for purposes of calculating the portion of interest carrying costs includible in the basis amount eligible for tax credits) is to take apartment units "out of service."

By removing units from service (i.e., relocating tenants temporarily while physical renovations are made), you make your acquisition basis (the cost of acquiring the "existing building") eligible as a production expenditure. The downside to this action is higher administrative costs.

Accordingly, this additional cost must be weighed against the additional tax credits that are produced. The upside, of course, is that all of the interest costs associated with "carrying" your existing building may now be included in eligible basis, generating additional credits, during the production period for your apartment units.

Expanding Your Interest Capitalization Period

The uniform capitalization rules are very generous regarding the determination of the length of

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the interest capitalization period. The rules allow you to capitalize interest (i.e., add interest to basis) through the end of the computation period in which your unit is "placed in service."

Because the rules allow you to use a quarterly computation period, in some cases you may be able to capitalize up to an additional three months' worth of interest carrying costs beyond the point when the units are placed in service, and thereby increase the amount of eligible basis and tax credits.

This may seem "too good to be true," as the adage goes. However, one should note that the uniform capitalization rules, as written by the IRS, were originally intended to minimize the amount of tax deductions by various types of taxpayers, including real estate developers. This bias, however, can benefit the tax credit developer through the production of additional tax credits.

Finally, it should also be noted that these same techniques can be used to maximize the basis amount eligible for the historic rehabilitation tax credit, and, to a selective degree, increase the amount of eligible basis in new construction housing tax credit projects.

For a further explanation of the uniform capitalization rules, readers should consult a tax advisor.

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Upcoming Events

*Meetings Sponsored by the
National Housing & Rehabilitation
Association and The Tax Credit Advisor*

NH&RA 2002 Annual Meeting

March 7-10, 2002

La Quinta Resort & Club

La Quinta, CA

OTHER 2002 CONFERENCES

January 14, Washington, DC

Inaugural Meeting

***National Council of Affordable Housing
Market Analysts***

January 15, Crystal City, VA

***Workshop by National Council of
Affordable Housing Market Analysts***

At NCSHA Winter Workshops

February 5, Los Angeles, CA

**NH&RA/NATIONAL TRUST FOR
HISTORIC PRESERVATION**

***Regional Meeting, Historic Preservation
Development Council***

March 18, Washington, DC

**NH&RA/NATIONAL TRUST FOR
HISTORIC PRESERVATION**

***Workshop, Historic Preservation
Development Council***

*At National Council of State Historic
Preservation Officers*

March 20, Boston, MA

**NH&RA/NATIONAL TRUST FOR
HISTORIC PRESERVATION**

Historic Preservation Development Council

Executive Seminar:

***Making Small to Mid-Sized Historic
Preservation Projects Profitable***

At Renovation & Restoration Conference

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