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A PRACTICAL LOOK AT DUE DILIGENCE

IPED
Housing Tax Credits "101"

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**PART I: OVERVIEW OF COMMON DUE DILIGENCE DOCUMENTATION
REVIEWED IN A TAX CREDIT TRANSACTION**

Partnership (Owner) Information

- **Initial Agreement Forming Partnership.**
- **Amendment to Partnership Agreement.**
- **Initially Filed Certificate.**
- **Amendment to Certificate.**
- **Evidence of Qualification in Foreign Jurisdiction.**
- **Certificate of Legal Existence/Good Standing.**
- **Partnership Financial Statements.**
- **Partnership Tax Returns.**

- **Employer Identification Number.**
- **UCC, Judgment, Bankruptcy and Lien Searches.**
- **HUD 2530 Certificate and Approval.**

Entity Formation Documents – Corporate General Partner/Developer/Guarantor

- **Articles of Incorporation/Certificate of Formation.**
- **Corporate By-laws/Operating Agreement/Partnership Agreement.**
- **Relevant Corporate Votes.**
- **Controlling Person Information.**
- **Nonprofit Determination Letter.**
- **Resume.**
- **Financial Statement.**
- **UCC, Judgment, Bankruptcy and Lien Searches.**
- **HUD 2530 Certificate and Approval.**
- **Certificate of Legal Existence/Good Standing.**

Property Acquisition/Real Estate Documents

- **Purchase and Sale Agreement.**
- **Deed (with evidence of recording).**
- **Ground Lease.**
- **Settlement Statement.**

Loan and Financing Documents

- **Application.**
- **Commitment Letter.**
- **Loan Documents.**
- **Intercreditor Agreement.**
- **Legal Opinion.**
- **Loan Disbursement Request.**
- **Miscellaneous Documents.**

Project Development/Construction Documents

- **Building Construction Plans.**
- **Building Construction Specifications.**
- **Soil Load Bearing Report, Other Engineering Studies.**
- **Engineer/Architect's Contract.**
- **Construction Contract.**
- **Payment Bond.**
- **Performance Bond.**
- **Development Services/Fee Agreement.**
- **Environmental Materials.**
- **Zoning and Utility Materials.**
- **Building Permits.**
- **Certificates of Completion/Occupancy.**

Project Operating Documents

- **Operating Subsidy, Section 8 Agreements.**
- **Real Estate Tax Deferral/Abatement Agreement.**
- **Property Management Agreement.**
- **Property Management Plan.**
- **Apartment Leasing Agreement.**
- **Master Lease/Operating Deficit Support Agreement.**
- **Common Facilities Joint Use/Access Services Information.**
- **Leases for Commercial Space.**
- **Supportive Services Agreement.**

Title Information

- **Title Policy Commitment.**
- **Title Policy.**

- **Documents Evidencing Title Exceptions.**
- **Property Survey with Flood Plain Certification.**

Low-Income Tax Credit Material

- **Credit Reservation Application.**
- **Credit Reservation.**
- **Carryover Application.**
- **Carryover Allocation.**
- **Evidence of 10% Costs Incurred (e.g., accountant's certification, invoices, checks, etc.).**
- **For Bond Deals - Application to Bond Issuer/Credit Agency for Section 42(m)(2)(D) Determinations Under Qualified Allocation Plan and as to Financial Feasibility.**
- **For Bond Deals - Issuer/Credit Agency Section 42(m)(2)(D) Determinations.**
- **For Bond Deals - Evidence of Compliance with 50% Test.**
- **For Bond Deals – Tax Regulatory Agreement.**
- **For Bond Deals – IRS Form 8038; Bond Legal Opinion.**
- **Local Housing Authority/Public Utility Determination of Utility Allowances.**
- **Credit Allocation/Form 8609.**
- **Evidence of Eligibility for 130% Increase in Credit Amount.**
- **Election to Fix Credit Percentage.**
- **Extended Use Agreement/Restrictive Covenants.**
- **For Acquisition Credit Deals - Evidence of Ten Year Holding Period; Waiver of Holding Period.**
- **Evidence of Participation by Nonprofit Sponsor.**
- **State Tax Credit Documents.**
- **Right of First Refusal Agreement.**

Property Insurance

- **Builder's Risk Insurance.**
- **Casualty Insurance.**
- **Liability Insurance.**
- **Contractor General Liability Insurance (worker's compensation and automobile coverage; proof of payment).**
- **Architect Errors and Omissions Policy.**
- **Miscellaneous.**

Property Financial Information/Third Party Reports

- **Property Appraisal.**
- **Property Market Study.**
- **Physical Needs Assessment.**
- **Phase I Environmental Site Assessment.**
- **Property Development Budget.**
- **Property Operating Budget.**

Contractor/Architect/Property Management Agent Information

- **Resume.**
- **Financial Statement.**
- **Licenses.**

Historic Tax Credit Information

- **U.S. Department of Interior Part 1 Application/Approval.**
- **U.S. Department of Interior Part 2 Application/Approval.**
- **U.S. Department of Interior Part 3 Application/Approval.**
- **State Historic Approvals.**

Legal Opinions

- **State Law Legal Opinion.**
- **Zoning Opinion.**
- **Tax Opinion.**

**PART II: INVESTOR HOT BUTTON ISSUES – MANAGING THE DUE DILIGENCE
PROCESS TO IDENTIFY AND MITIGATE INVESTOR CONCERNS**

QUESTION 1: DOES THE PROJECT HAVE A LONG TERM MARKET ADVANTAGE (IS THERE ENOUGH DEMAND FOR THE PROPOSED PROJECT)?

QUESTION 2: IS THE PROJECT FREE OF ENVIRONMENTAL RISK?

QUESTION 3: ARE THE OPERATING EXPENSES REALISTIC?

QUESTION 4: DOES THE MANAGEMENT TEAM HAVE THE CAPACITY TO DEVELOP, OWN AND OPERATE THE PROJECT DURING THE ENTIRE 15-YEAR COMPLIANCE PERIOD?

DUE DILIGENCE LIST

ITEM	DOCUMENT	STATUS	COMMENTS
I. UNDERWRITING DOCUMENTS			
a.	Correspondence		
b.	Closing Checklist		
c.	Letter of Intent/Proposal		
d.	Internal Approval Memorandum		
OPERATING ENTITY DOCUMENTS/ PARTNERSHIP OR LLC			
1.	Copy of certificate of limited partnership or articles of organization (LLC) and all amendments (with evidence of recording).		
2.	Appointment of registered agent and designation of registered office (if not shown on formation certificate).		
3.	Copy of all prior partnership/operating agreements and all amendments (with evidence of recording, if applicable).		
4.	Evidence of qualification of the partnership/company to do business in a state other than that in which the partnership/LLC was formed (if applicable).		
5.	Within 30 days prior to execution of partnership/operating agreement, certificate of existence or good standing from the secretary of state from the state of organization of the partnership/LLC.		
6.	Employer identification number (IRS EIN) for the partnership/LLC.		

ITEM	DOCUMENT	STATUS	COMMENTS
7.	Partnership tax returns for any year in which: a. Project was under construction; b. Project was in operation; or c. A carryover allocation was received; and d. Initial tax return for partnership.		
8.	UCC and Judgment Lien Search of Partnership/LLC		
9.	Preliminary Project Financial Projections		
GENERAL PARTNER(S) OF THE OPERATING ENTITY			
10.	Resume (including a list of multifamily projects developed, location, number of units in each, and whether the project is low-income (HUD, FmHA, state, tax credit assisted or financed, etc.).		
11.	General partner(s) questionnaire completed by each general partner or officer of each corporate general partner		
12.	Financial statements (including balance sheet and income statement of each general partner prepared within the past 90 days and signed).		
13.	Personal guarantor's (if different from the general partner's) financial statement(s) prepared within the past 90 days (signed).		
14.	Employer identification number (IRS EIN) for each corporate general partner.		
15.	Copy of IRS tax exemption in the case of any nonprofit corporation.		
16.	Formation documents: Articles of Incorporation and bylaws if a corporation Articles of Organization and Operating Agreement if an LLC		
17.	Evidence of qualification of the general partner to do business in a state other than that in which it was formed (if applicable).		
18.	UCC and Judgment Lien Search of each General Partner		

ITEM	DOCUMENT	STATUS	COMMENTS
19.	Within 30 days prior to execution by Investor of the partnership/LLC agreement, a certificate of existence or good standing from the secretary of state from the state of organization of each corporate general partner.		
20.	Within 30 days of execution by Investor of the partnership/LLC agreement, an incumbency certificate and evidence of authority to enter into the transaction from the corporation's secretary.		
21.	Resume and completed questionnaire for Developer, if a different entity (recommended)		
22.	Current financial statement for Developer		
23.	UCC and Judgment Lien Search of Developer		
II. DUE DILIGENCE DOCUMENTS			
REAL ESTATE			
24.	Copy of Owner's ALTA extended title insurance policy and all subsequent updates and endorsements and copy of each document evidencing an exception to title. If policies are not yet available, send commitments, copies of exception documents and indicate when policies will be available.		
25.	ALTA real estate survey with easements plotted. (Must be certified by State where project is located)		
26.	Flood-zone certification (May be included on survey)		
27.	If in an Earthquake prone area, letter from engineer re design requirements		
28.	Evidence that the property does not contain "wetlands" or compliance with state and federal regulations regarding wetlands		
29.	Conceptual Site Plan showing location of each building		
30.	If the project will be exempt from real property taxes, copies of state law, local ordinances, and any correspondence supporting exemption or tax abatement.		
31.	PILOT Agreement		

ITEM	DOCUMENT	STATUS	COMMENTS
32.	Zoning documentation, use permit approvals (if applicable), and building permit and/or letter from building department advising of status.		
33.	Geotechnical/Soils Report.		
34.	Utility Availability Letters (Water, Sewer, Gas, Electric, Telephone, Cable TV)		
35.	Relocation Agreement and budget (if applicable)		
	INSURANCE		On all insurance policies, Investor must be named as additional insured and certificate holder with no less than 30 days notice of cancellation.
36.	Owner's Commercial General Liability \$6MM combined single limits (per occurrence per location in the aggregate) of which up to \$5MM may be provided under an umbrella policy		
37.	Owner's Special Form (All-Risk) Property Insurance in an amount not less than full replacement value of the buildings and personal property, but in no event less than the amount of all outstanding debt; coverage shall include special hazard coverage and 6 mos. rental interruption coverage		
38.	Builder's Risk (Special form) providing replacement cost coverage in an amount equal to completed construction value, including soft cost coverage		
	LAND ACQUISITION DOCUMENTS		
39.	Purchase agreement or option agreement for site acquisition.* (Must be in the name of the Operating Entity)		
40.	Closing or settlement statement.*		
41.	Partnership/LLC deed to land and improvements.*		
42.	If acquisition was financed, copies of financing documents		
43.	Ten-year chain of title (for acquisition/rehabilitation projects).		
	If the partnership acquired the land from an affiliate, also include the same documents with respect to the affiliate's acquisition of the land from a third party.		

ITEM	DOCUMENT	STATUS	COMMENTS
	ENVIRONMENTAL		
44.	Copy of Level I environmental report.		
45.	Copy of Level II environmental report		
46.	Copy of UST decommissioning report		
47.	Asbestos certification		
48.	Reliance Letter from environmental consultant to Investor		
49.	Closure from Investor's Consultant		
	LOW-INCOME HOUSING TAX CREDIT ALLOCATION		
50.	Copy of application to state credit allocation entity, including operating pro forma, all amendments, attachments, and exhibits.		
51.	Evidence of DDA or QCT (eligibility for 130% basis)		
52.	Copy of any reservation agreement, including all amendments, attachments, and exhibits.		
53.	Copy of any allocation agreement, including all amendments, attachments, and exhibits.		
54.	Election of applicable percentage.		
55.	Copies of every bill, invoice, or agreement relating to meeting the 10 percent requirement f/Carryover allocation, including any assumption or reimbursement agreement		
56.	Copy of the executed Development Services Agreement between the Operating Entity and the Developer		
57.	Accountant's letter or Legal opinion(s) provided to state credit agency in connection with carryover allocation		
58.	Copy of state calculation of maximum rents.		
59.	Utility cost calculations and/or housing authority or FmHA required utility cost allowances.		
60.	If Bond Financed Project: evidence of compliance with Qualified Allocation Plan (42(m) letter)		
61.	If Bond Financed Project: Copy of Inducement Resolution		
62.	CPA final cost certification of eligible basis (if available).		

ITEM	DOCUMENT	STATUS	COMMENTS
63.	Owner's sworn statement provided to state credit allocating entity application for 8609 (if available).		
64.	IRS Form 8609 with respect to each building in the project (if available).		
65.	Copy of proposed or (if available) recorded extended use agreement and all attachments and amendments.		
HISTORIC REHABILITATION TAX CREDIT			
66.	Letter listing property on National Register.		
67.	Letter listing property in Registered Historic District		
68.	Historic Preservation Certification Application & Approval-- Part 1 (Department of Interior form) and backup		
69.	Historic Preservation Certification Application & Approval-- Part 2 (Department of Interior form) and backup		
70.	Historic Preservation Certification Application & Approval-- Part 3 (Department of Interior form).		
71.	State Historic Credit Application (if applicable)		
72.	State Historic Credit Approvals		
CONSTRUCTION LOAN			
73.	Copy of loan commitment agreement (signed).		
74.	Copy of loan agreement.		
75.	Copy of any final or draft promissory note.		
76.	Copy of any final or draft trust deed. Note: Investor limited partner requires that it be provided with notice of default in the trust deed.		
77.	Copy of borrowing resolutions.		
78.	Copy of any assignment of leases and rents.		
79.	Copy of any financing statement.		
80.	Copy of any guaranties (if applicable).		
81.	Copy of any other loan documents, including closing statement		

ITEM	DOCUMENT	STATUS	COMMENTS
82.	Copies of all draw requests on construction loan and supporting documentation, including architectural reports.		
BRIDGE LOAN			
83.	Copy of loan commitment agreement (signed).		
84.	Copy of loan agreement.		
85.	Copy of any final or draft promissory note.		
86.	Copy of any final or draft trust deed. Note: Investor limited partner requires that it be provided with notice of default in the trust deed.		
87.	Copy of any assignment of leases and rents.		
88.	Copy of borrowing resolutions.		
89.	Copy of any financing statement.		
90.	Copy of any guaranties (if applicable).		
91.	Copy of any other loan documents, including closing statement.		
PERMANENT LOAN (FOR ALL LAYERS OF FINANCING)			
92.	Copy of loan commitment agreement (signed).		
93.	Copy of loan agreement.		
94.	Copy of any final or draft promissory note (this note should be without recourse).		
95.	Copy of any final or draft trust deed. Note: Investor limited partner requires that it be provided with notice of default in the trust deed.		
96.	Copy of any assignment of leases and rents.		
97.	Copy of any financing statement.		
98.	Copy of borrowing resolutions		
99.	Copy of any guaranties (if applicable).		
100.	Copy of any other loan documents, including closing statement.		

ITEM	DOCUMENT	STATUS	COMMENTS
SOFT FINANCING AND GRANTS			
101.	Copy of application, all attachments, and amendments for each grant or soft financing request.		
102.	Grant/loan commitment (signed).		
103.	Copy of any proposed (or, if available, recorded) regulatory agreement(s).		
104.	All closing documents (see Permanent Loan above).		
105.	No Federal Funds Letter (if applicable)		
106.	For housing assistance (Section 8 or other assistance): a. fair market rents and number of outstanding vouchers in market area; and b. agreement to enter into Housing Assistance Payments Contract (Section 8) or other rental assistance agreements (if applicable).		
APPRAISALS/MARKET STUDIES			
107.	Current market feasibility study using appropriate income and rent limits. May be in appraisal. Update if over one-year old.		
108.	Appraisal (as built) meeting FIRREA standards. Please provide reliance letter to Investor		
109.	Project description and location.		
110.	Sponsor prospectus, if any.		
ARCHITECTURE AND ENGINEERING			
111.	Resume and Questionnaire for architect.		
112.	Resume for civil engineer (if applicable).		
113.	Architect's contract.		
114.	Civil engineer's contract (if applicable).		
115.	Site improvement plans and specifications.		
116.	Building improvement plans and specifications (detailed drawings). Exterior elevation and floor plans of units and auxiliary buildings.		

ITEM	DOCUMENT	STATUS	COMMENTS
117.	Copy of Architect Errors and Omissions, Liability Insurance in amount equal to total project costs		
118.	Architect's certification regarding zoning, land use and utilities.		
GENERAL CONTRACTOR INFORMATION			
119.	Resume and Questionnaire		
120.	Financial statements prepared within the past 90 days (signed).		
121.	Copy of construction contract (AIA form) and all amendments and all attachments and exhibits.		
122.	Copy of form of draw requests.		
123.	Copy of payment and performance bond with Investor named as additional co-obligee / insured (if applicable).		
124.	Copy of Contractor's letter of credit and/or completion assurance agreement (if applicable)		
125.	Contractor's Cost Breakdown		
126.	Construction Schedule.		
PROPERTY MANAGEMENT			
127.	Resume and Questionnaire of property management agent.		
128.	Copy of management contract if already executed. Note: Final form of this agreement may be provided by Investor limited partner.		
129.	Copy of management plan.		
130.	Copy of any referral and marketing agreements.		
131.	Copy of proposed lease to be entered into between partnership and each tenant. Note: Investor requires use of its form addendum (Rider) to the lease.		
132.	Copy of tenant certification forms.		
LICENSES AND PERMITS			
133.	Certificate of Occupancy (if any).		
134.	Business licenses.(If there is a commercial component)		

ITEM	DOCUMENT	STATUS	COMMENTS
DEVELOPMENT AND OPERATING COST PRO FORMAS			
135.	Sources and uses of funds breakdown.		
136.	Total development cost breakdown (hard and soft costs).		
137.	Income and Expense Statement including vacancy and inflation assumptions (15 years).		
138.	Operating Expense Budget.		
139.	Projections including cash flow and tax benefit analysis and IRR computation. (Investor to prepare)		
140.	Interest rate of return over 15 years with and without cash flow. Note: Projections must include the following: a. Limited partner capital account for all 15 years. b. Detailed calculation of first-year credit, including analysis of number of units expected to be rented during each month during the lease-up period. c. Sources and uses of funds listing the construction loan. d. Sources and uses of funds showing each capital contribution to be made by the limited partner separately. e. Sources and uses of funds showing operating income and expenses during the lease-up period for each month. f. Debt-coverage ratio at the end of each year of the project. g. Deposit and reserve balances for each year. h. Calculation of gain or loss on sale of project for outstanding debt after the end of compliance period. Do not include the result in the projected internal rate of return.		
141.	Legal opinion regarding partnership organization and enforceability of partnership documents.		
ADDITIONAL DOCUMENTS			



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CHECKLIST FOR MEETING 10% CARRYOVER ALLOCATION TEST

As you are probably aware, corporate investors in all low-income housing tax credit programs have been increasing their due diligence to verify that each of the operating partnerships in which they invest both has a valid tax credit carryover allocation and has properly and timely incurred at least 10% of the applicable project's reasonably anticipated basis. These investor requirements have been prompted in part by an increasing number of audits of low-income housing tax credit projects by the Internal Revenue Service. To assist you in building the best possible administrative file, and to assist in providing investors with timely verification of satisfying the 10% test, we have developed the following checklist of documents that should be obtained, and reviewed by counsel to the investor (as well as by your accountants and counsel), to ascertain compliance with the requirement of a carryover allocation that at least 10% of a project's reasonably anticipated basis be incurred by year end. Please note that review of these documents by the investor and its counsel does not relieve the developer of responsibility for compliance.

The checklist is broken down into categories reflecting how the 10% is being met, e.g. acquisition of land/building, incurrence of construction costs, payment of fees, etc. The 10% test can be met in a variety of ways, some of which may involve a combination of factors, e.g. acquisition of land plus incurrence of construction costs. Please review each category. Each category contains a list of documents that will evidence incurrence of costs. In each relevant category, please check those documents that apply to substantiate the costs. These documents are the documents that must be submitted to the investor.

IN ADDITION TO DOCUMENTS TO BE SUBMITTED CHOSEN FROM THE CHECKLIST, FOR EACH PROJECT AN ACCOUNTANT'S CERTIFICATION MUST ALSO BE SUBMITTED. PLEASE MAKE SURE THAT YOUR ACCOUNTANT HAS BEEN SUPPLIED WITH ALL NECESSARY DOCUMENTS TO COMPLETE THE CERTIFICATION.

Categories

1. Acquisition of a land/building

- Recorded deed to entity receiving carryover allocation
- Purchase Money Note/Mortgage
- Other financing documents including evidence of down payment
- Appraisal
- Title Insurance Policy
- Settlement Sheet

2. Construction Costs

- Invoices for all costs, payable by same entity receiving carryover allocation
- Lumber storage contracts, including evidence of insurance, down payment and promissory note for unpaid balance
- Construction contract

3. Developer Fees

- Development Agreement, including schedule of payments and amounts earned as of year end, description of services to be performed by year end, and affidavit of services received

4. Fees for Services

- Written agreements, such as architect and engineering contracts
- Invoices for services rendered
- Description of services rendered; i.e., if services are legal, services must be related to the actual acquisition, construction etc. of the project, and not for syndication, partnership formation or permanent loan.

5. Construction Financing Fees and Construction Period Interest

- Evidence of obligation to pay
- Evidence that construction has started

6. Who Has Incurred the Costs?

- Evidence that entity incurring costs has been formed, e.g. partnership formation documents.
- If entity incurring costs is not the Partnership/LLC which has received tax credit allocation, Reimbursement Agreement between Partnership/LLC and entity incurring costs (together with detailed schedule) obligating Partnership/LLC to reimburse such entity.

7. Other Documentation

- Any documents not listed above. Please describe below.



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ACCRUING COSTS TO MEET THE 10% TEST

The last quarter of the calendar year is frequently the time period when developers of property intended to be eligible for low-income housing tax credits receive carryover allocations from state housing agencies. A critical element of receiving a valid carryover allocation is properly incurring at least 10% of the costs anticipated to be part of the basis of the property when it is finished. The following guidelines for accrual of costs should be followed in order to provide assurance to developers and investors that they have satisfied the 10% test.

1. Land Acquisition. The costs of acquiring land are included in the 10% test. If the land is purchased using a purchase money note, the purchase price should be supported by an appraisal and a cash down payment of at least 10% should be made. The deed should be recorded and the settlement statement should show the cash down payment. Following these guidelines is especially important if the land is being acquired from a related party in order to show that the benefits and burdens of the property have transferred to the buyer. If the land is being contributed to the partnership, remember that only the contributing partner's own basis in the land is included in calculating the 10% test, not its fair market value. If the land being acquired is going to be used for more than one project, make sure that only the costs attributable to the land actually used for the project is included in basis

2. Developer Fees. To include a portion of the fee for developer services in the 10% test, the following criteria should be followed: (1) a written agreement between the partnership and the developer must be entered into by the end of the year in which the carryover allocation is issued, the agreement must set forth benchmarks for earning the fee and state which benchmarks were met by the end of the year, (2) the total amount of the fee must be reasonable (state agency guidelines should be consulted), (3) the amount of the fee treated as having been earned for the 10% test must be reasonable in light of how far along the development of the project is, and (4) the services must have actually been performed, and there should be an acknowledgment of the services rendered.

3. Construction Costs. Actual costs of construction are includable, and should be evidenced by a construction contract and invoices. In some cases, building materials may be purchased prior to use, for example if the control of the construction site is not yet complete. If so, these costs will be includable if the buyer has been invoiced for the costs, has paid at least 10% in cash, and has taken delivery either by having them delivered to the buyer or by having the seller store them separately for the buyer. In the latter instance, the buyer should enter into a storage agreement with the seller to segregate the materials and should purchase insurance in the event of loss or damage. This will help to establish that the buyer has the burden of ownership.

4. Fees for Services. Like the developer's fee, fees for services actually rendered can be included in basis provided that the fees are pursuant to a written agreement, have been properly invoiced, are reasonable in amount and are for the kinds of services directly related to the development of the property. Do not attempt to increase the 10% costs by prepaying fees for services, such as architects' fees and construction services advisory fees; these will not be includable in the 10% calculation. Fees, such as legal fees for syndication or partnership organization are not included in the 10% test.

5. Who Has Incurred the Costs? One of the most common mistakes made by developers is having the wrong entity incur the costs. The entity that is receiving the allocation must be the entity that has incurred the costs. This means, for example, that if the application for credits has been submitted in the name of a partnership, the partnership itself must be formed, the partners must be in existence and all of the invoices and contracts must be in the name of the partnership, not the general partner. Alternatively, the general partner can incur the costs if it is the entity receiving the allocation and it is named as owner on the carryover allocation.

6. Tax Returns. Make sure that the entity receiving the allocation and incurring the costs properly reflects them on the tax return for the year of allocation. For example, if land and materials are acquired, these should be included as assets on the return. Most importantly, if the entity is incurring expenses without actually paying cost, the entity must be an accrual basis taxpayer. The election to be on the accrual basis is made on the entity's first tax return.

7. Accountants' Certification. Not all state agencies require an accountant to certify that the 10% test is met. However, our tax attorneys and numerous of our investors' tax attorneys do require these. The accountants' cost certification should allow us to rely on this. In addition, they should be prepared to send the back-up documents to us. Your accountants preparing the cost certification should make sure they are familiar with the special rules applying to tax credit transactions.

Once you have completed your cost certification, it should be sent to the investor before being sent to the state agency. Once the investor has reviewed and approved of the certification, it can be submitted to the state agency. This will help identify any problem areas for the investor and its investors before the state reviews it. Also, once the carryover allocation has been received from the state agency, send a copy of it to the investor as soon as possible. This will ensure that our files are complete at such time as the interests in the project are syndicated.

Although a valid carryover allocation can be obtained by incurring only 10% of the reasonably anticipated basis of a project, we suggest that developers incur at least 12%. This will provide a small cushion to protect the allocation in the event that mistakes have been made or counsel for potential investors disagrees as to whether certain items can be properly accrued.

Lastly, please note that the foregoing is a general discussion of the 10% test and should not be interpreted as a comprehensive treatment of the law governing the items

discussed. Each developer should get advice from his or her tax attorney as the investor is not responsible for any actions taken by developers in meeting the 10% test.



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REVIEW OF TAX CREDIT APPLICATIONS

In reviewing the due diligence materials for partnership closings, we have noticed in some instances that the documents do not always track the information provided to the state housing agency in the initial tax credit application. In some cases, the discrepancy is not material, such as when the name of the permanent lender or the potential syndicator has changed. In other instances, it can make a very big difference. For example, if an application is made for credits from the nonprofit set-aside, it is important that the partnership agreement reflect the statutorily-required level of the nonprofit's participation. In addition, some applications have mistakes in them, such as eligibility for an acquisition credit when this is not the case.

A review of the tax credit application should become part of the standard procedures for completing a due diligence review in every project. Although each state housing agency's application differs in form, we have found that they all ask for the same types of information. While not exhaustive, the following is a list of sections in each application that should be reviewed to spot the most common problems:

1. Owner Information. Make sure that the name of the owner is correct. This means that the entity that is being treated as the owner of the real estate and recipient of the tax credit allocation is correct. Match this against deeds and carryover allocations.
2. Minimum Set-Aside. Confirm that the minimum set-aside that the applicant indicated would be selected is correct. The issue that can arise here is that the agency may have given extra points if the applicant said that the project would be under the 20-50 set-aside, and the applicant may have done its projections, and even signed an IRS Form 8609, using the 40-60 set aside.
3. Type of Credit. Verify that the correct type of credit has been selected, i.e. 4% versus 9%. This requires that the reviewer determine that the type of funding (federal vs. non-federal) is appropriate for the credit selected and whether or not the property is eligible for the acquisition credit.
4. Step Up in Basis. Applications request information on the step up in basis given to projects in hard to develop areas. If this appears in your application, make sure that the project does qualify.
5. Non-Profit Set-Aside. Determine if the credits were applied for out of the non-profit set-aside or whether the project was eligible for extra points, and whether a non-profit was designated as the general partner. This is one area where we have seen a lot of mistakes and confusion as to whether the project did in fact receive credits out of the set-aside. It is not enough just to note that the project did apply for credits under the set-aside. We also need to know if the housing agency actually awarded credits out of that set-aside. This is not, admittedly, always easy to find out since most agencies allocate many more credits to non-profit sponsors than the 10% minimum set-aside. In addition, if points were

awarded for nonprofit participation we need to know what level of participation the state requires to be met for the nonprofit.

6. Design and Building Configuration. Track the number of units and buildings indicated in the application with what appears on the reservation/carryover. If there is a discrepancy, find out why. Although most of the time it is because there has been a change in the configuration of the buildings due to architectural considerations, or available funding, sometimes it is because a mistake has been made by either the agency or the sponsor. If so, the carryover allocation may have to be corrected. In addition, certain states may give points for design characteristics. For example, Kansas gives points for energy efficiency items selected by the sponsor. If a sponsor gets these points, you will need to make sure during construction that the items are included.

7. Special Needs Housing. Check to see if the sponsor has indicated that the project will provide any special needs housing, e.g. disabled, elderly, transitional housing. Credit agencies usually give extra points for this, so make sure that this is reflected in the partnership documents.

8. Deeper Targeting. Check to see if the sponsor indicated that some units will be rented to lower income persons. If so, the projections for rents should reflect this.

9. Commercial Space. Check application to see if the project is supposed to have any commercial space and, if so, how much and whether it is meant to be dedicated to a particular purpose, e.g. community services.

10. Market Rate Units. If you understand that a project is to have market rate units, check to see if the sponsor has included this in the application. Never assume that a sponsor can add or delete market rate units from the level indicated in the application. Many state agencies have strict priorities as to whether or not (or to what degree) market rate units are acceptable.

11. Subsidies. Check to see if the sponsor has indicated whether the project will be receiving any subsidies. Certain federal subsidies such as Section 8 do not create any issues, but we periodically see applications indicating that HUD or some other federal agency is providing an operating subsidy. This creates big issues with respect to the amount of eligible basis.

12. Development Fee. Check if the amount of the development fee in the application is consistent with the development agreement. State agencies sometimes award extra points if the development fee is low. You want to check to see that it has not increased materially.

Allocations a. Special Allocations of any tax items b. General Partner Capital	<input type="checkbox"/> <input type="checkbox"/>	
Cash Flow/Residual Splits/Fees a. Greater than 80-20 b. Percentage of Cash Flow for Incentive Management Fee	<input type="checkbox"/> <input type="checkbox"/>	
Tax Credits³ a. 4% new construction b. 4% acquisition 1. 10 Year Rule Met 2. Related Party c. 9% rehabilitation d. 9% new construction e. historic 1. Part I 2. Part 2 f. State tax credits	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	
Tax Credit Allocation a. Carryover 1. 10% Checklist completed ⁴ b. Bonds ⁵ 1. Sec. 42(m) letter 2. Opinion on exempt interest 3. Volume Allocation 4. IRS Form 8038 5. 50% test met	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	
Project Information a. 100% low income ⁶ b. Market rate units c. Commercial space d. Multiple buildings – contiguous ⁷ e. Checked Application and any other governing docs, eg. HOME Agreement ⁸ f. Projections – do they match the deal?	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	

Tenant Information a. 40-60 b. 20-50 c. Elderly d. Public Housing e. Disabled f. Family	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	
Developer Fee a. Portion Deferred b. Interest Rate c. Note d. Priority of Repayment e. Guaranteed	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	

¹ See document #61617 regarding HOME Funds.

² Has impact on depreciation.

³ See document #40954 for general outline on tax credits.

⁴ See documents #19481 and 135355 for discussion of 10% issues.

⁵ See document #51170 for discussion of use of bonds in Section 42 deals.

⁶ If not, what is split?

⁷ If not contiguous, must be 100% low income.

⁸ See document #45093 for Tax Credit Points Checklist



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A PRACTICAL LOOK AT DUE DILIGENCE

IPED

Tax Credits "101"

Thomas A. Giblin
Nixon Peabody LLP

INVESTOR DUE DILIGENCE QUESTIONS – MANAGING THE DUE DILIGENCE PROCESS TO IDENTIFY AND MITIGATE INVESTOR CONCERNS

QUESTION 1: DOES THE PROJECT HAVE A LONG TERM MARKET ADVANTAGE?

- Evaluating Demand – Characteristics of a Good Market Study
 - A Good Market Study Identifies the Appropriate Market
 - A Good Market Study Addresses Targeted Tenants
 - A Good Market Study Provides a Detailed Analysis of the Competition
 - A Good Market Study Evaluates Local Demographic Trends
 - A Good Market Study is Prepared by an Experienced Independent Professional

- Underestimating Demand: Short and Long Term Consequences
 - Projected Cash Flow Fails To Materialize
 - High Vacancy Rates Can Delete Reserves
 - Weak Demand Can Delay/Prevent Permanent Loan Closing
 - Slow Lease-Up Can Adversely Impact First Year Tax Credit Delivery

QUESTION 2: IS THE PROJECT FREE OF ENVIRONMENTAL RISK?

- Identifying Environmental Issues - Phase I Environmental Site Assessments
 - A Good Phase I Report Adheres to the Scope and Limitations of ASTM Standards
 - A Good Phase I Report Covers All Parcels of Land Controlled by the Owner
 - A Good Phase I Report Investigates Surrounding Areas for Potentially Hazardous Materials
 - A Good Phase I Report is Recent or Updated (i.e., within 6 months of closing)
 - A Good Phase I Report Addresses Issues Such as Mold, Radon, Lead-Based Paint and Asbestos
- Phase II Environmental Reports
 - Status of Environmental Remediation/Closure Evidence
 - Estimating Remediation Costs
- Managing Environmental Risk
 - Understanding all Federal, State and Local Laws/Procedures/Requirements
 - Environmental Insurance
 - No Action Letters/Closure Letters
 - Asbestos/Lead Paint/Mold O&M Plans
 - Underwriting Cost of Proposed Remediation
 - Engaging Licensed Contractors/Environmental Professionals

QUESTION 3: IS THE PROJECT FINANCING STRUCTURED CORRECTLY?

- The Tax Perspective
 - Is There a True Debtor/Creditor Relationship?
 - Loan Terms/Security
 - Interest Rate
 - Unconditional Obligation to Repay (No Forgiveness Provisions)
 - Reasonable Likelihood of Repayment at Maturity
 - Is the Loan Federally Subsidized?
 - Is the Loan Nonrecourse?
 - Is There Related Party Financing?
- The Business Perspective
 - Transferability of Partnership Interests
 - Notice and Cure Periods for Default Events
 - Rebuilding Upon Casualty
 - Construction Delays

- Cross Default/Cross Collateralization Issues
- Transfer Fees/Prepayment Penalties
- Permanent Loan Commitments
- Interest Rate/Refinancing Risk (Fixed Rate vs. Variable Rate)
- Conditions for Conversion/Permanent Loan Closing
- Permanent Loan Re-Sizing Issues
- Limitation on Cash Flow Distributions

QUESTION 4: WILL THE PROJECT BE DEVELOPED AND OPERATED IN ACCORDANCE WITH THE TAX CREDIT AGENCY'S EXPECTATIONS?

- Reviewing the Tax Credit Application
 - Owner Information
 - Design and Building Configuration
 - Special Needs Housing
 - Deeper Income Targeting
 - Development Fee Limitations
 - Social Services
 - Low Income/Market Rate Units
 - Minimum Set-Aside
 - Type of Credit
 - Step-Up in Basis (QCT or DDA)
- Land Use Restriction Agreement
 - Understanding Section 42 Requirements
 - Reviewing Tax Credit Agency Requirements

QUESTION 5: WILL THE PROJECT BE BUILT ON TIME AND AT BUDGET?

- Key Construction Documents
 - Building Plans and Specifications
 - Construction Contract
 - Payment and Performance Bonds
 - Architect Contract
- Underwriting General Contractor Experience
- Role of Inspecting Architect/Draw Review Procedures