

A BRIEF DESCRIPTION OF LOW-INCOME HOUSING TAX CREDITS

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The Low-Income Housing Tax Credit is a federal income tax credit that is available each year for ten years and results in a dollar-for-dollar reduction of the taxpayer's regular tax liability. The credit is available to the owner of residential rental housing that meets the requirements of Section 42 of the Internal Revenue Code of 1986 (the "Code"). Unless, however, one purchases a building that already has an allocation of credit, the owner must obtain an allocation of credit for a proposed building before buying or constructing it. Thus, the credit is generally only available to those who know about it and plan to develop a building that qualifies for it. In Washington, developers must compete to win an allocation of credit.

The credit that a building generates is based upon the number of low-income units in the building and the development cost of the building. An owner is only entitled, however, to receive credits up to the amount allocated to the building by the state. Thus, a project can fail to generate its maximum potential credits if the owner is not familiar with the allocation plan of the state.

The amount of credit generated by a tax credit project and the general business credit rules of and passive activity loss limitations of the Code make it difficult for most developers to directly use the credits generated by a building. Most developers of low-income housing tax credit projects therefore sell the credits to a syndicator, who purchases a limited partner or investor member interest in the ownership entity. The low-income housing tax credit generated by a building may, however, be useful to a corporate developer with significant taxability who is willing to own a residential rental project in order to obtain tax credits.¹

I. LIHTC PROJECT ELIGIBILITY

A. MINIMUM SET-ASIDE REQUIREMENT

In order for a residential rental project to constitute a "qualified" low-income housing project, the Owner of the project must irrevocably elect to meet one of the following minimum set-aside requirements:

¹ Section 42 of the Code is 38 pages long (at least in my CCH version). The reader who is bookish enough to master Section 42 will realize that this article describes only the general requirements of Section 42 and ignores many exceptions, special rules and technical definitions. Hopefully, however, this article will help developer's counsel to learn enough about the LIHTC to know if it may be of interest to his or her clients.

- (1) at least 20% of the residential units must be made available to tenants with incomes at or below 50% of the area median income, *or*
- (2) at least 40% of the residential units must be made available to tenants with incomes at or below 60% of the area median income.²

The minimum set-aside requirement must be met within 12 months of the date the project is placed in service³ and must be complied with continuously for 15 years from the start of the first taxable year in which the credit is claimed.

B. EXTENDED USE REQUIREMENTS

A building⁴ must also be subject to a restrictive covenant (between the owner and the state allocating agency) that subjects the building to an additional 15-year period of continued low-income use commencing after the initial 15-year compliance period. In addition to the income and rent restrictions, the restrictive covenant must allow qualified tenants to enforce the covenant and must prohibit evictions or rent increases for three years after the end of the 30-year extended use period. The restrictive covenant must be binding on all subsequent transferees, except through foreclosures or transfers in lieu of foreclosure.⁵

The extended use period may terminate prior to the 30th year either upon foreclosure or if, during the 14th year of the initial compliance period, the owner asks the state housing credit agency to find a buyer for the project. If the agency finds a buyer, the price is established pursuant to the Code. If the agency cannot find a bona fide purchaser within a year, the extended use period terminates. The owner may not, however, evict low-income tenants or increase rents of the low-income units for three years.

C. QUALIFIED LOW-INCOME HOUSING UNITS

The credit is available only with respect to units that are “qualified low-income housing units.” A qualified low-income housing unit must be:

² 26 U.S.C. §42(g)(1). Due to the competition for an allocation of credits in Washington, an owner frequently commits to greater set-asides such as 100% of the units at 60% of area median income.

³ “Placed in Service” means placed in service by the owner claiming the credits. A new project is placed in service when it is first used. An existing project is placed in service when ownership interests change. As explained below, an existing project (an acquisition/rehab project) cannot qualify for credits if it has been placed in service within 10 years.

⁴ Except buildings receiving an allocation of credit before 1990.

⁵ The requirement that the covenant bind all successors in interest is understood by some attorneys for tax credit investors to require the covenant to be prior to all deeds of trust on the property. Thus a developer should make sure its lender is familiar with the tax credit program.

- (1) leased to an income-eligible tenant (as defined below);
- (2) rent-restricted (as defined below);
- (3) suitable for occupancy under state and local health or building rules and regulations;⁶
- (4) used on a nontransient basis, i.e., subject to a lease with a minimum term of six months;⁷
- (5) leased to a non-student household;⁸ and
- (6) available to the general public (the unit must be leased in a manner that does not discriminate in favor of or against special populations except as allowed under HUD guidelines).⁹

D. TENANT INCOME ELIGIBILITY

A Tenant is income-eligible if his or her actual household income is at or below the set-aside requirement elected by the owner (e.g., 50% or 60% of area median income). The Department of Housing and Urban Development publishes the median income standards for various geographic areas annually. The area median income standards are adjusted for family (household) size. Tenants must meet the income limitation at the time of initial occupancy and each year thereafter during the compliance period. Each year the project owner must certify the level of low-income occupancy.

A household whose income rises above the applicable qualifying income standard is still considered to meet that income standard until its income exceeds 140% of the applicable qualifying income standard. When the tenant's income exceeds 140%, that unit ceases to be a qualified low-income unit unless the owner rents the next available unit of comparable or smaller size to a household with qualifying income.¹⁰

If a qualified tenant moves out, the vacant low-income unit is still considered to be qualified low-income housing unit if reasonable attempts are made to rent the unit and no comparable

⁶ Violations may be cured within a specified period of time.

⁷ Single room occupancy (SRO) units, however, may be leased on a month-to-month basis.

⁸ Dwelling units occupied by students receiving AFDC payments are exempt from this requirement.

⁹ HUD regulations and policies do allow preferences to certain classes of tenants such as the elderly, homeless, disabled and/or handicapped in the circumstances and under the conditions set forth by HUD. Including such preferences does not violate the general public use requirement.

¹⁰ 26 U.S.C. §42(g)(2)(D)(ii)

or smaller units are rented to non-eligible tenants. If the unit is rented to a non-eligible tenant, it is no longer qualified.

E. RENT RESTRICTIONS

The gross rent paid by a tenant may not exceed 30% of the imputed income limitation (i.e., 50% or 60% of the current area median income, adjusted for family size) for the unit. Unlike income qualification, which is based on the tenant’s actual family size, rent restriction is based on an imputed family size. For single room occupancy units or studios (units with no separate bedroom), the number of occupants is assumed to be one. For all other units, the number of occupants is assumed to be one and one-half times the number of separate bedrooms.

Number of Bedrooms	Deemed Household Size
0 BR	1
1 BR	1.5
2 BR	3
3 BR	4.5
4 BR	6

Thus an owner can charge rent based on the size of the unit rather than the size of the tenant household. The maximum gross rent allowable in the initial year serves as the minimum rental floor in subsequent years; therefore, a subsequent decrease in area median income will not result in a decrease in gross rent.

Gross rent is the total rental or occupancy charge for a unit including all utilities except telephone. If the tenant pays utilities directly, the owners must provide a utility allowance, reducing the maximum rent that can be charged to tenants.

Gross rent does not include any payments to third parties for the provision of meals, laundry, housekeeping and other services. If, however, receipt of those services is a condition of occupancy, payments to the owner for those services will be included in gross rent. If the owner provides continual nursing, medical, or psychiatric care, it will be presumed that such services are mandatory. For projects receiving credit allocations after 1991, meals provided in a common dining facility are presumed to be mandatory if tenants have no practical alternative for obtaining meals outside the common dining facility.

F. ELIGIBILITY OF EXISTING BUILDINGS

The credit is not available in connection with the acquisition of an existing building if the building was placed in service during the 10-year period preceding the acquisition. A building is placed in service under Section 42 upon its first use and upon a change in ownership interests. Thus, a developer planning to claim the credit in connection with the acquisition and rehabilitation of an existing building must investigate the ownership

history of the project and seller to determine when the seller acquired the project and what ownership interests were transferred within the last 10 years. There are limited exceptions to the 10-year rule.¹¹

The credit is not available in connection with the acquisition of an existing building (even if it meets the 10-year hold rule) unless the building is also substantially rehabilitated. The rehabilitation expenses in a given 24-month period must be the greater of 10% of the adjusted basis of the building (at the start of the period) or \$3,000 per unit. The credit is not available if the building was previously placed in service by the owner or a related person. Thus, an owner can only obtain the credit for a building once.

II. DETERMINATION OF ANNUAL LIHTC

The credit is available each year for ten years beginning when the building is placed in service.¹² The annual credit amount is determined by multiplying the “qualified basis” of each low-income building in the project by the “applicable percentage.” To account for lease-up, the credit for the first year is adjusted to reflect the actual low-income occupancy for the year (determined on a monthly basis). The balance of the first-year credit is available in the eleventh year.

Qualified basis is the portion of a project’s “eligible basis” attributable to the acquisition and rehabilitation, or construction, of qualified low-income housing units. The applicable fraction is (i) the ratio of the number of qualified low-income housing units to the total number of residential units in the building, or (ii) the ratio of the total floor area of the qualified low-income housing units to the total floor area of all residential units in the building.¹³ The owner must use the fraction that creates a lower qualified basis.

Eligible basis consists of (i) the properly capitalized and depreciable costs of developing a new building, (ii) the properly capitalized and depreciable costs of a substantial rehabilitation

¹¹ The exceptions include placements in service in connection with: (1) carry-over basis transactions, in which the transferee determines his basis in whole or in part from the transferor’s basis, (2) certain transfers from decedents, (3) certain nonprofit or governmental agencies, (4) foreclosures, and (5) technical partnership terminations. 42 U.S.C. 42(d)(2)(D)(ii).

¹² The credit period commences with the taxable year in which the building is placed in service or, at the election of the owner, the succeeding taxable year. The project owner is deemed to defer the start of the credit period unless he affirmatively elects to start it in the year each low-income building in the project is placed in service.

¹³ The adjusted basis of a unit occupied by a full-time resident manager is included in the building’s eligible basis, but the unit is excluded from both the numerator and denominator of the applicable fraction for purposes of determining the building’s qualified basis (Rev. Rul. 92-61). This rule may also extend to units occupied by full-time resident maintenance personnel or other on-site personnel. The significance of the ruling is that such resident managers or others are not subject to applicable median income limitations.

of an existing building, and (iii) the cost of acquisition of certain existing buildings if a substantial rehabilitation is performed.¹⁴ Eligible basis includes furnishings and other personal property, but excludes land and other separately capitalized costs (whether amortizable or non-amortizable) such as organization costs, syndication costs, marketing and other pre-opening costs, permanent financing costs, and excluding project reserves and deductible expenses.

Eligible basis must be reduced by the amount of any historic rehabilitation tax credit which is attributable to residential rental property.

The annual “applicable percentage” which is used to determine the credit amount depends on several factors, including the nature of the project (i.e., new construction, rehabilitation or acquisition), the nature of the financing (i.e., with or without a federal subsidy), and the date the project is placed in service or the date which a reservation contract is entered into.

For new construction or substantial rehabilitation of qualified low-income housing units that is not financed with tax-exempt bonds, below-market rate federal loans or other federal subsidies, the applicable percentage is a percentage that will yield, over a 10-year period, credit with a present value equal to 70% of the qualified basis of the building.¹⁵

For new construction or substantial rehabilitation of qualified low-income housing units financed with tax-exempt bonds, below-market rate federal loans or other federal subsidies, or the acquisition and rehabilitation of existing qualified low-income housing units, the applicable percentage is a percentage that will yield, over a 10-year period, credit with a present value equal to 30% of the qualified basis of the building.¹⁶ The applicable percentages for November 2003 are: 7.96% for rehabilitation/new construction, and 3.41% for acquisition.

Using those percentages, a new building consisting of 110 units with an eligible basis of \$12,000,000 and an applicable fraction of 40% would have a qualified basis of \$4,800,000. The annual credit would be \$382,080 ($\$4,800,000 \times .0796 = \$382,080$). Over the 10-year credit period, the total credits would be \$3,820,800. If the applicable fraction is 100%, the annual credit would be \$955,200 and the 10-year credit stream would be \$9,552,000.

¹⁴ In “qualified census tracts” or “difficult to develop areas” designated by HUD, the eligible basis of new construction or substantial rehabilitation expenditures is deemed to be 130% of the actual amount.

¹⁵ This is referred to as a “9% credit” because it represents an annual credit of approximately 9% of qualified basis.

¹⁶ Known as a 4% credit. To be eligible for the credit, the building must meet the placed-in-service rules discussed above.

The acquisition and rehabilitation of a 65-unit building located in a difficult to develop area (thereby qualifying for the 30% boost in basis), with an applicable fraction of 100%, an eligible acquisition basis of \$1,600,000 and an eligible rehabilitation basis of \$6,500,000, would generate a total annual credit of \$727,180. The 10-year credit stream would be \$7,271,800. The annual acquisition credit would be \$54,560 ($\$1,600,000 \times .0341\% = \$54,560$). The annual rehabilitation credit would be \$672,620 ($\$6,500,000 \times 1.3 \times .0796 = \$672,620$).

III. OVERVIEW OF TAX BENEFITS AND LIMITATIONS

The credit is a general business credit. General business credits claimed by a taxpayer for any tax year may not exceed the taxpayer's net income tax less the greater of: (a) the taxpayer's tentative minimum tax for the tax year, or (b) 25% of the taxpayer's net regular tax liability that exceeds \$25,000. Net income tax is the sum of the taxpayer's regular tax liability and the alternative minimum tax less all nonrefundable credits. Net regular tax liability is the taxpayer's regular tax liability reduced by these nonrefundable credits.¹⁷ Any credit that is not allowed in a particular taxable year due to the general business credit limitation or to the alternative minimum tax can be carried back one year and forward 20 years (back 3 years and forward 15 years for credits that arise in tax years beginning before 1998). Low-income housing projects typically generate taxable losses in the first 7 to 10 years. These losses reduce the taxpayer's regular tax liability in proportion to the taxpayer's marginal tax rate.

The credit and any taxable losses are subject to the at-risk and passive activity limitations.¹⁸ Individuals and certain closely-held corporations *are* subject to the at-risk limitations and the limitations on passive activity losses and credits. However, corporations, other than personal service corporations and certain closely-held corporations, are *not* subject to the at-risk limitations and the limitations on passive activity losses and credits. An exception to the passive activity credit limitations for individuals allows individuals to utilize the credit up to an amount equal to the deduction equivalent of \$25,000 per year at the individual's marginal tax rate (e.g., a taxpayer in the 35% marginal bracket may use \$8,750 in credit per year [$\$25,000 \times 35\% = \$8,750$]) regardless of whether or not the individual has any passive income and, for projects placed in service after 1989, regardless of the individual's income level. The amount of credit that the typical project generates and the constraints on use of the low-income housing tax credit make it clear why the credit is typically syndicated to large corporate buyers.

¹⁷ 26 U.S.C. § 38(c)(1)

¹⁸ 26 U.S.C. § 465; 26 U.S.C. § 469

IV. PARTNERSHIP ALLOCATIONS

Due to the size of the low-income housing tax credit and the limits on use of the credit, most developers are unable to use the credit for their own benefit. Therefore, developers of tax credit projects typically sell an ownership interest in the project to a partnership whose members include corporations seeking tax credits. Much work goes into structuring the partnership to allocate all the losses, depreciation and tax credits to the investor while allocating the profit and distributions more evenly among the partners. The rules concerning partnership allocations also force low-income housing tax credit projects to use non-recourse financing.

An owner may allocate the tax and economic benefits of a project disproportionately among its members (within reasonable limitations) by using a partnership to own the project. For federal income tax purposes, a partnership is treated as a pass-through entity whereby all partnership tax items are taxed to the partners and are allocable among them pursuant to a partnership agreement, subject to regulations which determine the validity of those allocations.

While any partnership can be used, almost all developers choose a limited partnership or limited liability company because those entities allow the developer to control day-to-day matters and the investor to obtain pass through of tax benefits with limited liability for the obligations of the ownership entity.

A typical LIHTC partnership will allocate 99.9% of all tax credits and taxable losses to the investor and .01% to the developer, and will allocate cash flow from operations and proceeds from sale or refinancing of the project 50% to the investor and 50% to the developer.¹⁹ Generally, the validity of such allocations must be determined pursuant to the regulations under IRC Section 704(b). Those regulations do not specifically address the allocation of low-income housing tax credits among partners because they were drafted prior to the enactment of the low-income housing tax credit program. They do, however, address the allocation of other credits.

The regulations distinguish between the allocation of the investment tax credit and the allocation of other credits. They recognize a safe harbor for allocating the investment tax credit among partners in accordance with the manner in which they share partnership profits as of the date the investment tax credit property is placed in service. For other credits, however, they indicate that credits attributable to partnership expenditures should be

¹⁹ For nonprofit 501(c)(3) developers, however, all allocations, including residual allocations, must be the same to avoid the impact of the tax-exempt use rules. Those rules impose a less favorable depreciation schedule to the extent of the nonprofit partner's greatest percentage allocation of items of profit (income, gain, or distribution) during the entire term of the partnership.

allocated in the same manner as the losses and deductions attributable to the expenditures which give rise to such credits.²⁰

While the low-income housing tax credit is similar in some ways to the investment tax credit, it is different in some significant ways. For example, the investment tax credit is a one-time credit earned when the property is placed in service while the low-income housing tax credit is earned each year for 10 years based on continued compliance under the credit program. Also, it seems inappropriate to allocate the low-income housing tax credit in accordance with the manner in which the partners share partnership profits when investors generally do not expect to generate profits from LIHTC investments and Section 183 of the Code does not require them to do so.²¹

Most commentators therefore believe that the applicable regulations are those that address the allocation of other credits. Thus, since the low income housing tax credit is attributable to expenditures for the acquisition and development of low-income housing, the credit should be allocated among the partners in the same manner as the ordinary losses, depreciation and other deductions from the ownership and operation of the housing are allocated.

When the credit is allocated in accordance with partnership losses and deductions, the focus in determining the validity of low-income housing tax credit allocations in a partnership is on the validity of the loss allocations during the entire term of the partnership and, particularly, during the 10-year credit period. The technical requirement is that loss allocations must have substantial economic effect.

Under the applicable regulations, loss allocations (and hence LIHTC allocations) have substantial economic effect as long as the partnership agreement contains certain mandatory provisions regarding the proper maintenance of partner capital accounts and the distribution of proceeds on liquidation of the partnership in accordance with partner capital accounts, and the capital accounts of partners receiving loss allocations are not reduced below zero.

In the event that loss allocations would or likely could reduce partner capital accounts below zero, such allocations which actually would reduce partner capital accounts below zero will still be considered to be valid (i.e., have substantial economic effect) provided that (1) the partners receiving such allocations are obligated to restore the deficit (if any) that remains in their capital account upon liquidation of the partnership, or (2) the losses are attributable to

²⁰ Treasury Reg. 1.704-1(b)(4)(ii).

²¹ Section 183 of the Code disallows losses, deductions or credits attributable to activities that are not engaged in for profit. The legislative history of the LIHTC program however indicates that Congress contemplated that tax benefits (including credits, losses and deductions) would be available to taxpayers investing in low-income housing even though the investment would not otherwise provide a potential for economic return. In 1992, the IRS adopted Treasury Reg. 1.42-1 that states Section 183 does not apply to the LIHTC.

nonrecourse deductions (i.e., deductions attributable to nonrecourse liabilities of the partnership), and the partnership contains certain mandatory provisions regarding the allocation of nonrecourse deductions and the allocation of partnership minimum gain among the partners.

Deficit restoration obligations are not acceptable to most investors because they tend to undermine their limited liability as limited partners. In light of the unacceptability of deficit restoration obligations, it is essential that the debt financing for the project be nonrecourse. The key provisions are referred to as qualified income offset and minimum gain chargeback provisions. In summary, once the capital accounts of the investor partners are reduced to zero, any further loss allocations to them will be invalid and will be subject to reallocation to other partners with positive capital accounts or to the general partner unless the partnership has both nonrecourse financing and proper qualified income offset and minimum gain chargeback provisions.

Developers of low-income housing tax credit projects are not necessarily bound to give up 99% of the economic benefits of the project. The applicable guidance allows portions of a development service fee to be included in eligible basis. The ownership entity therefore pays a development services fee to a related entity²² and includes a portion of that fee in its eligible basis. The developer thus receives compensation above the line. Above the line fees are commonly used to allocate cash flow and to fine tune the loss-making ability of the ownership entity.

VI. LIHTC ALLOCATIONS AND PROGRAM ADMINISTRATION ALLOCATION SYSTEM

Each state is granted annual authority to allocate \$1.75 per capita per year in 2002 (adjusted for inflation) and is required to designate a state agency to allocate the credits and monitor tax credit compliance. The housing credit agency in the state of Washington is the Washington State Housing Finance Commission. The agency must adopt an allocation plan.

To obtain an allocation of credit, a project must be consistent with the plan. In many states the allocation plan favors projects with greater low-income set asides. The process can be competitive. For example in the state of Washington in 2003, fifty eight projects applied for an allocation, and 28 projects received an allocation. Due to the competition in Washington, most applicants commit to restricting 100% of the units to low-income use.²³

²² Corporations, unlike partnerships, are not subject to self-employment tax. Thus a thoughtful developer can eliminate some tax on the developer fee by using a corporation as the developer.

²³ Certain projects financed with tax-exempt bonds need not obtain an allocation of credits. Credit given to such projects does not reduce the state's annual credit authority. In order to qualify, 50% or more of the aggregate project costs must be financed with tax-exempt bonds which are subject to state volume limitations. However, the project must still be consistent with the qualified plan of allocation.

State housing credit agencies are required to evaluate the financial feasibility of projects, to give consideration to other available subsidies committed to the project, to consider the degree to which the credits will be used for project costs, to consider the reasonableness of the developmental and operational costs of a project and to adjust the amount of credit allocated to the project accordingly. The applicant must prepare a comprehensive market study of the housing needs of low income individuals in the area to be served by the project before an allocation may be made.

VII. COMPLIANCE MONITORING

Federal law mandates many features of a state's compliance programs. For instance, project owners must keep records for each building showing the total number of residential rental units, the percentage of low-income units, the rent charged on each residential unit, the low-income unit vacancies and the rentals of the next available units, the low-income certification of each low-income tenant and supporting documentation, and the character and use of the nonresidential portion of the building (if any) included in the building's eligible basis.

In addition, project owners must certify at least annually under penalty of perjury that the project meets the applicable minimum set-aside requirements, and that the owner has received an annual low-income certification from each low-income tenant, along with supporting documentation; that each low-income unit is rent-restricted; that all units are available for use by the general public on a nontransient basis; that each building in the project is suitable for occupancy under local health, safety and building codes; that there has been no change in any building's eligible basis (or that there has been a change, with an explanation of the nature of the change); that all tenant facilities included in eligible basis are provided on a comparable basis without separate charge to all tenants; that reasonable attempts are made to rent low-income units that become vacant during the year to tenants with qualifying income and while vacant no units of comparable or small size are rented to nonqualifying tenants; and that if the incomes of tenants of low-income units increase above the allowable limit, the next available units of comparable or smaller size are rented to tenants with qualifying income.

Finally, the state housing credit agency has the right to inspect each building in the project and the right to audit the owner's records during the 15-year compliance period.

Violation of the compliance requirements can result in recapture of the credit taken. The credit may be recaptured due to (1) a failure to maintain the project as a qualified low-income housing project, (2) a reduction in the low-income occupancy of the project, or (3) a transfer or disposition of the project or an interest in the project during the 15-year compliance period. Recapture is limited to the "accelerated portion" of the credit allowed in prior years plus interest from the year or years allowed. The "accelerated portion" is equal to one-third

(1/3) of the credit allowed in prior years if the recapture event occurs during the first 11 years and declines ratably during the 12th through 15th years of the compliance period.

Recapture is a bad thing, but you don't need a lawyer to tell you that.