Section 42 Low-Income Housing Tax Credit Program

Advanced Issues

PHFA Housing Conference

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Advanced Credit Issues

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The Role of the IRS

- The IRS has overall responsibility for program oversight; and
- The IRS has final authority on receipt of credits (with the following exceptions):

Four circumstances where credit is returned to the HFA:

**Building not qualified within required time period (failure to place in service or failure to meet minimum set-aside;*

**Noncompliance with terms of allocation;*

**Mutual consent; and*

**Amount not required for financial feasibility.*

  - *The HFA has only 180 days following the close of the first taxable year of the credit period to take back all or part of an allocation.*

- The IRS establishes general program rules
  - Section 42 of IRC
  - Regulations
  - Revenue Rulings
  - Procedures
  - Private Letter Rulings

Determines which properties will be audited

- Audits are generally assigned based on 8823's issued by State Housing Finance Agencies ("HFA's").
  - Highest risk of audit occurs when 8823s are uncorrected.

Major IRS Issues That Increase Risk of Audit

- Failure to recapture tax credits
- Violation of habitability standards
  - Related Issue: Casualty Loss
- Incorrect rents
  - Major issue: inappropriate fees
- Foreclosures
- Credits claimed without 8609

Extended Use Agreements

SECTION 42 (h)(6)

An Extended Use Agreement is a "Restrictive Covenant" entered into between the Owner of the Property and the State HFA. The IRS is not a party to the Agreement. Minimum extended use period is 30 years, but longer requirements are common.

Note – the first extended use agreements will expire in 2020.

Due to competitive nature of credits, EUA's can be difficult on management.

In 2019, HFAs may award $2.75625 per capita or $3,166,875, whichever is greater.

The Agreement will outline the promises made by the owner in return for the credits:
E.g.,

- Special Set-asides;
- Training programs;
- Lower-incomes than required by Minimum Set-aside.

Seven Code required elements of the "EUA:"

1. Applicable fraction must be maintained through extended use period;
2. Agreement may be enforced in State Court;
3. No part of a building may be sold;
4. May not refuse voucher recipients;
5. Binding on successors;
6. Must be recorded as a Restrictive Covenant; and
7. Low-income residents may not have leases terminated without good cause.

Two ways out of EUA:

1. Foreclosure (or Instrument in Lieu of Foreclosure) – Note: this results in automatic termination of the EUA.
    a. Unless the purpose of the foreclosure is to get out of EUA; and
2. Inability of HFA to find a "Qualified Contract" purchaser.

Critical Tests & Timeframes

Completion of Buildings (Section 42(h)(1)(E)(i))

All buildings must be completed and placed in service no later than the end of the second calendar year after the allocation of credits.

- Example: Property is allocated credits in 2017; all buildings must be in service by December 31, 2019.

Failure to meet this deadline results in loss of allocation. (The only exception is for properties located in a Presidentially declared disaster area, which may be permitted one additional year).

Note: *This rule does not apply for buildings that receive credits based on the issuance of tax-exempt bonds.*

The Minimum Set-Aside – Section 42(g)(1) – Election made on IRS Form 8609

The Minimum Set-Aside test establishes the minimum percentage of units in a project that must be low-income in order to qualify for tax credits.

- An owner may elect to set aside as few as 20% of units as low-income if he/she agrees to rent all low-income units to households with income at or below 50% of the median income for the area.
- The owner may rent low-income units to households with income as high as 60% of the median, but in this case, a minimum of 40% of the units must be maintained as low-income.
    - In New York City, this election is replaced with the 25/60 election.
- **Income Average Set-Aside**: brand new set aside is now available.
    - Must rent at least 40% (25% in NYC) of the residential units in the project to households whose income does not exceed the imputed income limit designated by the owner of the project for a respective unit.
    - The average of the imputed limit may not exceed 60% of the AMGI.
    - Imputed income limits shall be 20%, 30%, 40%, 50%, 60%, 70%, and 80%.

A critical deadline in the tax credit program is the deadline for meeting the Minimum Set-Aside; this set-aside must be met no later than the end of the tax year after the placed in-service year.

E.g., Building with a calendar tax year was placed in service in October 2018, has 100 units, and the owner is going to elect the 40/60 minimum set-aside.

-Deadline for meeting the minimum set-aside is December 31, 2019. By this date, at least 40 % of units will have to be low-income or the building will receive no credits – ever! (The only exception is for properties located in a Presidentially declared disaster area.)

Once the set-aside is met, it is also important to qualify all low-income units by this same deadline. Any unit not qualified by this time becomes a "2/3" unit. (Credits are taken over the compliance period and not the credit period). – See Section 42(f)(3).

Placed in Service Dates

IRS Revenue Notice 88-116

"For purposes of Section 42, the term 'placed in service' has two definitions – one for buildings and one for rehabilitation expenditures that are treated as a separate new building (Section 42 (e)(4)(A))."

- New or existing building: the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law.
  - A transfer of a building to a new owner results in a new placed in-service date if, on the date of the transfer, the building is occupied or ready for occupancy.
- Rehabilitation expenditures: These expenditures are placed in service at the close of any 24-month period, over which such expenditures are aggregated.
  - This applies even if the building is occupied during the rehabilitation period.
  - Additional guidance from the IRS has made clear that the rehab expenditures may be placed in service in less than 24 months.
  - This provision is intended to dictate the tax credit percentage applicable to the rehab costs as the credit percentage from the final month of the 24-month period.
  - Rehab costs may use 9 percent credits unless tax-exempt bonds are used.

Acquisition Credits & The Minimum Expenditure Test

*No credits on an acquisition/rehab project unless rehab minimum expenditure test is met.

--The *higher* of 20% of the depreciable cost of the building, or more than $6,000 per low-income unit.

- For rehab expenditures placed in service for any calendar year after 2009, an inflation adjuster, using 2008 as the base year, increases the $6,000 per unit.
    - For 2019, the amount should be at least $6,800 per unit.

*The applicable fraction may be established based on the acquisition placed in service date. (There is no need to do a separate resident qualification when rehab is completed).

States often impose higher minimum expenditure requirements.

Qualifying Tenants in an Acquisition/Rehab Deal

- Under Rev. Proc. 2003-82, units may be qualified before the beginning of the credit period. The unit remains qualified, even if the household's income exceeds the income limit at the beginning of the first year of the credit period, if the unit is rent restricted and the following specific conditions are met:
    - If a household occupies a unit at the time of acquisition, and the initial tenant certification is completed within 120 days after the date of acquisition (using income limits in place at acquisition), the TIC is effective on the acquisition date.
    - If a household occupies a unit at the time of acquisition, and the initial tenant certification is completed more than 120 days after acquisition, the household is treated as a new move-in. Use income limits in effect at time of certification. *The effective date of TIC is the date the last adult signs the TIC, and the household is treated as a new move-in.*

    - For new households to a project moving in before the beginning of the first credit year, the TIC is completed using the income limits in effect at the time of move-in.

The Safe Harbor Rule

- Households qualified prior to the beginning of the first credit year must be tested for purposes of the Available Unit Rule at the beginning of the first year of the building's credit period (this is an IRS *"Safe Harbor Test," and may not be necessary for 100% low-income properties.* ***Owners in PA should be aware that the HFA requires a fully verified safe-harbor certification.)***
    - The test must be completed within 120 days before the beginning of the first year, *so, qualifications occurring after September 3 in the year before claiming credits will meet this requirement*;
    - The "test" consists of confirming with the household that certified income is still current. If there is additional income, the TIC must be updated. It is not necessary to complete third party verifications for IRS purposes, but some HFAs do require third party verification;
    - If income exceeds the 140% level, the Available Unit Rule applies.
- If the effective date of the initial TIC is 120 days or less before the required "test," testing is not required. The recert will be due on the anniversary of the original TIC effective date.
- If the effective date of the TIC is more than 120 days before the required "test," the income must be tested within 120 days before the beginning of the first year of the credit period.

Important Note for Section 8 properties: Tenants may not be displaced involuntarily in order to put credits on a Section 8 property. Incentives may be offered.

Affordability (Rent) Issues

- Gross Rent Floor: §42(g)(2)(A) gives authority to establish the lowest gross rent a LIHTC property will ever have to charge. IRS Revenue Procedure 94-57 states that the gross rent floor for a property takes effect on the date of credit allocation to the building or on the placed in service date for the building.
  - Owner normally makes this election at the time of allocation, but no later than the PISD.
  - For bond properties, the choice is either when the Agency reserves bonds for the building (issuance of initial determination letter) or the PISD.
  - Due to HERA Hold Harmless Income Rule, it is recommended that the allocation date always be used for Gross Rent Floor purposes.
- Utility Allowance Issues:
  - IRS Regulation 1.42-10
    - The cost of Tenant paid utilities must be included in gross rent (telephone, cable, and Internet are not considered utilities);
    - Applicable utility allowances:
      - RHS assisted buildings;
        - Including RHS assisted tenants only;
      - HUD – regulated buildings
      - Other buildings
        - Voucher residents will use PHA allowance
        - Other Tenants: May use PHA allowance;
        - If local utility company estimate is obtained that estimate is used for all rent-restricted units of similar size and construction in the building.

1.42-10 was amended in July 2008, and provides three additional methods:

1. Housing Finance Agency;
2. HUD Model Allowance; and
3. Professional Estimate

Update allowances at least once each calendar year (follow HFA guidance).

- After the allowance has initially been determined for a new development, an update will not be required until the earlier of the date the building has achieved 90% occupancy for 90 consecutive days or the end of the first year of the credit period.
- If utility company estimate, HFA allowance, HUD Model, or Professional Estimate is used, the method may only be changed if it is to achieve a more accurate estimate [see 8823 Guide, Chapter 18].

Updated allowances must be put in place within 90 days of the date of the update.

- E.g., Utility allowance of $50.00 increases March 1 to $80.00, causing the rent to go above the maximum allowable. Rents must be reduced no later than May 31.
        - If increase in the allowance causes excess rent, rents must be lowered.
            - The local utility company estimate, HFA estimate, HUD Model or energy consumption model may not be used for RHS, HUD, or Voucher units.
            - Any interested party may obtain a utility allowance estimate, at any time during the extended use period.
            - At the beginning of the 90-day period, a copy must be furnished to HFA if estimate is derived from utility company, HUD Model or Energy Consumption model.
                - If estimate is derived from utility company, HUD Model, Energy Consumption model or from the HFA, tenants must be given notice at the beginning of the 90-day period.
    - Changes in Allowance:
        - Must be in place 90 days after change.
        - Must be reflected in the first rent due after the 90th day.

A utility allowance is permitted only if the resident pays directly to the utility company, or, if utilities are submetered, the resident pays no more than the actual rate charged by the utility company.

- *If owners charge an administrative fee for submetering, gross rent includes any amount by which the aggregate amount of monthly fees for all of the unit's utilities under one or more submetering arrangements exceeds the greater of (1) $5.00 per month; (2) an amount (if any) designated by publication in the Internal Revenue Bulletin (IRB); or (3) the lesser of a dollar amount (if any) specifically prescribed under a State or local law or a maximum amount (if any) designated in the IRB.*
- *"RUBS" type billing systems may not use a utility allowance.*

<u>Optional Fees</u>

Two primary types of fees: One time and recurring

- One Time Fees:
  - Often paid "up-front," such as application fees.
  - If required as a condition of occupancy, fees may not exceed actual "out-of-pocket" costs paid to third parties.
    - E.g., Application fee of $35 of which $30 is actual cost to process application. In this case, $5 is an inappropriate fee and the property will be out of compliance.
    - Other one-time fees such as "redecoration fees," "Occupancy fees," etc. are never permitted (an owner is responsible for preparing a unit for occupancy.)
      - Such fees are also not permitted if required to be paid as an "exit" fee –e.g., requirement for mandatory professional carpet cleaning when moving out.
    - Medical services in assisted living projects (if fees for such services are required as a condition of occupancy.)
- Recurring Fees:
  - May be allowable if clearly "optional" to the resident.
  - Examples of generally acceptable fees:
    - Pet fees;
    - Washer/dryer rentals
  - Examples of Recurring fees that are generally not acceptable:
    - Month-to-Month fees;
    - Fee to use in-unit washer/dryer hook-ups
    - Renters insurance

In *The General Explanation of the Tax Reform Act of 1986* it states, "a service is optional if payment for the service is not required as a condition of occupancy." It also states that "any charges for services that are not optional to low-income tenants must be included in gross rent for purposes of Section 42(g)(2)(A)."

IRS Regulation 1.42-11 requires that non-optional charges to tenants be included in gross rent.

Note: the IRS has indicated that a fee charged for transferring a resident between buildings may also be a problem since the tenant's lease stays in place. HFA approval for any such fees is recommended.

Common Area Fees

IRS Regulation 1.42-5(b)(ix): Owners of tax credit properties must maintain records that show for each year in the compliance period "the character and use of the nonresidential portion of the building included in the building's eligible basis under Section 42 (d) (e.g., tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project)."

The *Eligible Basis* discussion of the General Explanation Report on the LIHC states that "the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas may be included (*in basis)* provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project."

This requirement is also outlined in Treasury Regulation 1.103-8 (b)(4)(iii).

Common area that is included in eligible basis will have costs prorated among residential buildings in the project.

Commercial Use

*A “commercial use” is one that is making or intended to make a profit.

**Instructions to the States in the “8823 Guide” state that if common area is converted to commercial use, the HFA must report it as non-corrected, even if put back to residential use; the IRS will decide when or if the issue is corrected.

The *Joint Committee Report on the LIHC* states, “Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for commercial use. No portion of the costs of such nonresidential rental property may be included in eligible basis.”

- This is re-stated in the *General Explanation*.

Home businesses of residents are not considered commercial use as long as the primary use of the unit is residential.

a. If a tenant is providing daycare services, the tenant must have applied for (and not have been rejected), be granted (and still have in effect), or be exempt from having a license, certification, registration, or approval as a daycare facility under state law.
b. Note: *A tenant may rent a two-bedroom unit and dedicate one of the bedrooms as an office.*

Tenants Receiving Federal Rental Assistance

A low-income resident may pay more than the restricted tax-credit rent in certain situations. If a federal rental subsidy is paid on behalf of a low-income resident (e.g., Section 8), Section 42(g)(2)(E) permits the resident to pay more than the maximum LIHC rent, if:

1. The excess of the gross rent over the applicable rent limit is due to the tenant's income exceeding the applicable income limit (for this reason, rent above the maximum §42 rent may never be paid at move-in);
2. A federal rental assistance payment is made on behalf of the tenant; and
3. The sum of the rental assistance payment and the gross rent for the unit does not exceed the amount of rental assistance payment and gross rent that would be paid for the unit if
    a. The income of the occupants did not exceed the applicable income limit; and
    b. The unit was rent-restricted.

It is this third condition that tends to be most confusing to people. It is designed to ensure that while an owner may collect more than the tax credit allowable rent from a tenant in certain situations, the owner does not receive more total rent than he received prior to the increase in the tenant's income. In other words, while the tenant pays more, the rental assistance payment is less.

If no subsidy is paid on behalf of the resident, the tenant portion may not exceed the allowable tax credit rent. Also, keep in mind that at move-in, the tenant portion of the rent may never exceed the allowable Section 42 rent. This is due to requirement #1 above. *In fact, even if a resident's income increases, unless it is above the maximum income limit, rent above the tax credit limit may not be charged.*

The second circumstance where a tenant may pay more than the LIHTC maximum rent is when overage payments must be made to the Rural Development Service, and all amounts in excess of the tax credit maximum are paid to RD in the form of overage.

Establishing LIHTC Income Limits

Section 42(g)(4) refers to Section 142 (d) (1) relative to the methodology for calculation of income for tax credit properties, i.e., the same methodology as the Tax Exempt Bond Program.

Section 142(d)(2)(B) provides that the income of individuals and Areawide Median Gross Income is determined in a manner consistent with determinations of lower income families and AMGI under HUD Section 8. Therefore, the HUD Section 8 rules relative to determination of income and income limits is used for Section 42. (IRS Revenue Ruling 94-57 affirms this).

IRS Revenue Notice 88-80

- HUD rules in income calculation must be used;
- Section 42 income is not the same as taxable income.

The income limit in rural areas (as defined in Section 520 of the Housing Act of 1949) for LIHTC properties that do not use tax-exempt bonds shall be the greater of the area median gross income or the national nonmetropolitan gross income.

Income determinations for LIHTC (and Bond) projects may not decrease for any year after 2008.

Projects placed in service prior to 2009 will use the HUD HERA Special Income limits if available to an area; projects placed in service after December 31, 2008, will use the regular HUD Multifamily Tax Subsidy Project (MTSP) income limits.

Note: *IRS Revenue Ruling 94-57 states "taxpayers may rely on a list of income limits released by HUD until 45 days after HUD releases a new list of income limits, or until HUD's effective date for this new list, whichever is later."*

<u>Available Unit Rule</u> – Section 42(g)(2)(D) & Regulation 1.42-15

1. All tax credit properties are subject to this rule.
    a. Not just mixed income properties

The Rule:

Whenever a qualified low-income household recertifies with income higher than 140% of the <u>current</u> qualifying income limit, two things must happen in order to continue taking credits on the over-income unit:

1. The unit must remain rent restricted; and
2. The next available unit <u>in the building</u> of comparable or smaller size must be rented to a qualified low-income resident at restricted rent.
    a. Comparability is determined based on unit size and amenities.

This requirement remains in place as long as any low-income household in the building is over-income (above the 140% level).

<u>Available Unit Rule (AUR) With the Income Average Minimum Set-Aside</u>

- If the designated income for an over-income unit (over 140%), is 60% or less, the available unit rule is triggered when the income of the household exceeds 140% of the 60% income limit.
- If the designated income for an over-income unit exceeds 60% (i.e. either a 70% or 80% unit), the AUR is triggered when the income of the household exceeds 140% of the designated income limit.

- If a unit that is comparable or smaller in the BIN becomes vacant:
  - If it is a LIHTC unit, it must be rented at the designated income limit it had immediately prior to becoming vacant;
  - If it is a market unit, the unit must be rented to a household that meets the income designation for the over-income unit.

The Penalty:

Violation of the rule results in <u>all</u> over-income (140%) units that are subject to the "comparable or smaller" requirement being considered market units, with potential "recapture" for each of the over-income units.

- Recapture: recovery all previously claimed "accelerated" credit ("1/3"). IRS Form 8611 is used to calculate potential recapture.

<u>Special Occupancy Issues</u>

1. Vacant Units:
    a. IRS Regulation 1.42-5(c)(1) – owner must certify annually to HFA that if a low-income unit became vacant, reasonable attempts were or are being made to rent the unit or next available unit of comparable or smaller size <u>in the project</u> before any units in the project of comparable or smaller size were or are rented to market rate tenants ("vacant unit rule").
    b. IRS Reg. 1.42-15(a) – a unit is not available if it is contractually obligated under State or local law.
    c. Revenue Ruling 2004-82 – Vacant market units may be rented before vacant low-income units as long as reasonable attempts are made to rent the low-income units.
        i. Reasonable attempt is based on facts and circumstances.
            1. Size & location of project;
            2. Tenant turnover rates;
            3. Market Conditions;
            4. Available advertising options.

    E.g. of reasonable methods:
    - Banners & For Rent signs;
    - Classified ads; and
    - Use of local PHA waiting list.
2. Employee Units:
    a. Revenue Ruling 92-61
        i. Adjusted basis of a full-time resident manager is included in the eligible basis of a qualified low-income building under Section 42(d)(1) of the Code, but the unit is excluded from the applicable fraction for purposes of determining qualified basis.
    b. PLR 9330013
        i. Maintenance unit may receive same treatment as employee unit.
    c. Recommendations:
        i. Obtain State approval;
        ii. Obtain State approval for any rent charged; and
        iii. Employee should be full time to the property.

3. Security Officer Units:
    a. PLR 9538015 and Revenue Ruling 2004-82
        i. Units occupied by Security Officers are includable in basis and the unit is excluded from the applicable fraction calculation.
        ii. This is the case as long as the presence of the Officer is "reasonably required" by the property, as approved by the HFA.

Note: Approval of an employee unit by the HFA does not transfer to a Security Officer Unit. Separate approvals are required.

Recommended steps for providing a Security Officer Unit:

1. HFA approval;
    i. Obtain State approval for any rent charged
2. Professional Law Enforcement Officer or other qualified person; and
3. Agreement in file outlining duties and responsibilities.

Keep in mind that on mixed income properties, employee and security officer units should always be in market units (unless the employee or security officer is qualified low-income).

<u>Model Units</u>

In an opinion expressed in PLR 9330013 and in the 8823 Guide, the IRS stated that a model unit is a residential rental unit under section 42 of the Code. Therefore, a model unit's cost is included in the building's eligible basis under section 42(d)(1) and is included in the denominator of the applicable fraction when determining a building's qualified basis under section 42(c)(1)(B).

Basically, credits may not be claimed on the cost of a model unit. If a unit is held for use as a model, it is essentially a market unit.

Non-Transient Use

Units may not be transient; to avoid this, a minimum six-month lease at move-in is recommended.

- Exceptions for Single Room Occupancy (SRO) or Transitional Housing for the Homeless.

Initial Resident Files

1. Every household to live in a unit up to the end of the first credit year should be considered an "initial" resident.
2. Initial residents are the residents that qualify a property for full credits.
   a. These files are the only way to prove the minimum set-aside was met by the end of the first year of the credit period.
3. Since they are the qualifying residents, the IRS has the right to examine those files for up to 21 years after the initial credit year.

SO:

- Keep initial resident files until at least six years after the due date of the tax return for the last year of the compliance period.
- Make copies of initial resident files and secure them away from the site
  - It is recommended that they be kept by the General Partner
  - Investors may also want a copy

Scanning or hard copies are acceptable.

- Revenue Procedure 97-22 outlines IRS requirements relative to scanning; also see Revenue Ruling 2004-82, F.

All other resident files should be retained for at least six years after the due date of the tax return for the year in which the resident moves out.