

**Low-Income Housing Tax Credits
An Overview**

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Low-Income Housing Tax Credits

I. OVERVIEW OF TAX BENEFITS AND LIMITATIONS

- The LIHTC is a federal income tax credit which is available each year for ten (10) years and results in a dollar-for-dollar reduction of the taxpayer's regular tax liability.
- Low-income housing projects also typically generate taxable losses in the first 7 to 10 years or more which result in a reduction of the taxpayer's regular tax liability in proportion to their marginal tax rate.
- Certain low-income housing projects which involve the substantial rehabilitation of a certified historic structure may also generate a substantial one-time historic rehabilitation tax credit in the year the project is placed in service. However, any historic rehabilitation tax credit allowed will reduce the eligible basis of the project for purposes of computing the LIHTC.
- The LIHTC is a general business credit. General business credits are allowed only to the extent of \$25,000 plus 75% of the taxpayer's regular tax liability in excess of \$25,000 in any one year. However, the LIHTC is not allowed against the alternative minimum tax.
- Any LIHTC which is not allowed in a particular year due to the general business credit limitation or to the alternative minimum tax can be carried back 3 years and carried forward 15 years.
- The LIHTC and any taxable losses from a low-income housing project are subject to the at-risk and passive activity limitations. 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.
- The LIHTC is transferable along with a qualified low-income housing project during the 10-year credit period. The transferee can claim the annual LIHTC for the remainder of the 10-year credit period (less any accelerated LIHTC claimed by individual taxpayers on a one-time basis). The OBRA of 1993 provides that the transferor and transferee may agree to use either the exact number of days or the mid-month convention to determine the division of the LIHTC in the month of disposition.
- Potential recapture of LIHTC claimed in prior years may result from (1) a failure to comply with the requirement 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 LIHTC allowed in prior years plus interest from the year or years allowed. The “accelerated portion” is equal to one-third (1/3) of the LIHTC 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 can be avoided in connection with the transfer of a project if the transferor posts a bond or obtains a letter of credit in an amount prescribed under Treasury Department guidelines and provides reasonable assurances of continued compliance by the transferee for the remainder of the 15-year compliance period. Bond factors are published on a quarterly basis.
- The depreciable basis of a LIHTC project is *not* reduced by the LIHTC.
- The capital accounts or adjusted basis of partners in a LIHTC project partnership are *not* reduced by the LIHTC.

II. LIHTC PROJECT ELIGIBILITY

A. MINIMUM SET-ASIDE AND EXTENDED USE REQUIREMENTS

- In order for a residential rental project to constitute a qualified low-income housing project, the project must irrevocably elect to meet one of the following minimum set-aside requirements:
 - (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, *or*
 - (3) at least 15% of the residential units must be made available to tenants where certain deep rent skewing rules apply.
- The minimum set-aside requirement must be met within 12 months of the date the project is placed in service and must be complied with continuously for 15 years from the start of the first taxable year in which the LIHTC is claimed.
- Projects receiving allocations of LIHTC after 1989 must be subject to a 30-year extended low-income use agreement which restricts the transferability or operation of the project for other than continued low-income use after the initial 15-year compliance period. The restrictions must be recorded as restrictive covenants binding on all subsequent transferees, except through foreclosures or transfers in lieu of foreclosure.
- Under the extended low-income use agreement, the property may be transferred after the expiration of the initial 15-year compliance period for continued low-income use, but the property may be converted to market rate use and disposed of only after the state housing

credit agency has tried and failed to find an eligible purchaser for the property at a price based on a formula during the one-year period after receiving written notice of the owner's intent to dispose of the property. The project owner may give notice anytime after the 14th year of the compliance period. If no purchaser is located by the housing agency and the property is converted to market rate use, a three-year transition period must be observed whereby existing low-income tenants may not be evicted and rent restrictions will continue to apply to such tenants.

B. OTHER PROJECT ELIGIBILITY REQUIREMENTS

- Scattered site housing may be treated as a single project provided that 100% of the dwelling units are qualified low-income units and there is a common plan of financing.
- The allocation of LIHTC may be made on a per project rather than on a per building basis, although separate BIN numbers will continue to be required for each low-income building.
- The project must not be a hospital, nursing home, sanitarium, life care facility, retirement home, or trailer park. However, in certain circumstances, a retirement-type facility may qualify as residential rental property notwithstanding that significant services other than housing are furnished to tenants.
- Project owners may allow certain rights of refusal to purchase low-income units at the expiration of the 15-year compliance period to the individual tenants, tenant cooperatives, resident management corporations, qualified nonprofit organizations, and governmental agencies without jeopardizing the availability of the tax benefits associated with the LIHTC program.
- In order to qualify for LIHTC in connection with the acquisition of an existing building, such building must not have been placed in service during the preceding 10-year period. Exceptions to the 10-year placed-in-service rule exist for certain non-taxable transfers. Furthermore, provisions exist to petition the IRS for waiver of the 10-year placed-in-service rule in certain specified circumstances. For example, there is a waiver exception for existing low-income housing which is subject to a HUD-insured mortgage that is eligible for prepayment if the exception is necessary to avert the conversion of the property to market rate use. There is another waiver exception for certain buildings acquired from failed financial institutions, including such property acquired and held by the RTC.

C. QUALIFIED LOW-INCOME HOUSING UNITS

- The LIHTC is available only with respect to units that meet the definition of a qualified low-income housing unit.
- A qualified low-income housing unit is a unit that is:
 - (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 (although violations may be cured within a specified period of time);
 - (4) used on a nontransient basis, which is defined as being subject to a lease with a minimum term of 6 months, except with respect to single room occupancy (SRO) units which may be leased on a month-to-month basis;
 - (5) not leased to an all-student household (although dwelling units occupied by students receiving AFDC payments do not fail to qualify); and
 - (6) available to the general public, i.e., does not discriminate in favor of or against special populations except as allowed under HUD guidelines (e.g., preferences to certain classes of tenants such as the elderly, homeless, disabled and/or handicapped, does not violate the general public use requirement).

D. AREA MEDIAN INCOME AND TENANT INCOME ELIGIBILITY

- Area median incomes are published annually (as of February) by HUD.
- Median income standards are adjusted for family (household) size.
- The following table reflects the adjustments for one- to four-person households:

Family Size	Percentage of Area Median Income	
	50% Standard	60% Standard
4	50%	60%
3	45%	54%
2	40%	48%
1	35%	42%

- Each year the project owner must certify the level of low-income occupancy.
- Income is defined broadly in the same manner as under HUD guidelines and is not limited to taxable income. For example, imputed interest income on below-market rate deposits in qualified continuing care facilities is to be taken into account in determining tenant income.

- Tenants will still be considered to be low-income tenants provided that their income does not exceed 140% of the applicable qualifying income standard (i.e., 50% or 60% of the area median income for the current year, adjusted for family size).
- When the income of a tenant exceeds 140% of the qualifying income standard, that tenant's unit ceases to be a qualified low-income unit unless the project owner continues to rent units of comparable or smaller size that subsequently become vacant to tenants with qualifying income. Similarly, rent restrictions continue to apply to the unit until the tenant vacates the unit.
- Vacated low-income units are still considered to be qualified low-income housing units (unless rented to non-eligible tenants) assuming reasonable attempts are made to rent the units and no comparable or smaller units are rented to non-eligible tenants.
- The OBRA of 1993 provides that an applicant may not be denied admission to a low-income housing tax credit project because the applicant holds a voucher or certificate of eligibility under Section 8 of this Housing Act of 1937.

E. RENT RESTRICTION AND DEFINITION OF GROSS RENT

- Residential units do not constitute qualified low-income housing units unless they are rent restricted.
- The gross rent paid by a tenant may not exceed 30% of the qualifying income standard (i.e., 50% or 60% of area median income for the current year, adjusted for family size).
- 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 defined as the total rental or occupancy charges for a unit including all utilities except telephone. If utilities are paid directly by the tenants, a utility allowance must be provided which reduces the maximum rent that can be charged to tenants. The source of utility allowances depends on the nature of the building and the existence of any government regulation or rental assistance. Utility allowances must be updated whenever rents are revised. An interested party may challenge a utility allowance under a designated procedure.
- Gross rent does not include any payments to third parties for the provision of meals, laundry, housekeeping and other services. However, payments for such services to the project owner would be includable in the definition of gross rent if such services are a condition of occupancy. If continual nursing, medical, or psychiatric care is provided, it will be presumed that such services are mandatory. For projects receiving credit allocations after 1991, meals provided in a common dining facility will be presumed to be mandatory if no practical alternative exists for tenants to obtain meals other than at the common dining facility.

- ❑ Project owners must determine whether or not tenants satisfy the income limitations based on actual family size, but must use unit size rather than family size as the basis for determining rent restrictions. For single room occupancy units or studios (units with no separate bedroom), the number of occupants is assumed to be one (1). For all other units, the number of occupants is assumed to be 1.5 times the number of separate bedrooms. The following table illustrates this:

<u>Number of Separate Bedrooms</u>	<u>Deemed Number of Occupants</u>
0-BR	1
1-BR	1-1/2
2-BR	3
3-BR	4-1/2
4-BR	6

III. LIHTC ALLOCATIONS AND PROGRAM ADMINISTRATION

ALLOCATION SYSTEM

- ❑ The LIHTC program is administered by the states through designated housing credit agencies. For example, the applicable housing credit agency in the state of Washington is the Washington State Housing Finance Commission (WSHFC), which is the same independent state agency empowered to issue tax-exempt bonds for single- and multi-family housing.
- ❑ Each state is granted annual credit authority of the greater of \$1.75 per capita per year or \$2,000,00. The \$1.75 per capita is increased annually for each year after 2002 by a cost of living adjustment. The 2008 per capital allocation is \$2.00.
- ❑ Certain projects financed with tax-exempt bonds are eligible for LIHTC without receiving an allocation and without reducing 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 and to give consideration to other available subsidies committed to the project and to adjust the amount of credit allocated to the project accordingly.
- ❑ State housing credit agencies are required to consider as a factor in project evaluations the degree to which each credit dollar would be used for project costs, not including the cost of intermediaries.
- ❑ The consideration of other sources of financing, other available subsidies, the amount of credit needed by a project to be financially feasible, and the degree to which each credit dollar would be used for project costs is typically accomplished through an equity gap analysis and the selection of a tax credit equity factor.

- ❑ The OBRA of 1993 requires a housing credit agency to consider the reasonableness of the developmental and operational costs of a project as an additional factor in making its determination as to the proper amount of low-income housing tax credits to allocate to a project. However, the provision is not intended to create a national standard of reasonableness. It is intended for allocating agencies to set standards of reasonableness reflecting the applicable facts and circumstances including the location of the projects and the uses for which the projects are built.
- ❑ Not less than 10% of each state's annual credit authority must be reserved for the exclusive use of qualified nonprofit organizations. The nonprofit organization must materially participate in the development and operation of the project and must own (directly or indirectly) an interest in the project throughout the 15-year compliance period. Finally, the nonprofit organization may not be affiliated with or controlled by a for-profit organization.

IV. DETERMINATION OF ANNUAL LIHTC

- ❑ The annual LIHTC amount during the 10-year credit period is based on a formula which consists of multiplying the "qualified basis" of each low-income building in the project (determined as of December 31 of each year during the credit period) by the annual "credit percentage".
- ❑ At the election of the taxpayer, the 10-year credit period may begin either in the year in which each low-income building in the project is placed in service or in the subsequent 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.
- ❑ A first year credit adjustment is required to reflect the actual low-income occupancy for the year (determined on a monthly basis), and the balance of the annual LIHTC amount from the first year is available in the eleventh year.
- ❑ Qualified basis is the fraction of a project's eligible basis attributable to the acquisition and rehabilitation or construction of qualified low-income housing units. The low-income fraction for a project is based on the lesser of the ratio of the number of qualified low-income housing units to the number of total residential units in the project or 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 project.
- ❑ The IRS has ruled that the adjusted basis of a unit in a qualified low-income building 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). Such ruling probably would 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.

- ❑ Eligible basis consists of (i) the properly capitalized and depreciable costs of new construction, (ii) the properly capitalized and depreciable costs of a substantial rehabilitation, and (iii) the cost of acquisition of certain existing buildings if a substantial rehabilitation is performed, and is determined at the end of the first taxable year of the credit period.
- ❑ In certain qualified census tracts or difficult to develop areas designated by HUD, the eligible basis of new construction or substantial rehabilitation expenditures will be deemed to be equal to 130% of the amount that the eligible basis would otherwise be. This effectively increases the maximum potential annual credit allocation, although the final allocation will be subject to the state housing credit agency's project evaluation and equity gap analysis.
- ❑ Eligible basis consists only of properly capitalized and depreciable costs, including furnishings and other personal property, but excluding 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 allowed which is attributable to residential rental property.
- ❑ In connection with certain transitional housing for the homeless, eligible basis may include any portion of a building used to provide supportive service.
- ❑ The annual "credit percentage" which is used to determine the annual LIHTC 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.
- ❑ A 70% present value credit (commonly referred to as the "9% credit") is allowed in connection with the new construction or substantial rehabilitation of qualified low-income housing units provided they are not financed with tax-exempt bonds, below-market rate federal loans or other federal subsidies.
- ❑ A 30% present value credit ((commonly referred to as the "4% credit") is allowed in connection with the 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 of existing qualified low-income housing units not previously placed in service in the preceding 10 years provided such units are to be substantially rehabilitated.
- ❑ The 70% and 30% present value credit percentages are published monthly by the Treasury Department based on a formula. The following table identifies the 2007 monthly credit percentages.

2007	70%	30%
January	8.00%	3.46%
February	8.11%	3.48%
March	8.15%	3.49%
April	8.10%	3.47%
May	8.11%	3.47%
June	8.11%	3.48%
July	7.18%	3.50%
August	7.21%	3.52%
September	8.15%	3.49%
October	8.07%	3.46%
November	8.08%	3.46%
December	8.03%	3.44%

- A project owner is allowed to elect either to use the credit percentage published for the month in which the owner enters into a credit reservation contract with the allocating housing agency (provided a written election is made within the first 5 days of the following month) or to use the credit percentage published for the month each building is placed in service. The credit percentage will remain the same for the entire 10-year credit period.
- A substantial rehabilitation is a rehabilitation in which the rehabilitation expenditures during a given 24-month period equal or exceed the greater of \$3,000 per low-income unit or 10% of the unadjusted basis of the building as of the beginning of the applicable 24-month period.
- The credit period with respect to acquisition costs may not begin prior to the credit period for the related rehabilitation costs.

V. TREATMENT OF OTHER SUBSIDIES

- The amount of any federal grant must be excluded from eligible basis. Non-federal grants arguably are not excluded from eligible basis, although the IRS has raised concerns regarding this result. Accordingly, most non-federal grants have been restructured as deferred loans.
- The project owner may elect to exclude the amount of any tax-exempt financing or below-market rate federal loan from the eligible basis of new construction or substantial rehabilitation and apply the 70% present value credit to the remaining eligible basis in lieu of applying the 30% present value credit to the entire eligible basis.
- Repayment of tax-exempt financing or below-market rate federal loans before the date the project is placed in service does not result in the reduction in the amount of any LIHTC available.
- Below-market rate federal loans include Farmers Home Administration Section 515 loans and any loans made or subsidized, directly or indirectly, with funds from Urban Development Action Grants, Housing Development Grants, Rental Rehabilitation Grants, or other federal grant or loan programs where the interest rate to the project is below the Applicable Federal Rate (which depends on the date and term of the loan).
- Grants or below-market rate loans from state or local government agencies funded from the proceeds of tax-exempt bonds will be considered to be federal subsidies. Where state or local funding sources include general revenues, other revenues (e.g., earnings on security deposits of broker deposits) and tax-exempt bond proceeds, grants and loans should be funded only out of general or other revenues to the extent possible.
- The OBRA of 1993 provides that a building will not be treated as federally subsidized solely by reason of receiving below market financing derived from Federal HOME Program funds if at least 40% of the residential units in such building are occupied by individuals with income at or below 50% of the area median income (or at least 25% of such units in projects located in certain high cost areas, although the 130% high cost area adjustment to eligible projects which may be otherwise available is not available in this context).
- A below-market rate loan will not be considered to be a below-market rate federal loan solely by reason of receiving an interest subsidy under the FHLB Affordable Housing Program.
- Certain Community Development Block Grants are excluded from being treated as below-market rate federal loans.
- State or local below-market rate loans do not reduce the amount of the LIHTC.

- ❑ LIHTC is denied to projects receiving Section 8 moderate rehabilitation assistance (other than those funded under the Stuart B. McKinney Homeless Assistance Act of 1988) but not to those receiving Section 8 tenant or project-based assistance (i.e., vouchers or certificates).
- ❑ The LIHTC attributable to acquisition costs of existing qualified low-income housing units is based on the 30% present value credit and therefore is unaffected by how they are financed (other than by federal grants if acquisition credit on existing buildings are anticipated).
- ❑ The determination of whether new construction or rehabilitation is federally subsidized is made without regard to the source of financing for the acquisition of land or an existing building.

VI. COMPLIANCE MONITORING

- ❑ The RRA of 1990 mandated compliance monitoring of LIHTC projects by state housing credit agencies beginning as of January 1, 1992. A monitoring procedure must be included in a qualified allocation plan and such monitoring must apply to all LIHTC projects, including projects with LIHTC allocations prior to 1992.
- ❑ Proposed rules for compliance monitoring of LIHTC projects were published by the IRS on December 27, 1991. Final rules were published on September 2, 1992, and were effective on June 30, 1993. However, the requirement that qualified allocation plans provide a monitoring procedure is effective January 1, 1992.
- ❑ Under the proposed regulations, a monitoring procedure must contain certain recordkeeping and retention provisions, certification and review provisions, auditing provisions, and provisions for notifying project owners and the IRS of noncompliance or lack of certification. The provisions specified in the regulations are minimum requirements. A compliance procedure may contain additional or more strict provisions or requirements.
- ❑ A monitoring procedure must contain certain recordkeeping and record retention provisions, certification and review provisions, an auditing provision, and provisions for notifying owners and the IRS of noncompliance or lack of certification.
- ❑ A monitoring procedure must require LIHTC project owners to 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.
- ❑ A monitoring procedure must require the records for each building be kept a minimum of six (6) years beyond the end of the building's compliance period.

- ❑ A monitoring procedure must require LIHTC project owners to certify at least annually under penalty of perjury that the project meets the applicable minimum set-aside requirements.
- ❑ In addition, the monitoring procedure must require LIHTC project owners to certify under penalty of perjury that such 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.
- ❑ The monitoring procedure must require the above certifications be made at least annually through the end of the 15-year compliance period.
- ❑ A monitoring procedure must provide for review by state housing credit agencies of certain records kept by LIHTC project owners. Such a review procedure must require either (1) that LIHTC project owners submit to the state housing credit agency copies of annual low-income certifications along with supporting documentation from each low-income tenant, or (2) that the state housing credit agency inspect a reasonable number of LIHTC projects each year.
- ❑ If a state housing credit agency elects to inspect a reasonable number of LIHTC projects each year, at a minimum the inspection must include an on-site review of the annual low-income certifications along with supporting documentation from each low-income tenant for that year. The LIHTC projects to be inspected must be selected in a manner that will not give owners advance notice that their records will or will not be inspected for a particular year. However, the housing agency may give an owner reasonable notice (e.g., 30 days advance notice) that an inspection will occur so that the owner may assemble records.
- ❑ A monitoring procedure may exempt from the certification and review requirements certain buildings that are subject to other monitoring programs. Exempted buildings include buildings financed under the Farmers Home Administration (FmHA) Section 515 program or buildings of which 50% or more of the aggregate basis is financed with the proceeds of tax-exempt private activity bonds.
- ❑ The monitoring procedure must require the owner of any exempted building to certify at least annually under penalty of perjury that the building complies with the applicable requirements of the FmHA assistance or tax-exempt financing, and that the minimum set-aside, tenant income, rent-restriction and suitability-for-occupancy requirements are also

met, or to inform the housing credit agency if they are unable to make one or more of the required certifications.

- ❑ The monitoring procedure must give the state housing credit agency the right to perform an audit of any LIHTC project at least through the end of the compliance period. An audit includes an inspection of any building in the project as well as a review of the relevant records required to be maintained.
- ❑ A monitoring procedure must require state housing credit agencies to notify LIHTC project owners in writing as soon as possible if the agency does not receive the required certifications, or if the agency discovers that the project is not in compliance. Owners must be provided an opportunity to supply missing certifications or to correct noncompliance within a correction period (not to exceed 90 days from the date of the notice) and may be provided an extension of up to six (6) months if the agency determines there is good cause for granting the extension.
- ❑ The monitoring procedure must provide that state housing credit agencies are to notify the IRS of an owner's noncompliance or failure to certify no later than 45 days after the end of the correction period (whether or not the matter is corrected) by filing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance. The agency must explain on Form 8823 the nature of the noncompliance or failure to certify and indicate whether the matter has been corrected.
- ❑ State housing credit agencies may retain agents or other private contractors to perform compliance monitoring and may be delegated all of the agencies' functions to monitor compliance, except for the responsibility of filing Form 8823. The agencies must use reasonable diligence to ensure that agents or other private contractors properly perform the delegated monitoring functions.
- ❑ The proposed regulations do not address issues relating to state housing credit agency administrative fees. However, nothing prohibits an agency from charging a fee for covering administrative expenses in monitoring compliance.
- ❑ The OBRA of 1993 authorizes the Treasury Department to provide a waiver of penalties for de minimis errors in the application of the low-income tenant occupancy requirement.
- ❑ The OBRA of 1993 authorizes the Treasury Department to grant a waiver from the annual recertification of tenant income for tenants in buildings that are occupied entirely by low-income tenants. The new rules also provide that third-party verification of a tenant's or prospective tenant's income from his combined assets is not necessary if (1) the combined assets do not exceed \$5,000 and (2) the tenant or prospective tenant provides a signed, sworn statement to this effect to the building.

VII. APPLICATION OF IRC SECTION 183 NOT-FOR-PROFIT RULES TO LIHTC PROJECTS

- In general, IRC Section 183 disallows losses, deductions or credits attributable to activities not engaged in for-profit activities.
- On June 10, 1992, the IRS adopted final regulations (Regs. Section 1.42-4) which provide that, in the case of a qualified low-income building with respect to which the LIHTC is allowable under IRC Section 42, IRC Section 183 does not apply to disallow losses, deductions or credits attributable to the ownership and operation of the building. The regulations are retroactive for all qualified low-income buildings placed in service after December 31, 1986.
- The regulations provide some additional flexibility in structuring LIHTC investments. They could be interpreted to support disproportionate sharing of economic benefits (if any) in favor of the sponsor or favorable buy-out provisions in favor of the sponsor. However, the regulations specifically state that losses, deductions or credits attributable to the ownership and operation of a qualified low-income building may be limited or disallowed under other statutory provisions or principles of tax law. The regulations cite as examples the general business credit limitations, interest expense limitations, at-risk limitations, and the passive activity limitations and case law examples dealing with the analysis of sham transactions, economic substance and ownership.
- In light of the regulations and the fact that most LIHTC projects are owned and operated in a partnership or limited liability company setting, the most important limitations on the availability of the related tax benefits are in the regulations under IRC Section 704(b) dealing with partnership allocations.

VIII. PARTNERSHIP ALLOCATIONS

- It is not possible to transfer or sell low-income housing tax credits separate and apart from the LIHTC project. The credits are available only to the owner or owners of the LIHTC project. However, it is possible to transfer a LIHTC project together with the credits either prior to or during the 10-year credit period and all or the remaining portion of such credits will be available to the transferee provided the transferee complies with the requirements of the LIHTC program.
- The goal of allocating tax benefits and economic benefits disproportionately among different parties can be accomplished (within reasonable limitations) by using a partnership vehicle for the ownership of a LIHTC project. For federal income tax purposes, a partnership is treated as a conduit or pass-through entity whereby all partnership tax items are taxed to the individual partners and are allocable among the partners pursuant to a partnership agreement, subject to regulations which determine the validity of partnership allocations.
- A limited liability company is treated as a partnership for federal income tax purposes. All references to partners includes members of a limited liability company and references to

partnerships include limited liability companies.

- ❑ A typical LIHTC partnership or limited liability company will often provide that 99.9% of all tax credits and taxable losses will be allocable to the investor(s) and .01% to the sponsor, and 20% of all cash flow from operations and proceeds from sale or refinancing of the project will be allocable to the investor(s) and 80% to the sponsor. Note that such an allocation of cash flow from operations and proceeds from sale or refinancing of the project may not be available to a nonprofit general partner without lengthening the depreciation schedule for the Project. The validity of such allocations must be determined pursuant to the regulations under IRC Section 704(b).
- ❑ The applicable regulations do not specifically address the allocation of low-income housing tax credits among partners. The only provisions that address the allocation of tax credits generally were drafted prior to the enactment of the LIHTC program. These regulations distinguish between the investment tax credit and other credits and recognize a long-standing safe harbor for allocating the investment tax credit among partners in accordance with the same manner in which they share partnership profits as of the date the investment tax credit property is placed in service.
- ❑ However, the LIHTC technically is not an investment tax credit, and, while there are similarities, there are significant differences under the LIHTC program. For example, the investment tax credit is a one-time credit earned when the property is placed in service and the LIHTC is a credit earned each year for 10 years based on continued compliance under the LIHTC program. Similarly, it would seem inappropriate to allocate the LIHTC in accordance with the manner in which the partners share partnership profits in light of the fact that investors generally do not expect to generate profits from LIHTC investments, nor are they required to do so under IRC Section 183.
- ❑ Most commentators believe that the applicable regulations that control are those that address the allocation of credits other than the investment tax credit. These regulations indicate that credits which are attributable to partnership expenditures should be allocated in the same manner as losses and deductions attributable to the expenditures which give rise to such credits. Thus, since the LIHTC is attributable to expenditures for the acquisition and substantial rehabilitation or new construction of low-income housing, the LIHTC should be allocated among the partners of a partnership in the same manner as the ordinary losses, depreciation and other deductions from the ownership and operation of the low-income housing.
- ❑ Based on the above conclusion that the LIHTC should be allocated in accordance with partnership losses and deductions, the focus in determining the validity of allocations in a LIHTC partnership is on the validity of the loss allocations during the entire term of the partnership, but 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) are valid (i.e., 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 account, 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 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 ameliorate their limited liability as limited partners. However, it may be advisable to provide investors the right to adopt optional limited (as opposed to unlimited) deficit restoration obligations under the partnership agreement in the event the partnership may unexpectedly in the future have some recourse indebtedness or temporarily may not technically have partnership minimum gain to support the allocation of nonrecourse deductions.
- ❑ In light of the unacceptability of deficit restoration obligations, the importance of having nonrecourse financing and the appropriate provisions in the partnership agreement cannot be overemphasized. 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 such partners 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. Ideally, partner capital accounts and partnership minimum gain should be projected over the anticipated holding period (e.g., the 15-year compliance period) based on projected partnership losses and distributions to identify any potential allocation problems.
- ❑ Some investors insist that all partnership allocations from the ownership and operation of a LIHTC project be consistent during the holding period to provide even greater certainty that such allocations will be deemed to be valid. The applicable regulations provide that, in the absence of having substantial economic effect, an allocation will be deemed to have substantial economic effect if it is made in accordance with the partners' interests in the partnership. If all allocations are consistent, such allocations are likely to be in accordance with the partners' interests in the partnership. Therefore, it is not unusual to see 99.9% of all items of income, gain, loss, deduction and credit and all distributable cash flow from operations allocated to the investor(s)-partner(s) in a LIHTC partnership.

- ❑ The payment of a reasonable management fee or incentive management fee should not be considered to be a partnership allocation or distribution, but will reduce the amount of distributable cash flow and reduce the amount of partnership taxable income or increase the amount of partnership taxable loss allocable to the investor(s)-partner(s). The result is that the general partner-sponsor is subject to tax on the incentive management fee income and the investor(s)-partner(s) receive an additional tax benefit from the deductible fee. The arrangement is particularly attractive to a nonprofit sponsor who is not taxable on the fee income. However, the amount of the fee is the subject of much discussion and negotiation to ensure that all parties and their respective tax advisors feel comfortable that the fee will in fact be deemed a reasonable fee and not a distribution.
- ❑ Maintaining consistent allocations (i.e., .99% of all items) generally does not apply to residual allocations of proceeds from the sale or refinancing of the LIHTC project (which generally may provide up to 80% of such receipts to the general partner) except in certain cases involving nonprofit general partner-sponsors where consistency among all allocations including residual allocations is necessary to avoid the impact of the tax-exempt use rules which result in the imposition of 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.
- ❑ There are several techniques which can enable a general partner-sponsor to retain a larger share of cash flow from operations. One technique is to provide for a fixed annual or inflation-adjusted asset management or partnership management fee before applying the standard cash flow sharing or incentive management fee arrangement. The result, depending on the level of the fixed annual or inflation-adjusted fee, can be that the sponsor effectively retains significantly more of the cash flow from operations.
- ❑ Another technique corresponds to the not uncommon situation where the general partner-sponsor defers a portion of its maximum allowable development fee. To be included in Eligible Basis, the maximum allowable development fee must be paid in full during the initial compliance period. There exists some difference of opinion on the outside date for such payment but most investors are comfortable with a 13 year period.
- ❑ The portion of the maximum allowable development fee which is loaned back to the partnership (frequently referred to as the deferred development fee loan) can be repaid first out of available partnership cash flow, together with interest at a rate equal to or greater than the applicable federal rate, before the distribution of cash flow to partners.