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The Professional Property Manager's Guide to the Low-Income Housing Tax Credit

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FOREWORD

In 1987, I wrote the first edition of A Site Manager's Guide to the Low Income Housing Tax Credit. It was 19 pages long and concerned itself almost entirely with issues relating to income and rent. While Section 42 of the Internal Revenue Code ("IRC") has always been long and complex (this is the section of the IRC that governs the Low-Income Housing Tax Credit Program), in the early days of the Program, there was very little guidance from the IRS regarding property operations. Since 2012, I have tried to keep the number of pages around 100, but with program changes and added complexity, that has not been possible. However, my goal is stll not to overwhelm but to inform. One major program change has occurred since 2013 (the Average Income Minimum set aside), which is reflected in this edition. You will find a full discussion of Change 4 of HUD Handbook 4350.3 and changes in student rules relating to same-sex married couples. In addition, recent changes to income determination rules (part of the HUD Final HOTMA Rule) are covered in detail. As always, I have kept the Guide as short as possible. The reason for this relative brevity is simple – I have tried to eliminate any information that is not useful to management personnel while including everything managers need to know.

As I complete this update in April 2024, the tax credit program has matured and is also threatened by events at the National level. In early 2024, the equity market is healthy, and the program was left intact by the recent tax law changes. More changes to the program are possible in 2024, but as of April 2024, the information in this book is up-to-date.

Having said this, it is the reader's responsibility to stay abreast of current laws and regulations, including the requirements of the various allocating and monitoring agencies involved in the Section 42 program. I hope that this guide will be a useful tool as you work to comply with the multitude of rules governing your property, but it is only one of many resources available to you.

The guidance provided here reflects my interpretation of Internal Revenue Code regulations and procedures – not the requirements of individual state and local agencies. We are long past the days when knowing how to set rent and verify income was adequate for management personnel – it is now equally as important to understand complex issues impacting the eligible basis and applicable fraction of our properties. While this Guide will continue to be very useful to site staff, it is written to also serve as a comprehensive reference for senior-level property managers, asset managers, and compliance staff.

Finally, I am a "working author," in that my company reviews many properties for various clients. I enjoy working with individual clients the most. So, if you've bought this Guide, I consider you a client; if you have any questions, give me a call at (757) 259-9920 or email me at aj.ajjcs@gmail.com.

This manual does not provide legal or accounting advice. Laws, regulations, and interpretations can change, and owners are advised to consult with qualified legal and tax advisors regarding their properties' compliance.

Introduction

When I last updated this Guide in 2019, the LIHTC program was stable, generating significant numbers of affordable housing units. As of April 2024, the same circumstances apply. The program is mature and popular, but care must be taken to protect the integrity of the program. Since 2019, the LIHTC program has undergone notable changes to enhance its effectiveness in addressing affordable housing challenges. Reforms include an increased allocation authority, permitting income averaging, and a 4% fixed rate for bond-financed projects. The adjustments aim to stimulate more affordable housing production and attract private investment. Moreover, temporary relief measures were introduced in response to the COVID-19 pandemic, offering deadline extensions and easing certain compliance requirements. In 2023, HUD published a final Housing Opportunities Through Modernization Act (HOTMA) rule. A number of the HOTMA changes impact the LIHTC program, and those are covered in this updated Guide. HUD also implemented the National Standards for the Physical Inspection of Real Estate (NSPIRE). The jury is still out on how significantly NSPIRE will impact LIHTC properties, but at the very least, it has changed the physical inspection approach of many Housing Credit Agencies.

Compliance differences between state agencies remain, and this is not likely to change. In general, however, the industry now understands what procedures are required at the operational level to minimize risk to credits.

The publication of the IRS Audit Guide has further improved our understanding of IRS expectations relative to the operation of LIHTC projects. This increased level of understanding means that owners and managers now have no excuse for compliance shortcomings.
Continuing education in the credit field and the willingness to draw on knowledgeable resources are requirements of the modern tax credit practitioner.

The 1990 Amendments to Section 42 of the Internal Revenue Code (which governs the tax credit program) require compliance monitoring for <u>all</u> properties utilizing the credit. This monitoring became effective on January 1, 1992, and the responsibility for it rests with the allocating agencies. The exact way each agency will conduct its monitoring must be outlined in the State's Allocation Plan.

In accordance with IRS compliance regulations, State Housing Finance Agencies were required (beginning 01/01/01) to review all new buildings and 20% of low-income units and resident files by the end of the second year after the year in which the last building in the project is placed in service. After that, HFAs will review a certain percentage (generally 20%) of units and files every three (3) years.

It is to assist persons responsible for oversight of tax credit properties in their understanding of the LIHTC program that this guide has been prepared. I do not intend to outline the highly technical and complex requirements governing the use of the credit, nor do I offer legal or accounting advice. Questions regarding specific legal or tax issues should be discussed with legal or tax professionals.

This guide will hopefully assist the reader's understanding of tax credit requirements related to management and compliance issues in enough detail to operate projects that utilize the credit successfully. It will also assist operators of LIHTC properties in understanding the difference between State Agency requirements and the tax-related requirements of the IRS.

Once a property is built, management becomes the critical component of success. In fact, it is my sincere belief that if there is one potential danger to the survival of the tax credit program, it is in the area of compliance.

Management is responsible for exercising "due diligence" in ensuring that qualified households occupy tax credit units. "Due diligence," as defined by Blacks Law Dictionary, is "such measure of prudence, activity, or assiduity (the big legal word for "effort"), as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances; not measured by any absolute standard but depending upon the relative facts of the special case."

So, what does the IRS (and most State Agencies) expect regarding due diligence? As stated above, it will depend on the facts of any particular case. Still, it is safe to say that to be considered diligent for tax credit purposes, each of the following elements will have to be present on a tax credit property:

1) Management must ensure that all household income is identified;
2) Management must inquire about additional roommates when there are more bedrooms in a unit than occupants;
3) Information relating to tenant eligibility must be verified;
4) Independent reviews of compliance should be performed;
5) Properties must be kept in good physical condition, with regular inspections (violations relating to the physical condition of properties are the most reported noncompliance events);
6) Recertifications (if required) must be up-to-date;
7) Management must inquire about changes in household size, jobs, or student status;
8) All common areas must be operated in accordance with IRS rules and
9) Rents and utility allowances must be properly determined, and no inappropriate fees charged.

With this level of diligence in mind, this Guide has been written.

A Quick Note on the IRS

To many tax credit managers, the IRS is like the “boogeyman” lurking in the darkness - never truly seen, yet a consistently unsettling thought. Unlike the “boogeyman,” the IRS is a real entity. While an IRS visit to your property is unlikely, audits of LIHTC properties occur. The positive aspect is that minimizing the likelihood of an IRS audit isn’t complex. Operate your property in alignment with the program rules, and you should be in good standing. In fact, although no guarantees exist regarding the IRS, adhering to sound management and compliance practices significantly aids in averting heightened levels of IRS scrutiny.

It is important to remember that the IRS conducts thorough property examinations. They will address matters that may not appear initially linked to on-site compliance but still signal potential noncompliance. For instance, based on IRS guidance, during a tour of Section 42 properties, agents might search for the following:

1) Signage and advertising: what indications are there that the property is affordable/low-income? Is it being marketed as luxury or student housing?
2) Is the amount of common area reasonable in relation to the residential units? If there seems to be an excess common area, what is it used for?
3) Are the buildings and grounds well-maintained and safe?

4) What types of vehicles do the tenants drive, and are there student stickers on the cars?
5) Are there any colleges, universities, or other educational institutions close at hand?

So, the basic rule in preparing for the IRS is – don't! If you follow the suggestions outlined in this Guide and learn what special rules your State Agency may have, you will have done all you can to protect the property's credits.

Those of you with previous editions of the Guide will note considerably more technical detail in this edition. However, as in the past, I've kept the material as understandable as possible while still providing the information you need to stay in compliance.

I offer a suggestion that, if implemented, can significantly simplify on-site management. The Tax Credit Program establishes income eligibility in accordance with the requirements of the HUD Section 8 Program. The Section 8 Program requirements are contained within HUD Handbook 4350.3, REV. 1, CHG. 4, and you would be well advised to obtain a copy. The HUD Area Office in your State can tell you how to obtain a copy, or you may download a copy from the web at www.hudclips.org.

What is the Low Income Housing Tax Credit?

The LIHTC program provides tax credits to owners of “qualified” low-income housing units. The owners generally take the credits each year for ten (or 11) years but must maintain the low-income status of the housing for period of at least 30 years (compliance with IRS rules is required for the first 15 years – known as the “compliance period”). These federal credits reduce an investors federal tax liability on a dollar-for-dollar basis (e.g., a million dollars in tax credits means a million dollars less in federal taxes).

The value of the credit varies, depending on how the housing is financed, and whether the building is existing, new, or rehabilitated. The annual credits are 9% of the qualified cost (“basis”) of low-income units for new construction or renovation. However, if the project uses tax-exempt bonds, the credit is worth 4% of basis. For purposes of simplicity, I will refer to these as the 4% and 9% credit. Existing buildings that are acquired may claim only the lower (4%) credit on the cost of acquisition, regardless of the type of financing, and, in some cases, the previous owner must have owned them for at least 10 years.

Example of Value

Project A, a 100% low-income property, costs $10,000,000 to build, not including the cost of land. All the units in the project are low-income. The project does not use tax-exempt bonds, so is eligible for the larger (9%) credit. 9% of $10,000,000 is $900,000. The owner may claim this $900,000 credit each year for ten years, for a total tax credit of $9,000,000.

Project B also costs $10,000,000 to build (not counting land cost) but uses federal tax-exempt bonds to finance the development. This complex is eligible for only the 4% credit, or $400,000 per year. Over a ten-year period, the owner will be entitled to $4,000,000 in credits, which is $5,000,000 less than the conventionally financed project.

Although the tax credit for a conventionally financed development is obviously more valuable than that available with bond financing, the conventional projects are often not feasible due to the stiff competition for the 9% credits. This has led to an increase in the use of the 4% credits that are obtained through tax-exempt bond financing. When bonds are used to finance at least 50% of the cost of a property, credit can often be obtained without competing in the State allocation process.

All tax-credit properties have a 15-year compliance period, during which IRS rules must be followed. After this initial compliance period, there will be at least an additional 15-year "extended use period." We'll cover the extended use period later.

What is a “Qualified Low-Income Housing Project?”

In order to utilize any tax credits, a development must adhere to seven major qualifying criteria – income and rent restrictions, physical condition requirements, resident eligibility, existence of an extended use agreement, non-transient units, and in some cases, annual recertification of residents. The developer of a tax credit project also has a choice between three “minimum set-aside tests.” The first is referred to as the “20/50 test,” and requires that 20% or more of the units in the development be occupied by tenants whose incomes are 50% or less of the median gross income, as adjusted for family size. The second set aside is the “40/60 test,” and requires that 40% or more of the units be occupied by tenants whose incomes are 60% or less of the median gross income (25% in New York City), again adjusted according to family size. In addition to the 20/50 and 40/60 minimum set-aside tests, a new minimum set-aside test was established by Congress in March 2018. This new set-aside is the 40/60 (average income) test, known as the “Average Income” minimum set-aside. If this new test is elected, a project will be required to rent at least 40 percent (25 percent in New York City) 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 owner of the project will designate the imputed income limit for each low-income unit. The average of the imputed income limit may not exceed 60 percent of the area median gross income. The imputed income limits for units shall be 20 percent, 30 percent, 40 percent, 50 percent, 60 percent, 70 percent, or 80 percent of the area median gross income.

This new set-aside will permit a broader range of incomes in LIHTC projects and increase the feasibility of many deals, especially in high-cost areas. As noted above, in New York City, the 40/60 test is replaced with the 25/60 test, meaning that at least 25% of units must be rented at or below 60% of the area-wide median gross income ("AMGI"). For projects with the Average Income election in New York City, at least 25% of the units must be low-income, and the average of the imputed income limits for those units may not exceed 60%.

An owner must choose one of these "threshold" tests in order to qualify the project for tax credits, and once made, the election may not be changed. This election is made prior to claiming credits for the project and is made on IRS Form 8609. The deadline for meeting this minimum set-aside test is the end of the partnership tax year after the year in which the last building in a project is placed in service. For example, if the last building in a project was placed in service in March 2023, the minimum set-aside would have to be met by December 31, 2024 (assuming a calendar tax year.) If this minimum set-aside is not met by this date, the entire credit allocation will be lost.

However, if the project is in a Presidentially declared disaster area, an extension of up to one-year may be possible. In addition to meeting the minimum set-aside by this date, all units for which credits are desired should also be qualified by the same date. Even if the minimum set-aside is met, any unit not qualified as low-income by that date will not be able to claim full tax credits.

As a manager, it is important to know which of these tests the owner has selected since it will determine the maximum eligible incomes for your property and the maximum rent levels. Hopefully, the 40/60 or Average Income tests will be chosen, and you will have the highest possible income. However, you must know whether or not the owner made any special promises to the State Housing Finance Agency (HFA) to obtain the credits. Allocation of tax credits is a very competitive process, and owners often promise to limit occupancy to households with income lower than those mandated by Section 42 (such as keeping a portion of the units for persons at 50% or 40% of median income) to score higher on their applications. If this has happened, you need to know it. These required lower income limits are also one of the main reasons many owners will want to elect the Average Income minimum set aside. By making this election, owners can offset the lower rents of the 40% and 50% units with rents for 70% and 80% units.

A rent test must also be met to qualify a unit. The maximum rent is based on the number of bedrooms, assuming an occupancy of 1.5 persons per bedroom. (A detailed explanation of this calculation is contained elsewhere in this Guide.)

Generally, tax credits are used only on “traditional” residential rental complexes, including apartments, single-room occupancy (SRO’s), and homeless shelters. Credits may also be claimed for rental buildings configured as single-family dwellings, townhouses, row houses, duplexes, and condos. The credit may be used with cooperatives, but the investor partnership must own these leasing cooperatives, and there may then be a Master Lease between the owning partnership and the Cooperative.

The Co-op may not receive any credits or other tax benefits (i.e., depreciation, interest deduction, and real estate tax deductions). All such benefits go to the owning partnership.
When discussing credit compliance issues, we are sometimes concerned with each <u>building</u> (individually), and at other times we talk about the <u>project</u>. Multiple buildings qualify as a project if:

1. they are of similar construction;
2. are on the same tract of land (a scattered site project may qualify if all other conditions are met and the project is 100% rent-restricted);
3. all buildings have the same owner for tax purposes and
4. there is common financing.

Also, the owner must “elect” on IRS Form 8609 whether to make a building part of a multiple-building project. Otherwise, for Section 42 purposes, each building is treated as a separate project.

The Housing Manager's Role in the Tax Credit Program

In the "old" days of rental housing (before 1987), there were three basic reasons for investing in apartments. These were cash flow, appreciation, and tax benefits.

However, cash flow is usually restricted in government-assisted rental housing, either by regulation or market limitations. These same factors also restrict the future value of LIHTC properties by restricting the rents of these properties for long periods. Thus, the major ownership benefit related to affordable housing is tax savings. The financial benefit from tax savings was previously accomplished by allowing the owner (investor) to depreciate or "write off" the cost of the project buildings over a relatively short period of years. A low-income housing development could be completely depreciated in just 15 years, with the early years receiving a large portion of the write-off. The beauty of this system, from the investor's point of view, was that only 20% of the units in a development had to be occupied by low-income tenants to obtain this tax benefit for the entire project.

A complex with federal financing (such as Rural Housing Service Section 515) automatically qualified for accelerated depreciation benefits. In short, this system required minimal tenant qualification in return for maximum tax benefits.

The Low-Income Housing Tax Credit is a very different tax benefit. Although the amount of credit is calculated based on the cost of the physical structure (the project), it is also totally dependent on rental to qualified tenants at restricted rents.

This places greater burdens on site managers in tenant selection than ever before. Property management, especially the on-site and front-line property managers, now play a crucial role in determining how much tax benefit an owner is entitled to receive. Managers must not only qualify tenants according to income and other eligibility factors but also ensure that proper rent levels are maintained in compliance with tax credit guidelines and keep track of tenant income and applicable median incomes. They must also understand such obscure issues as utility allowances, what kinds of fees may be charged, and what constitutes a qualified student resident. Unfortunately, many decisions relating to these issues are made long before management becomes involved with a property. For this reason, a close working relationship between the management and development teams is necessary for a successful tax credit project.