The Low-Income Housing Tax Credit

By Jeanne L. Peterson

The Low-Income Housing Tax Credit was created by Congress in 1986 as part of the sweeping Tax Reform Act of that year and remains little known outside of the circle of affordable housing developers, syndicators, and some investors who have waded through its sometimes oblique rules to take advantage of this rather unique incentive for the creation of affordable rental housing for lower income people. This program, which has the dubious distinction of being contained in the single longest section of the Internal Revenue Code ("the Code"), and being the first federal housing program under the jurisdiction of the IRS and the Department of Treasury (instead of the Department of Housing and Urban Development), is designed to provide more affordable rental opportunities by permitting a dollar-for-dollar reduction in tax liability for owners of qualifying rental housing in exchange for their agreement that their privately owned rental units will be bound by certain income and rent restrictions over an extended period of time.

The credit available to the owner of such a property is a percentage of the owner's "qualified basis" in the affordable units and is available to be used by the taxpayer, once allocated, on an annual basis over a ten-year period. However, unlike some other federal tax credits—such as the child care credit—an owner of affordable rental housing cannot simply claim the credit on his or her tax return. Rather, this credit is allocated to owners by state credit agencies, and, for all except tax-exempt financed apartments, pursuant to a total annual authorization by Congress equal, in each state, to $1.25 per state resident. In Michigan, an annual minimum non-cumulative total of approximately $11.8 million in tax credits, based on this population, is available to award.[1] (Additional credit may be available based on unused, recaptured amounts and, conceivably, under certain circumstances, allocation from a national pool of credit unused by other states. To date, Michigan has not qualified for distribution from the national pool.)

In order to be eligible for credit, a building must meet certain minimum set-asides or a percentage of units that will be income- and rent-restricted over a period of years.

Since the demise of the expensive "Section 8" program in the early 1980s, a federally-funded program for housing affordability, there has been a dearth of federal dollars available for affordable rental housing. Under Section 8, the federal government agreed with private (and sometimes public) owners to subsidize rents for specific apartment developments for 30- or 40-year periods such that tenants living in those apartments need pay (now) 30% of their incomes towards rent, with the federal subsidy paying the difference between market rent and the tenant's share. (Through "HOME" and "HOPE" legislation enacted in 1990, Congress did authorize new federal dollars for housing, although few of these funds are being used as direct tenant subsidies.)

With fewer dollars available to make housing affordable, and against a social and economic backdrop where more young people have lower paying service industry jobs and where the elderly population living on fixed incomes is ever growing, the demand for affordable housing continues to rise sharply against its supply. Public housing, often in massive structures with thousands of people living in close proximity, has not proved a successful experiment. The reform-minded 1986-87 Congress wanted to abolish some of the previously lucrative real estate tax shelters and passive loss rules that had long been the backbone of the housing industry. It also, however, was mindful of affordable housing needs and it was thus that the Low-Income Housing Tax Credit was created, as Section 42 of the IRC of 1986 (a law important enough to change the reference to the Code, which although it was regularly amended, had previously been referred to as the IRC of 1954).

Section 42 provides a tax incentive, though not a "shelter" in the traditional sense, to developers and apartment/house owners to make their units affordable over a minimum 15-year period. The program was initially authorized for calendar years 1987, 1988, and 1989. It was re-authorized in late 1989, 1990, and 1991 for one-year periods, and after a hiatus of several months when then-President Bush vetoed the tax bill in 1992, the program was permanently extended in 1993. As a result, a major funding source for private developers/owners became available, making the development and ownership of affordable housing a very viable pursuit. The following explanation of the rules associated with the program and how the credit works is, of course, not intended to be definitive, but hopefully will give interested practitioners an overview of the tax credit program, which itself has changed the housing syndication business and continues to evolve over time.

ELIGIBILITY UNDER THE CODE

With the exception of nursing homes, life care facilities, retirement homes, and trailer parks, most new residential rental properties (and existing ones that will be acquired and have not changed ownership or had major improvements in the past ten years) are eligible under the Code to receive the benefits of the tax credit. Generally, each "unit" in a tax credit project must have a bathroom and kitchen (similar to tax-exempt financing rules), and although buildings may contain commercial space and other rental apartments that are not subject to the required rent and income limitations, expenditures attributable to any such commercial space and non-qualified apartments cannot be included in determining the tax credit the project is eligible to receive.

The tax credit allocated to a development is expressed as an annual figure, although, assuming compliance with program requirements, that amount can be claimed annually for ten years. The amount is the lesser of a building's "qualified basis" times "applicable percentage," or the amount determined by the state's housing credit agency (in Michigan, the Michigan State Housing Development Authority, "MSHDA") to be necessary for the building's long-term economic feasibility and viability. The applicable percentage is determined monthly by the U.S. Department of Treasury so as to yield, over the ten-year period

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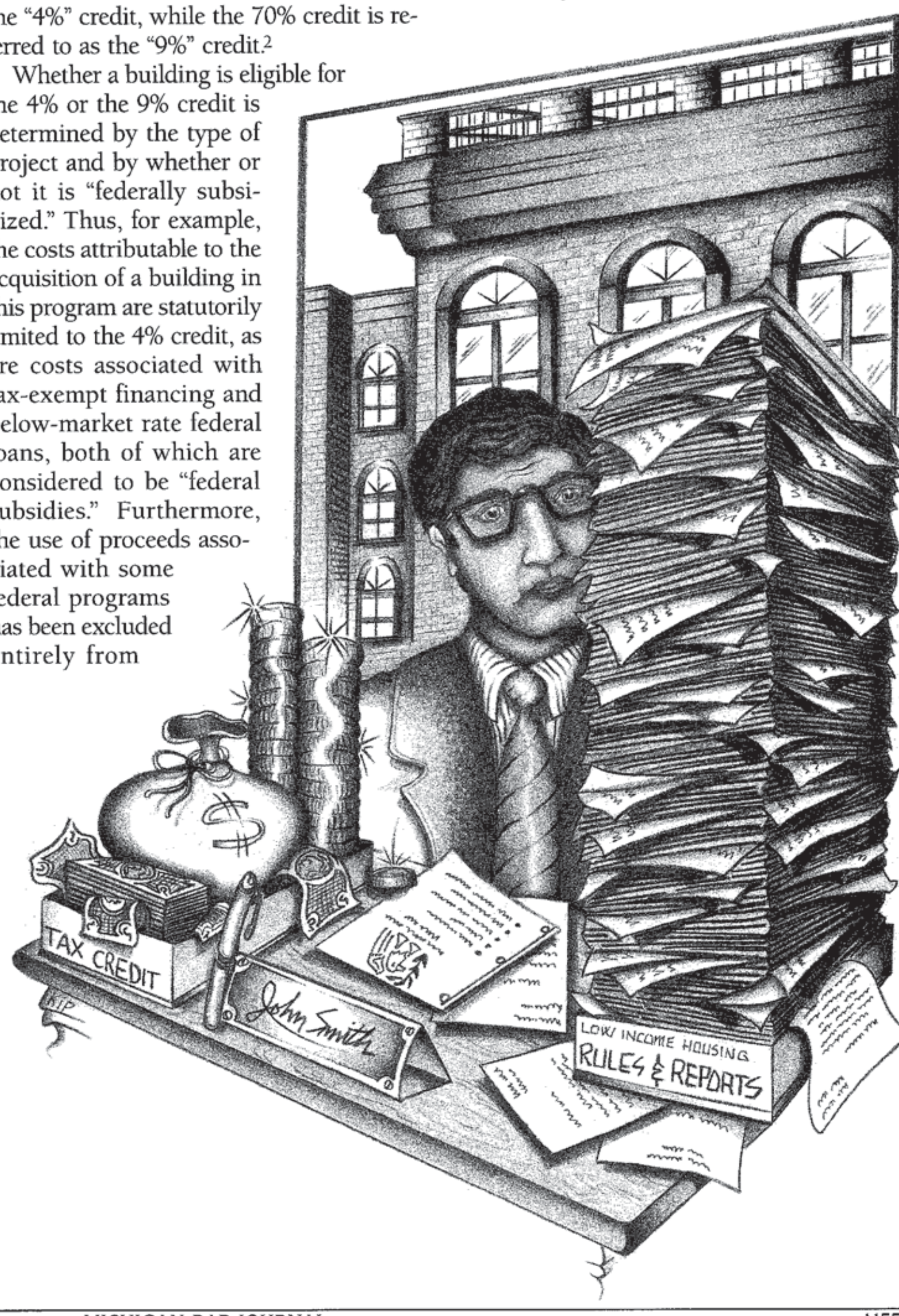
during which the credit may be claimed, a credit equal to either 70% or 30% of the present value of the qualified basis of the building. For estimation purposes, the 30% present value credit is often referred to as the "4%" credit, while the 70% credit is referred to as the "9%" credit.[2]

Whether a building is eligible for the 4% or the 9% credit is determined by the type of project and by whether or not it is "federally subsidized." Thus, for example, the costs attributable to the acquisition of a building in this program are statutorily limited to the 4% credit, as are costs associated with tax-exempt financing and below-market rate federal loans, both of which are considered to be "federal subsidies." Furthermore, the use of proceeds associated with some federal programs has been excluded entirely from being combined with tax credits (for example, the Section 8 Moderate Rehabilitation Program),[3] while the law makes specific exceptions so that the higher 9% credit may be used with others (including



loan proceeds of Community Development Block Grant funds[4] and, more recently, HOME funds if income and rent restrictions are applied to a higher percentage of tenants).

The "qualified basis" of the building is determined by multiplying its "eligible basis" by the "applicable fraction." As these phrases are terms of art, it is important to understand their meanings within the Code context.

"Eligible basis" generally means capital costs incurred with respect to the construction, rehabilitation, and acquisition of buildings that will meet certain minimum set-asides with respect to low-income tenants and concomitant restrictive rents. It does not include non-depreciable items such as land, certain financing fees attributable to permanent financing, syndication costs, etc., nor does it include costs associated with commercial facility space within the building. Eligible basis does not include any federal grant funds (although if structured as loans, with definite terms, these may be included, with a lesser applicable percentage applying). In cases where the building is not 100% tax credit-eligible, and where the market rate or non-tax credit-eligible units exceed the average quality standard of the tax credit units, a reduction in eligible basis also occurs.

Section 42(d)(5)(C) of the Code provides that in certain high cost areas, a building's eligible basis can be 130% of what it would otherwise be, thereby encouraging development of affordable housing in areas that would seem to be most in need of it. These areas are in qualified census tracts, determined by the U.S. Department of Housing and Urban Development where at least 50% of households have incomes less than 60% of the area's median income.

"Qualified basis" is a building's eligible basis multiplied by the applicable fraction. The applicable fraction is the lesser of the ratio of the number of low-income units to the total number of units or the ratio of the total floor space of the low-income units to the total floor space of all the units. Common areas and amenities for which no additional charge is made and that are available to all residents, may be included in the low-income portion. Costs attributable to a manager's unit are not included in eligible basis, nor is the unit counted in determining the applicable fraction. In a building where all units qualify, the application fraction is 1/1; where 20% of the units qualify, the applicable fraction is .2 or 1/5. This is simply a means of assuring that credit is available only for the low-income rental portion of the building.

INCOME AND RENT RESTRICTIONS

In order to be eligible for credit, a building must meet certain minimum set-asides or a percentage of units that will be income- and rent-restricted over a period of years. (Nationwide, this is rarely an issue as the vast majority of low-income housing tax credit developments are, in fact, 100% tax credit-eligible. In Michigan, however, and particularly where tax-exempt financing has been used, "mixed" income developments containing both tax credit units and market rate units are not an uncommon phenomenon.)

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An owner must elect to meet one of the following minimum set-asides:

- Either at least 20% of the project's units must be occupied (or available for occupancy) by households having incomes not exceeding 50% of area median income, adjusted for family size; or
- At least 40% of the project's units must be occupied (or available for occupancy) by households having incomes not exceeding 60% of area median income, adjusted for family size.[5]

Once the election has been made, it must be adhered to throughout the length of the program. Further, if the minimum set-aside is not met, severe consequences, in the form of taxpayer recapture of credit, befall the owner. As a result, most owners choose to have a higher than minimum percentage of eligible units.

Since permissible rents are tied to these set-asides, the owner has an important choice to make. Generally, if a project will have at least 40% tax credit units, this latter choice will be elected since the permissible rents can be higher, while if a project is utilizing tax-exempt financing, it may choose to elect the "20 at 50" set-aside since it will already be required by tax-exempt financing rules to have at least 20% of its units available for people with incomes no greater than 50% of area median income. (MSHDA's statute also requires that its borrowers have a minimum of 20% of units for people at 50% of income or below.)

The income and rent requirements of the program are continuous, and compliance is required in order to be eligible to claim the tax credit on an ongoing basis. For this reason, not only is recertification of tenant incomes an annual requirement, but change either in family composition or in family income may result in a change in whether the unit continues to qualify for tax credit purposes. In a slight nod to the difficulty in complying with the myriad of rules, the Code does provide that a unit occupied by a tenant who was initially income qualified will remain a qualified unit so long as the tenant's income does not increase by more than 40% of the qualifying income for that family's size, and the tenant's rent remains at the restricted level. Once the tenant's income becomes more than 140% of qualifying income, the unit may still qualify if the rent remains restricted *and* the next available unit of comparable or smaller size that becomes vacant is rented by qualifying tenants.[6]

Note that in a 100% tax credit building, the only time questions of this nature should arise would be if an in-place, over-income tenant wanted to move (when a tenant moves from one unit to another it is considered a new move-in) regardless of how high a tenant's income rises, since the next available unit will always be rented to a qualifying tenant. In all other buildings, however, intricate and extremely complex recordkeeping needs to be done to assure compliance with these rules.

Rents must be restricted in tax credit-eligible apartments. Initially, the Code provided that the gross rent paid by residents, inclusive of all utility charges paid by the resident except telephone and cable TV, could not exceed 30% of the applicable maximum qualifying income (based on 50% or 60% of area median, as elected above) for a family the size of the tenant's. What does this mean? It means that as a family's size changes, whether through birth, death, divorce, marriage, etc., the amount of rent that could be charged also changes, making it virtually impossible for an owner to accurately predict an income stream. In 1990, Congress changed this methodology applicable to all developments receiving tax credits beginning in that year, and to those earlier project owners who so elected, so that the maximum permissible rent is now calculated imputing a family size equal to 1.5 persons per bedroom.[7]

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EXTENDED USE REQUIREMENT

Beginning in 1990, owners of low-income housing tax credit-assisted developments have been required to enter into an extended low-income housing commitment that must be recorded as a restrictive covenant by the end of the first year in which credit is claimed. The owner and any successors are required to maintain the low-income occupancy during an initial 15-year compliance period, and for at least an additional 15 years unless certain events happen.

This covenant must be enforceable by past, present, or prospective income-qualified tenants, a requirement that dictated a change in the MSHDA statute to specifically permit standing to such people since a prospective tenant, for example, would have neither privity of estate nor privity of contract to seek specific performance of such a covenant.[8] In the event that the extended use period is ended, because no purchaser can be found, or through an act of foreclosure, the existing low-income tenants cannot be evicted (except for good cause), nor can their rents be raised above tax credit levels for a three-year period after the termination.

THE AWARD OF TAX CREDITS IN MICHIGAN

Beginning in 1990, state credit agencies were required to allocate the credit pursuant to a Qualified Allocation Plan. Section 42(m), dictates the use of certain selection criteria that must be set forth in the plan, while permitting each state the latitude to determine its own priorities according to its housing needs. Michigan's plan, promulgated after an addition to the MSHDA Act,[9] dissemination of the proposed plan, public hearings, passage by MSHDA's Board, and sign-off of the Governor, sets up three funding rounds during each calendar year, deadlines for application for those rounds, "set-asides" for funding, and a point system for scoring and ranking tax credit applications. The Code itself requires (and MSHDA's Act incorporates the requirement) that 10% of each state's allocable credit in a given year be set aside for projects in which a qualified nonprofit organization is a material participant.[10]

For these purposes, a qualified nonprofit is either a 501(c)(3) or (4), exempt from taxation under 501(a), that has as one of its exempt purposes the fostering of low-income housing and is determined by the state credit agency not to be affiliated with or controlled by a for-profit organization. Additionally, Michigan has the following set-asides: 10% for Farmers Home Section 515 projects; 10% for developments for the elderly; and 30% for developments located in eligible distressed areas.[11] To the extent that credit has not been allocated by November 1 of any year to meet these set-asides, it can thereafter be reapportioned reasonably so that it will not be lost.

Numerous pieces of documentation are required to be submitted and the process of review and evaluation is done in three stages, also as required by the Code. These stages in Michigan consist of Reservation, Commitment, and Allocation of the credit.[12] MSHDA undertakes a financial review to determine both the maximum amount of tax credit for which the development is eligible pursuant to its qualified basis, and the amount of credit necessary to achieve economic viability. For these purposes, it reviews sources and uses statements, projected and actual costs, for reasonability, and permits the inclusion of developer and builder profits.

At the first or Reservation stage, both the sources (mortgages, grants, etc.) and the uses (projected costs) are subject to change, and because syndication of the project has not yet occurred, MSHDA must estimate the net syndication proceeds that will be available to be contributed as sources for the project. As these estimates change and become firm over time, the amount of tax credit (from Reservation until Allocation) may change accordingly.

SYNDICATING THE PROJECT OR "SALE" OF THE TAX CREDIT

Neither nonprofits (because they have no tax liability to offset with the tax credit) nor often developers (because of limitations on the amount of credit that an individual can claim) can use the credit for their own accounts. For this reason, they generally use the vehicle of a limited partnership whereby limited partner investors (many individuals, or a single or several corporations) buy up to 99% of limited partner interests in the ownership of the development in return for an allocation of up to 99% of the tax credit benefits expected to be realized in the 10-year period described above.

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as well as the developer's own profit. Both public and private tax credit syndication offerings have been common in the past five years, as, in more recent times, nonprofit motivated equity funds have become frequent syndicators, in an effort to reduce syndication loads and make more of the proceeds available to the projects. The allocation of the tax credit, and of gains and losses, is frequently different in these developments than the allocation of available cash flow and any remaining residual value at the end of the credit compliance period. Generally, investors are most interested in the internal rate of return that will be generated from the development, arrived at primarily from an analysis of the tax credit benefits and allowable depreciation.

The required rate of return to induce investors into such projects varies with market conditions and other investment returns, of course. In the past several years, various tax credit syndicators have offered investors the option of making multiple pay-ins of investor capital so that the investor never need be "out-of-pocket." Such staged pay-ins usually are timed over a period of up to eight years.

With the aid of a $500,000 loan from MSHDA, a Michigan equity fund, the Michigan Capital Fund for Housing ("the Fund") was formed in 1993 with the dual purposes of raising corporate investment capital in Michigan, and investing in affordable tax credit developments in the state that, for various reasons, might not be attractive to national syndicators. The first fund offering is currently being marketed to potential investors, and financial projections show very competitive rates of return. Simultaneously, projects suitable for such investments are being identified. By reducing the syndication "load" associated with marketing, etc., the Fund hopes not only to provide a good investment vehicle, but also to make more money available to the tax credit projects.

CONCLUSION

The low-income housing tax credit, after annual, last minute renewals by Congress for several consecutive years, was finally made "permanent" by Congress last year. Its rules are complex when existent, and often times are simply non-existent. Few practitioners in Michigan are familiar with the intricacies of the program, as tax credit issues span real estate, taxation, and securities laws. Increasingly, however, the low-income housing tax credit has been the vehicle for the production of affordable housing in Michigan and throughout the country, and, as such, attorneys with developer and/or investor clients would do well to become more knowledgeable of the program. For more information on Michigan's low-income housing tax credit program, interested parties may call 517/373-6007. ■

Footnotes

1. IRC § 42(h)(3)(C).
2. IRC § 42(b)(2).
3. IRC § 42(c)(2).
4. IRC § 42(i)(2)(D).
5. IRC § 42(g)(1).
6. IRC § 42(g)(2)(D).
7. IRC § 42(g)(2)(C).
8. MCL 125.1422(dd); MSA 16.114(22)(dd).
9. MCL 125.1422(b); MSA 16.114(22b).
10. IRC § 42(h)(5).
11. MCL 125.1411(u); MSA 16.114(11)(u).
12. IRC § 42(m)(2)(C) and Michigan's Qualified Allocation Plan.