BUILDING AND FINANCING A LOW-INCOME HOUSING PROJECT

by Lawrence F. Sherman and Bradley Smith

Low-income housing credit, under Section 42 of the Internal Revenue Code, was developed by Congress and presented in the Tax Reform Act of 1986. The IRS Code provides tax credits for acquisition, rehabilitation and construction of low-income housing. The Low-Income Housing Tax Credit Program allows investors, typically limited partnerships, a dollar-for-dollar tax credit for qualifying low-income housing projects. This tax credit is determined by the applicable percentage of the qualified basis of each low-income housing project and reduces tax payments over a ten year period.

Overview Of Rules

IRS Code 42 provides tax credits for projects which follow the guidelines for low-income housing projects. The tax credits are taken annually over a ten year period and are based on calculations of the applicable percentage. This percentage represents 70% present value credit for certain new buildings, 70% present value of rehabilitating buildings and a 30% present value credit for the acquisition of existing buildings. Only a 30% tax credit is available for projects receiving other additional federal subsidies.

The true amount of credit depends on a number of other factors including: the amount invested in the low-income housing project, the portion of low-income housing units, whether the project is a new building or an existing building, whether federally subsidized financing was used and the set-aside percentage of credit provided by the state. It is important to note that each state has credit limitations which may be allocated to the state and that state approval is often the hardest obstacle in the building of low-income housing. State approval in many states has become easier to obtain, but in a number of states it is a major stumbling block to obtain low-income credit. This article considers this process in the state of California as an example of how the low-income tax credit works.

California Tax Credit Committee

Specifically, the tax credit is computed by applying the applicable credit percentage to the qualified basis of the low-income building. The qualified basis is the portion of the eligible basis of the low-income units in the building. Qualifications include: a minimum percentage of units occupied by low-income tenants and rent restrictions based on

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unit size and area median income. Also, the project must meet the low-income rental requirements for at least 15 years, but more likely for 30 years. Failure to uphold these requirements results in a recapture of the administered tax credits.

Rental Requirements

The low-income housing tax credit is available to projects which qualify under one of the two tests of the minimum set-aside requirements. The two tests are referred to as the 20/50 test and the 40/60 test; minimum set-aside tests. Under the 20/50 test, 20% or more of the project's residential units must be rent restricted and occupied by families with incomes equal to 50% or less of the area's median gross income, adjusted for family size. Applying the 40/60 test, 40% or more of the units are rent restricted and the families of those units must have incomes equal to 60% or less of the area's median gross income, adjusted for family size. Once the project is placed into service, the owner of the project must elect, irrevocably, the minimum set-aside test that will apply to the project. This percentage must be achieved before the end of the credit period's first year.

Beginning in 1990, to determine the income used for calculating the maximum unit rent, each unit is presumed to be occupied by a specified number of persons based on unit size, regardless of the actual number of occupants. Ultimately, a unit will be considered rent-restricted if the gross rent charged for the unit does not exceed 30% of the income limitation applicable to the imputed number of occupants.

Determination of area median gross income is to be made under Section 8 of the United States Housing Act of 1937. Adjustment to area median gross income is to be made for family size under rules similar to the adjustments under Section 8 of the United States Housing Act of 1937.

Also, the project must not only be rent-restricted, but must be occupied by a qualifying low-income family throughout the 15-year period. Even if the occupant's income increases by as much as 40% of the applicable income limitation, the unit will continue to qualify as a low-income unit.

Rent restrictions include gross rent which covers the tenant's utilities costs (other than telephone). Also, rental assistance payments made by governmental agencies on behalf of tenants are not included as part of gross rent. Once the project owner decides on the set-aside requirement that he will meet, the election is irrevocable and must be put into action within the first year after the project is completed.

Projects must observe the unit size when determining the maximum unit rent. For example, a unit without a separate bedroom is presumed occupied by one person, while a unit with one or more bedrooms is presumed occupied by 1.5 persons for each separate bedroom. Thus, under the income limitation, a unit will be considered rent-restricted if the gross rent charged for the unit does not exceed 30% of the income limitation applicable to the imputed number of occupants.

Eligible Basis

In general, the eligible basis of a qualified low-income building, which is the maximum amount upon which the tax credit is based, is equal to the adjusted basis of the building, with certain modifications, at the completion of the first taxable year the building is placed in service or, at the election of the taxpayer, the next succeeding taxable year. Land cost is not included from the eligible basis.

Amenities such as stoves, refrigerators, air conditioning units and other equivalents provided in low-income housing units, are included in the eligible basis if the cost of such amenities are comparable to the costs of the amenities in any non low-income housing units.

Also, common areas such as swimming pools, recreational facilities and parking areas are included in the eligible basis provided there are no separate fees for their use and the facilities are made available to all tenants on a comparable basis. The adjusted basis of a low-income building is also reduced by other subsidy items in determining the eligible basis.

In addition, the computation of eligible basis is dependent upon whether the low-income housing consists of an existing building or new construction. The eligible basis for a new building is the adjusted basis of the new building as of the close of the first taxable year of the credit period. This allows for costs incurred after the building is placed in service. To qualify for an increase in eligible basis the project must be in a high-cost and difficult development area. These projects are reviewed for a 30% increase in tax credit. To qualify, the project must be located in either a qualified census tract or a difficult development area.

A qualified census tract is defined as any census tract where 50% or more of the households have an income which is less than 60% of the area's median gross income. Also, the project cannot be in an area where 20% or more of the metropolitan population is included.

Credit Computation

The amount of available tax credit is computed using one of two percentages, the 70% credit and the 30% credit. Costs incurred in the construction of a new building and in the considerable rehabilitation of an existing building are eligible for the 70% credit when the building is not federally

subsidized. The annual credit is available for 10 years in an amount that will yield a present value of 70% of the qualified basis of the building over the 10-year period.

For the acquisition costs of an existing building and the construction costs of a new building using federally subsidized financing, an annual credit is available for ten years, equal to an amount that yields a present value of 30% of the qualified basis of the low-income building over the 10-year credit period.

Obtaining The Credit

The credit is taken over a 10-year period, known as the credit period, which begins with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. The taxpayer can defer the credit period in order to incur additional costs that will qualify for the credit or to have more time to increase the low-income occupancy rate.

The credit also is based on the taxpayer entering into an extended use commitment with the state or local credit granting agency. This commitment must extend the low-income occupancy of the project for a minimum of 15 additional years beyond the close of the 15-year compliance period. To obtain low-income housing credits, a project developer must file IRS Form 8609 with the state and local housing agency. The housing agency may accept or reject an application based on factors such as local need and alternate available means of project financing to equity based tax credit dollars. Form 8609 also serves as an annual statement to the IRS that the project's building or buildings are complying with the low-income set-aside and restricted rent requirements of Section 42.

Low-Income Tax Credit Market

For a number of years there has been a developing market for the sale of low-income tax credit. As a tax credit, the benefit is a direct reduction from individual taxes. The sale of tax credit programs primarily has utilized the limited partnership structure, and the partnerships are in general nonpublic partnerships. Shares in the partnerships are many times sold through seminars and through financial planners. With the availability of the limited liability company, there may be an opportunity to provide a vehicle in which to sell the low-income credits that meets the requirements of retirement plans and certain investors.

In that case, shares are sold rather than partnership units, and there may be less problem with the abuses that previously occurred due to the partnership type of organization. However, state law is evolving in this area, and the growth in popularity of the limited liability company is uncertain. The marketplace is a unique niche market and, while the market has been growing for Section 42 Low-Income Housing Credit, it is sufficiently technical with many specialized problems that have prevented growth, plus the partnerships are generally small. Syndicators that arrange the low-income housing credit programs often specialize and sell the tax credits through multiple programs. To attract clients or customers, they often develop unique marketing programs and acquire customers through word of mouth and past reputation. Tax credits are sold to individuals who are in middle to high tax brackets.

Conclusion

The Low-Income Housing Tax Credit Program is a success for developers, investors and the low-income population which needs decent housing. It is anticipated that the success should cause the program to expand in future years. The tax credits enable developers to make a reasonable profit from projects, and investors who provide the capital receive valuable tax benefits. The program ensures that affordable housing projects will be developed in areas where they are most needed. Overall, the Low-Income Housing Tax Credit Program is a win/win situation for developers, investors and the low-income population.

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