The Professional Property Managers Guide to the Low-Income Housing Tax Credit

2019 Edition
Sample

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Table of Contents

Foreword 1
Introduction 3
A Note on the IRS 7
Basics of the Low Income Housing Tax Credit 9
Defining a “Project” 12
The Manager's Role in the Program 16
Preparing for Tax Credit Management Full Version
Meeting the Minimum Set-Aside Full Version
The Extended Use Agreement Full Version
Determining Income Limits Full Version
Determining the Maximum Rents Full Version
Fees in Addition to Rent Full Version
Gross Rent Floor Full Version
Utility Allowances Full Version
Basic Management Issues Full Version
The Documentation Process Full Version
Initial Resident Qualification Full Version
Determining Household Income Full Version
Income Inclusions & Exclusions Full Version
Assets Full Version
Acquisition/Rehab Deals Full Version
Recertifications Full Version
The Available Unit Rule Full Version
Deep Rent Skewing Full Version
Special Occupancy Issues Full Version
Students Full Version

Leases - - - Full Version
Public Use/Transfers/Combining Programs - - - Full Version
Record Keeping - - - Full Version
File Organization - - - Full Version
Noncompliance - - - Full Version
Helpful Web Sites - - - Full Version

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 been able to keep the number of pages around 100; my goal is not to overwhelm, but to inform. There has been one major program change since 2013 (the Average Income Minimum Set Aside), and it 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. 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 of use to management personnel, while including everything managers need to know.

As I complete this update in January 2019, the tax credit program has matured, and is also threatened by events at the National level. In early 2019, 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 2019, but as of January 2019, the information in this book is up-to-date.

Having said this, it is the reader's responsibility to stay abreast of current law and regulation, including the requirements of the various allocating and monitoring agencies involved in the Section 42 program. It is my 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 knowledge for management personnel – it is now equally as important to understand complex issues that impact 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 actually reviews many properties for various clients. Working with individual clients is what I, in fact, enjoy doing the most. So, if you've bought this Guide, I consider you a client; if you have any questions give me a call. I'm at (757) 259-9920 or email me at aj@ajjcs.net.

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 2016, the LIHTC program was stable and generating significant numbers of affordable housing units. As of January 2019, the same circumstances apply. The program is mature and popular, but care must be taken to protect the integrity of the program. In the last two years, The Government Accountability Office (GAO) issued four reports on the LIHTC program. The first report was highly critical of the IRS oversight of the program and the second was also critical of the Housing Finance Agencies (HFAs) role in the program. The third report was an informational report on how syndicators operate relative to the Section 42 program, and the final report described the operation of the program in general. The takeaway from these reports – which were all developed to educate Congress on how the program is operating – is that while the LIHTC program has been generally successful, there are weaknesses and we must constantly work to improve how we as an industry use the program to develop affordable housing.

As noted above, one of the GAO reports was critical of HFA implementation of the LIHTC program, especially with regard to the differences in program operations among the various 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 in order to minimize risk to credits. 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 all properties utilizing the credit. The effective date for this monitoring was January 1, 1992 and the responsibility for monitoring rests with the allocating agencies. Exactly how 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, HFA's will review a certain percentage (generally 20%) of units and files every three (3) years.

It is for the purpose of assisting persons responsible for oversight of tax credit properties in their understanding of the LIHTC program that this guide has been prepared. It is not my intention 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. What this guide will hopefully do is assist in the reader's understanding of tax credit requirements as they relate to management and compliance issues in enough detail to successfully operate projects which utilize the credit. 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.

It is the responsibility of management to exercise "due diligence" in ensuring that tax credit units are occupied by qualified households. "Due diligence," as defined by Blacks Law Dictionary is "such measure of prudence, activity, or assiduity (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 in terms of due diligence? As stated above, it will depend on the facts of any particular case, but 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.

It is with this level of diligence in mind that this Guide has been written.

A Note on the IRS

To many tax credit managers, the IRS is like the “boogeyman” lurking in the darkness; never really seen, but a scary thought anyway. Unlike the “boogeyman,” the IRS really does exist, and although you are unlikely to ever have an IRS visit at your particular property, IRS audits of LIHTC properties do occur. The good news is that reducing the potential for an IRS audit is not difficult; just operate your property in accordance with the program rules, and you should be fine. In fact, while there are no guarantees where the IRS is concerned, adhering to sound management and compliance practices will go a long way toward preventing increased levels of IRS scrutiny.

It is good to remember that the IRS will be very thorough during a property examination. They will look at issues that at first glance may not seem related to on site compliance, but nonetheless are elements that give an indication of potential noncompliance. For example, according to IRS guidance, in a tour of Section 42 properties, agents may look 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 excess common area, what is it being 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 who have 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 have one suggestion, which, if followed, will make on-site management a lot easier. The Tax Credit Program establishes income eligibility in accordance with the requirements of the HUD Section 8 Program. Requirements of the Section 8 Program 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.

Basics of 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 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 approximately 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 often 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.

For projects placed in service in 1988 and after, the amount of credit with tax-exempt bond financing is based on monthly prevailing federal interest rates that will allow a “present value” of 30% of the qualified basis (in the case of the 4% credit) over the ten-year period. What this essentially means is that in any particular month the credit may be worth more or less than the month before. Properties that do not use tax-exempt bonds are entitled to at least the annual 9% credit. As of December 2015, the 9% credit is no longer adjusted on a monthly basis and is actually 9%.

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"). 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 2018, the minimum set-aside would have to be met by December 31, 2019 (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 one of these tests the owner has selected, since it will determine the maximum eligible incomes for your property, as well as the maximum rent levels. Hopefully, one of the 40/60 tests were chosen, and you will have the highest possible incomes to work with. However, you must know whether or not the owner made any special promises to the State Housing Finance Agency (HFA) in order 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) in order to score higher on their applications. If this has happened, you need to know it. These required lower income limits also is one of the main reasons many owners are going to want to elect the Average Income minimum set-aside. By making this election, owners will be able to offset the lower rents of the 40% and 50% units with rents for 70% and 80% units.

There is also a rent test that must be met in order to qualify a unit. The maximum rent is based on the number of bedrooms, while assuming 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 that are configured as single-family dwellings, townhouses, row houses, duplexes, and condos. The credit may be used with cooperatives, but these leasing cooperatives must be owned by the investor partnership, and there may then be a Master Lease between the owning partnership and the Cooperative. The Co-op itself 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 building (individually), and at other times we talk about the project. 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 has to “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, in government assisted rental housing, cash flow is usually restricted, either by regulation or market limitations. These same factors also restrict the future value of LIHTC properties by requiring that these properties remain low income for long periods. Thus, the major ownership benefit related to affordable housing is tax savings. The financial benefit as a result of 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 in order to obtain this tax benefit for the entire project.

Better yet, 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 breed of 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 the area of tenant selection than ever before. Property management, especially the on-site manager and front-line property manager, now play a crucial role in determining exactly 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 must ensure that proper rent levels are maintained in compliance with tax credit guidelines and keep track of both 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 of the decisions relating to these issues are being made long before management becomes involved with a property. For this reason, a close working relationship between the management team and development team is an absolute necessity for a successful tax credit project.

End of Sample

This has been just a small sample of the information provided in the full version of The Professional Property Manager's Guide to the Low-Income Housing Tax Credit. The full version provides easy to understand explanations about basic and advanced issues, such as how to determine a household's income, how to deal with student status, determining asset cash value and income, dealing with the available unit rule, acquisition/rehab management, and much more.

The Guide is an invaluable resource for anyone working in the multi-family housing industry. Whether your goal is to provide yourself with an easy to use reference guide, or increase your knowledge about Section 42, The Professional Property Manager's Guide to the Low-Income Housing Tax Credit will meet your needs.