Section 42 Low-Income Housing Tax Credit Program

Special Accounting & Tax Issues

(2021)

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Advanced Credit Issues
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COVID-19 Relief

In response to the COVID-19 pandemic, the IRS issued Notice 2020-53 in July 2020. This Notice provided temporary relief from certain requirements under §42 of the Internal Revenue Code and §§142(d) and 147(d) of the Code for properties with tax-exempt bonds. In response to the continuing presence of the pandemic, the IRS has issued Notice 2021-12, extending that relief and also providing temporary relief from additional §42 requirements not previously addressed in 2020-53.

Background

On March 13, 2020, the President issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in response to the ongoing COVID-19 pandemic. This emergency declaration instructed the Treasury Department "to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate…" The emergency declaration applies to all 50 states, Washington DC and the five territories.

Revenue Procedure 2014-49 provides temporary relief from certain requirements of §42 for Agencies and Owners of LIHTC projects. Revenue Procedure 2014-50 does the same thing for properties financed with tax-exempt bonds.

Prior Relief Actions

On April 9, 2020, the IRS issued Notice 2020-23, which provided certain relief to low-income housing projects and postponed due dates until July 15, 2020, with respect to certain tax filings and payments, certain time-sensitive government actions, and all time-sensitive actions listed in Revenue Procedure 2018-58 that were due to be performed by April 1, 2020, but before July 15, 2020. These time-sensitive actions include, among others:

- The time to show that 10% of project basis has been established;
- The 24-month rehab period; and
- Annual Owner Certifications to the HFA.

Scope of Relief Granted in This Notice

- The 10% Test for Carryover Allocations: If the last day for an Owner of a building with a carryover allocation to meet the 10% test is on or after April 1, 2020, and before September 30, 2021, the last day for the owner to meet the 10% test is postponed to the earlier of one year from the original due date or September 30, 2021.
- The 24-Month Rehabilitation Expenditure Period: If the 24-month minimum rehabilitation expenditure period for a building originally ends on or after April 1, 2020, and before September 30, 2021, the last day for the owner to incur the minimum rehabilitation expenditures test is postponed to the earlier of one year from the original end date or September 30, 2021.
- Placed in Service Deadline: if the deadline for a low-income building to be placed in service is the close of calendar year 2020, the last day for the owner of the building to place the building in service is postponed to December 31, 2021.

- Reasonable Period for Restoration or Replacement in the Event of Casualty Loss: If a low-income building has suffered a casualty loss and the reasonable period to restore by reconstruction or replacement ends on or after April 1, 2020, and before December 31, 2020, the last day for the Owner of the building to restore the loss by reconstruction or replacement is December 31, 2020.
- Reasonable Restoration Period in the Event of Prior Major Disaster: if a low-income building, not due to a pre-COVID-19-pandemic Major Disaster, has suffered a casualty loss that would have reduced its qualified basis and if the reasonable restoration period determined by the Agency for the building ends on or after April 1, 2020, then the last day of the reasonable restoration period is postponed by a period of one-year from the original end date but not beyond December 31, 2021. The allocating agency may require a shorter extension, or no extension at all.
- Extension to Satisfy Occupancy Obligations: If the close of the first year of the credit period is on or after April 1, 2020, and on or before June 30, 2021, then the qualified basis for the building for the first year of the credit period is calculated by taking into account any increase in the number of low-income units by the close of the six-month period following the close of that first year.
    - *E.g.: assume the deadline for meeting a project's minimum set-aside and qualifying all low-income units to avoid the "2/3" unit rule was December 31, 2020. The revised deadline is June 30, 2021.*

- Correction Period: If a correction period for non-compliance that was set by the HFA ends on or after April 1, 2020, and before September 30, 2021, then the correction period is extended by a year, but not beyond December 31, 2021.
    - *E.g.: The HFA discovered noncompliance on March 1, 2020 and gave the owner until June 1, 2020 to correct the noncompliance. The noncompliance was not corrected and the HFA reported it to the IRS as non-corrected noncompliance. The owner now has until June 1, 2021 to correct the noncompliance. The HFA may submit an amended 8823 to the IRS, citing this Notice and providing for the extended correction period.* ***Keep in mind that the HFA may require a shorter extension or no extension at all.***
- The 12-Month Transition Period to Meet Set-Aside for Qualified Residential Rental Projects: the last day of a 12-month transition period for tax-exempt bond projects that ends on or after April 1, 2020, and before September 30, 2021, is postponed to September 30, 2021.
- The §147(d) Two-Year Rehabilitation Expenditure Period for Bonds Used to Provide Qualified Residential Rental Projects: If a bond is used to provide a qualified residential rental project and if the two-year rehabilitation period for the bonds ends on or after April 1, 2020, and before September 30, 2021, the last day of that period is postponed to the earlier of one year from the original due date or September 30, 2021.
- Grant of Relief Pursuant to §1.42.13(a):
    - Income Recertifications: An owner of a low-income building is not required to perform income recertifications in the period beginning on April 1, 2020 and ending on September 30, 2021. The owner must resume the income recertifications as due after September 30, 2021.
        - E.g., a recertification that is due on September 1, 2021 does not have to be performed. The next recertification will be due on September 1, 2022, keeping in mind that HFAs may have their own requirement in this area.

    - Compliance Monitoring: An agency is not required to conduct compliance monitoring inspections or reviews in the period beginning on April 1, 2020 and ending on September 30, 2021. The Agency must resume compliance monitoring inspections or reviews as due under 1.42-5 after September 30, 2021.
    - Common Areas & Amenities: If an amenity or common area in a low-income building or project is temporarily unavailable or closed during some or all of the period from April 1, 2020 to September 30, 2021, in response to the COVID-19 pandemic, and not due to other §42 noncompliance, this temporary closure will not result in a reduction of the eligible basis of the building.
- Guidance Permitting Agencies to Conduct Telephonic Hearings: QAP hearings due on or after April 1, 2020, and before September 30, 2021, may be held by teleconference. The teleconference must be accessible to the residents of the locality where the Agency has jurisdiction by calling a toll-free telephone number.
- Emergency Housing for Medical Personnel & Other Essential Workers: If individuals who are medical personnel or other essential workers (as defined by State or local governments) provide services during the COVID-19 pandemic, then, for purposes of providing emergency housing from April 1, 2020 to September 30, 2021, for both LIHTC and tax-exempt bond projects, HFAs, Owners, and Operators of low-income housing projects may treat these individuals as if they were Displaced Individuals under Revenue Procedures 2014-49 or 2014-50.

Owners and operators of LIHTC and tax-exempt bond projects should consult with their HFAs or Issuing Agencies in order to determine if any requirements in addition to those outlined in this Notice will be implemented.

The Average Income Minimum Set-Aside

- Section 42 contains three "minimum set-aside tests:"
    - 20/50
        - At least 20% of the units in a project must be both rent-restricted and occupied by households with income of 50% or less of the area median gross income ("AMGI");
    - 40/60
        - At least 40% of the units in a project must be both rent-restricted and occupied by households with income of 60% or less of the area median gross income; and
    - Average Income Test ("AI")
        - At least 40% of the residential units in a project must be both rent-restricted and occupied by individuals whose income does not exceed the imputed income limitation designated by the owner of the project.
            - The average of the imputed income limitations designated may not exceed 60% of the area median gross income.

Special Rule for New York City

- In the case of properties located in New York City, instead of the 40% minimum for the 40/60 and Average Income tests, the "40%" is replaced by 25%.

Imputed Income Designations

- For purposes of the AI test, the designated imputed income limitations are:
    - 20% of AMGI
    - 30% of AMGI
    - 40% of AMGI
    - 50% of AMGI
    - 60% of AMGI
    - 70% of AMGI
    - 80% of AMGI

Minimum Set-Aside vs. the "Average" Test

- Understanding the difference between the "Average Income Minimum Set-Aside" and the "Average Income Test" is best illustrated with two examples.

E.g. # 1 – Meeting the Minimum Set-Aside

- Eight-unit project with the following income designations:
  - Unit 1: 40%
  - Unit 2: 60%
  - Unit 3: 50%
  - Unit 4: 70%
  - Unit 5: 80%
  - Unit 6: 60%
  - Unit 7: 60%
  - Unit 8: 70%
    - Result: Project meets the minimum set-aside test (i.e., at least 40% of the units are occupied by households whose income does not exceed the imputed income limit designated by the owner).
    - However, the Average Income test has not been met since the average of the owner designated imputed income is 61.25%.
    - *What does this mean?* ***Unit 8 must become a market unit in order for the 60% average to be met.***

E.g. #2 – Meeting the Average Income Test

- Eight-unit project with the following income designations:
    - Unit 1: 40%
    - Unit 2: 60%
    - Unit 3: 50%
    - Unit 4: 70%
    - Unit 5: 80%
    - Unit 6: 60%
    - Unit 7: 60%
    - Unit 8: 60%
        - Result: Project meets the minimum set-aside test (i.e., at least 40% of the units are occupied by households whose income does not exceed the imputed income limit designated by the owner).
        - But now, the Average Income test has been met since the average of the owner designated imputed income is 60%.
            - This is because Unit 8 is now a 60% unit instead of a 70% unit.

<u>Non-Compliance with the AI Rule</u>

- What happens if Units 7 and 8 (both 60% designated units) are out of compliance at the end of the tax year?
    - There are now six qualified low-income units and the average imputed income of the six units is 60% – what is the result?
        - The minimum set-aside is met (i.e., @ least four units are occupied by households that qualify with an average of 60% or less of the imputed income limit).
        - Therefore, only the two ineligible units (Units 7 and 8) are lost from the building's applicable fraction and the remaining six units remain LIHTC qualified since the average of the income designation of those units is 60%.

Is There a "Cliff Test?"

- Short answer – maybe.
- In order to answer this question, a literal reading of the Code is required.
    - §42(g)(1)(C)(ii)(I): this code section requires that the taxpayer "designate the imputed income limitation of each unit taken into account."
    - §42(g)(1)(C)(ii)(II) requires only that "the average of the income limitations designated under (I) shall not exceed 60% of the area median gross income."
        - Paragraph II is specific to each unit in Paragraph I.
        - If the owner ("taxpayer") has designated income limits for the units, **and** the average of those designations is 60% or less, the Average Test is met.
            - However, if a low-income unit is no longer considered low-income (e.g., not suitable for occupancy, rented to an ineligible household, etc.), it may no longer be included in the determination of the AI

I.e., **if the Average Test is met – and the minimum set-aside is met – credits may still be claimed for eligible units.**

AI and the Available Unit Rule (AUR)

- For purposes of the AI set-aside, a low-income unit will be considered "over-income" if the household's income is:
    - More than 140% of the 60% AMGI if the unit's designated income limit is 20, 30, 40, 50 or 60 percent; or
    - More than 140% of the unit's designated income if the unit's income designation is 70% or 80%.

- An Over-Income unit ceases to be a qualified low-income unit if any unit in the building of a comparable or smaller size is occupied by a new household whose income exceeds the designated income limit of that unit – based on the designation that unit had prior to becoming vacant.
- If the unit that becomes vacant is a market unit, the owner must designate the income of the unit such that the project continues to meet the Average Test.
- E.g., Household A lives in a 30% designated unit and B lives in a 70% designated unit.
- A's income exceeds 140% of the 60% AMGI, or B's income exceeds 140% of the 70% AMGI – the AUR is now applied to the BIN.
    - The income of both households goes over the 140% level at the same time. Assume the BIN has two market units, four 30% units, and four 70% units. *The Average Test is 50%*.
    - A market unit is rented at the 30% AMGI, maintaining four 30% and four 70% units – the 30% over-income unit now becomes a market unit and the Average Test is still 50%.
    - But – what if instead of renting the market unit to a 30% household, the owner rents the unit to a 50% household and makes the 30% over-income unit a market unit?
        - Result: There are now two market units, one 50% unit, three 30% units, and four 70% units (one of which is over-income). The Average Test is now 52.5% — the project still qualifies under the Average Test but has one less 30% unit.
        - The AUR requirement is met but this could be a LURA violation.
- The preceding example is why most HFAs do not allow mixed-income projects to select the AI Minimum Set-Aside.
- There are many complexities with the AUR when applied to AI projects.

Note – owners should check current guidance from their HFA regarding the specific rules when using the AI Minimum Set-Aside election.

<u>AI – Best Practice Recommendations</u>

- While in many ways the AI Minimum Set-Aside Test should be tracked and monitored in much the same way as the 20/50 or 40/60 tests, the moderate complexity of the AI lends itself to some recommendations relative to oversight and compliance:
  - If credits in the same project will be split between two different first credit years, it is recommended that an Average Test of 60% or less be met at the end of the first year.
    - E.g., assume a 100-unit AI project with ten buildings and ten units per building. The ten buildings will be a single multiple building project.
    - All buildings are placed in service in 2021.
    - At the end of 2021, six buildings (60-units) are fully qualified and elect to take credit beginning in 2021.
    - If all 100 units meet the Average Test requirement of 60%, the first six buildings should be able to claim credit in 2021 – even if the Average Unit designation of those 60 units exceeds 60%. *However, until there is some degree of certainty that this is the position of the IRS, making sure the 60% average is met for the six buildings at the end of 2020 is recommended.*
  - Due to the complexities involved with the AUR/AI, avoid mixed-income buildings.
  - Make sure to notify the HFA prior to changing the designation (i.e., “floating”) of units.
  - Do not make the election without specific syndicator/investor approval.
  - Do not make the election if it conflicts with the requirements of the Extended Use Agreement.

The "Fixed" Four Percent Credit

The COVID-19 relief legislation that was recently signed into law included a provision fixing the four percent LIHTC at an actual four percent rate. This floor applies both to properties with tax-exempt bonds and acquisition credits. However, there are transition rules and some properties that are in development and under construction will not be able to use the 4% floor.

In order to use the 4% fixed-credit, a building has to:

- Be placed in service after 2020, **and – if the building has tax-exempt bonds**
- The bonds must be issued after December 31, 2020.

One issue is whether a project with bonds issued in 2020 but not fully disbursed until 2021 can use the 4% floor. The truest answer is we don't know. Guidance from the IRS or a Congressional Committee would be helpful in this area. Until such guidance is received, using the 4% credit for 2020 bond issues that have not been fully used until 2021 is risky.

Some tax attorneys may be willing to provide legal opinions stating that the 4% floor may be used when a project has 2020 bonds, but some or all of the bond proceeds are not used until after 2020. This is an aggressive position, but some years ago the IRS took the position that they would define "issuance" as the date when the proceeds are drawn down. However, many tax professionals believe the IRS took this position to prevent taxpayers from avoiding new tax rules relating to bonds issued after a certain date. There is no way of knowing whether the Service will take the same position with regard to the 4% floor. In other words, permit the date the bond funds are drawn-down to be considered the "issue" date. It is very possible that the IRS will apply a traditional reading (i.e., literal) of the law and apply the fixed rate only to bonds actually "issued" after December 31, 2020. Ultimately, investors will have to make the choice with regard to the risk level to be accepted.

At this point, I am not advising my clients to use the 4% floor unless the bonds are actually issued after 2020. However, I am not a tax attorney, and I recommend reliance on opinions from tax counsel in these cases.

One other element to keep in mind is that Housing Finance Agencies (HFAs) may only allocate the amount of credit necessary for deal feasibility. If a deal is closed with an applicable percentage of less than 4% – and the deal works – claiming a 4% floor would very likely result in some deal adjustments. The agency could require additional amenities, reject some secondary ("soft") financing source, earlier payoff off a deferred developer fee, etc. ***My recommendation in this area is that if a deal works at the "floating 4% level," just stick with it and don't get too adventurous.***

Another scenario is a "split" bond issue – where some bonds are issued in 2020 and there is another issue in 2021. In this case, because the project has bonds issued after 2020, it seems clear that the 4% floor may be used. My confidence here is based on the wording in the Code. The rule applies to <u>any</u> building if <u>any</u> portion is financed by tax-exempt bonds, provided *any* such building is financed by *any* such obligation issued after 2020. This language indicates that as long as <u>any</u> bonds are issued after 2020 for a project, the taxpayer is entitled to use the 4% floor. Be aware though that this applies only to an "issuance" of bonds – not a "refunding" of bonds. In other words, this would have to be a fresh bond issue, in addition to the amount received under a 2020 issue.

The most interesting aspect of this 2020/2021 concept relates to acquisition/rehab projects. If a project was acquired in 2020 and the buildings were either occupied or occupiable as of the date of acquisition, the acquisition date is the placed in service date and even if bonds are issued for the project in 2021, the acquisition credit would have to be a floating credit (the building fails the first test noted above by not being placed in service after 2020). However, since for purposes of Section 42, the rehab expenditures are treated as a separate new building.

Therefore, assuming the bonds are issued in 2021, and the rehab is completed in 2021 (i.e., the rehab expenditure placed in service date would be in 2021), the rehab credit may be based on the 4% floor.

In summary, until and unless favorable guidance is forthcoming either from Congress or the IRS, I recommend a conservative approach to using the 4% floor with tax-exempt bonds. In other words, unless a building is placed in service after 2020 and the bond issue is also after 2020, the 4% floor should not be used.

Placed in Service (PIS) Dates

IRS Revenue Notice 88-116

"For purposes of Section 42, the term 'placed in service' has two definitions – one for buildings and one for rehabilitation expenditures that are treated as a separate new building (Section 42 (e)(4)(A))."

- New or existing building: the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law.
  - A Certificate of Occupancy (CO) is generally the best document for establishing the PIS date for new construction.
  - A transfer of a building to a new owner results in a new placed in-service date if, on the date of the transfer, the building is occupied or ready for occupancy.
- Rehabilitation expenditures: These expenditures are placed in service at the close of any 24-month period, over which such expenditures are aggregated.
  - This applies even if the building is occupied during the rehabilitation period.
  - Additional guidance from the IRS has made clear that the rehab expenditures may be placed in service in less than 24 months.
  - This provision is intended to dictate the tax credit percentage applicable to the rehab costs as the credit percentage from the final month of the 24-month period.
  - Rehab costs may use 9 percent credits unless tax-exempt bonds are used.

Issues Relating to the Acquisition/Rehab of Tax Credit Properties

Qualifying Tenants in an Acquisition/Rehab Deal – The "120-Day" Rule

- Under Rev. Proc. 2003-82, units may be qualified before the beginning of the credit period. The unit remains qualified, even if the household's income exceeds the income limit at the beginning of the first year of the credit period, if the unit is rent restricted and the following specific conditions are met:
  - If household occupies unit at time of acquisition, and the initial tenant certification is completed within 120 days after the date of acquisition (using income limits in place at acquisition), the TIC is effective on the acquisition date. (*E.g., property was acquired March 14, 2020; initial tenant certification is completed by July 12, 2020 – effective date of TIC is March 14, 2020. If TIC is signed July 13, 2020 – TIC effective date is July 13*). In this case, the move-in date is not the effective date, since the tenant was already in the unit when the project was acquired.
    - This is critical if credits will be claimed in the year of acquisition, i.e., rehab will be completed in the acquisition year.

- If credits will be claimed the year after acquisition, as many tenants as possible should be qualified by the end of January of the first year of the credit period (assuming January is the first month of the tax year).
  - *Be aware of the month in which the investors enter the partnership.*
- If household occupies unit at time of acquisition, and the initial tenant certification is completed more than 120 days after acquisition, the effective date of the TIC is the last adult in the unit signs it. Use income limits in effect at time of certification.
- For new households to a project moving in before the beginning of the first credit year, the TIC is completed using the income limits in effect at the time of move-in.

The Safe Harbor Rule

- Households qualified prior to the beginning of the first credit year must be tested for purposes of the Available Unit Rule at the beginning of the first year of the building's credit period (this is an IRS *"Safe Harbor Test," and may not be necessary for 100% low-income properties.)*
  - Test must be completed within 120 days before the beginning of the first year, *so, qualifications occurring after September 3 in the year before claiming credits will meet this requirement*;

    - The "test" consists of confirming with the household that certified income is still current. If there is additional income, the TIC must be updated. It is not necessary to complete third party verifications – unless the State HFA requires such verification;
    - If income exceeds the 140% level, the AUR applies.
- If the effective date of the initial TIC is 120 days or less before January 1 of the first year of the credit period, testing is not required. The recert will be due on the anniversary of the original TIC effective date.
- If the effective date of the TIC is more than 120 days before January 1 of the first year of the credit period, the income must be tested within 120 days before the beginning of the first year of the credit period.

See Revenue Procedure 2003-82 and IRS 8823 Guide.

Section 42(e)(4)(B) makes clear that the acquisition placed in service date may be used as the in service date for establishing the applicable fraction. The IRS, in PLR 200044020, confirmed this position.

Important Note for Section 8 properties: Tenants may not be displaced involuntarily in order to put credits on a Section 8 property. Incentives may be offered.

Households Qualified Under a Prior Allocation

With regard to the qualification of existing residents, per IRS Guidance in the 8823 Guide, any household determined to be income qualified at the time of move in for purposes of the EUA remains a qualified low-income household for any subsequent allocation of tax credits. In one of the examples on how this works for a new owner receiving both Acquisition & Rehab credits, it is indicated that the property is continuously subject to an EUA. The new owner may rely on the previous qualification but should test the income of the household at the beginning of the credit period in accordance with Rev. Proc. 2003-82.

This means you should obtain a fully completed certification, on which the resident states their income, student status and household membership.
If, at the time of acquisition, the tenant's income exceeds 140% of the current income limits, the AUR applies.
Guidance relating to qualifying tenants in place at the time of acquisition requires that such qualification occur within 120 days after the acquisition date in order to use the acquisition date as the effective date, since there is no move-in date. While there is no specific requirement by the IRS to complete a new certification at acquisition for tenants qualified under a prior EUA, the guidance indicates that the income of the household be tested at the beginning of the first year of the credit period in order to determine the applicability of the Available Unit Rule. The effective date of the TIC remains the same as the effective date under the prior allocation.
Note: student status rules do not change. If a household does not meet the Section 42 student requirements, it is not a qualified low-income household.

Transferring Residents Between Units
Keep in mind that when moving residents between units, the owner must pay attention to whether they are moving within the same BIN, different BIN's in the same tax project, or a different tax project. *Also, when transferring a household, be sure there is no change in household composition from one unit to the next.*

1. Moving within the same BIN: The units simply swap status and there is no requirement to perform a new certification or qualification. The resident takes their move-in date to the new unit with them and the unit they vacate takes on the status of the unit they move into.
    a. Care should be taken in a mixed-income building relative to the applicable fraction.

2. Moving to a different BIN within the same project: Such a move can be very complex, especially during lease up. While a household takes their qualifying status with them in such a move, one household cannot qualify two units in the same project; so, some special rules apply.
    a. The unit occupied in the first BIN may claim credits during the months the family is in that unit. E.g., resident moves into a unit in BIN #1 on February 15, 2020, becoming the first occupant of the unit. The BIN was placed in service in January 2020 and 2020 credits will be claimed;
    b. The household moves to BIN #2 (same tax project) on September 1, 2020, becoming the first qualified household to occupy that unit. The household does not have to requalify, and while they take their status with them, credits may not be claimed on both units for the same months;
    c. The unit in BIN#1 claims credits for February – August 2020; The unit in BIN#2 begins claiming credits in September 2020;
    d. Beginning in September 2020, the unit in BIN #1 is no longer considered a low income unit and will have to be requalified before the end of 2020 in order to avoid becoming a “2/3” unit. Assuming a new tenant occupies that unit in December 2020, the unit will be entitled to credits in December. The unit will not be in the applicable fraction for September – November.

3. Moving to a different BIN in a separate tax project: In this case, the household will have to qualify as a new move-in but could be the initial qualifying resident for both units, since they are in separate projects.

Remember that a resident may never move from one BIN to another if the income of the household exceeds 140% of the allowable income limit, but, with one exception, this would generally only occur after stabilized occupancy since they would have had to recertify at least once.

- The exception to this would be a property with a prior allocation of credits. In this case, it would be possible to have an existing resident with income in excess of the 140% level.
    - They could not move to a different BIN.
- Households residing in 100% LIHTC projects, where a household's current income is not known due to not recertifying the low-income households can also transfer between buildings within the project. This is the case because the household's income is not known.

Tenant Relocation

- Issue: are relocation costs includable in eligible basis?
    - The answer is unclear.
        - If current residents have to be relocated – and compensated in some way for the relocation – in order for rehab to proceed, the costs should be part of the rehab and capitalized to the rehab expense (i.e., included in eligible basis).
        - However, IRS Audit Technique Guide indicates that tenant relocation costs should be expenses, rather than capitalized (i.e., not included in eligible basis).
        - Owners should work with the HFA on whether such costs will be permitted in eligible basis.
    - *Note – one of the possible changes in any tax reform bill will be to clarify that such costs are includable in eligible basis.*

Seller Notes

Inclusion of Notes in Eligible Basis

The IRS has held that non-recourse notes taken to finance the construction of a building are genuine debt includable in eligible basis. This is the case even if the notes have lengthy terms (e.g., 30 years) with significant accruals of interest and do not require payments of principal or interest prior to the maturity date. (See Field Service Advice [FSA] 199948006, issued August 31, 1999). This assumes that the Note represents genuine debt with penalties if not paid when due.

Potential taxpayer ramifications relating to such notes should be discussed with a tax attorney. An example would be any liability due to Original Issue Discount (OID) rules. If the difference between the redemption price at maturity and the amount of the original note is more than de minims, there may be some taxable interest.

Offsite Costs & Local Fees

Eligible basis is the total allowable cost associated with the depreciable residential rental project.

One of the elements that is examined during an audit relative to eligible basis is documentation of cost allocations between land, land improvements, and depreciable residential rental property that has been included in eligible basis.

Indirect costs are defined in Treasury Regulation §1.263A-1(e)(3)(i) as "…all costs other than direct material costs and direct labor costs (in the case of property produced)… Indirect costs are properly allocable to property produced…when the costs directly benefit or are incurred by reason of the performance of the production…"

Only costs paid or incurred by the end of the first year of the credit period are includable in eligible basis.

The IRS has ruled that local impact fees (I.e., one-time costs with respect to a piece of property that are assessed when new construction takes place and may relate to such items as roads, water capital, educational facilities, law enforcement and fire/rescue facilities) incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building (see Revenue Ruling 2002-9). Also, the IRS has ruled that infrastructure improvements such as streets and underground utility connections that are constructed by a developer in connection with a low-income building but conveyed to a municipality and, thus, are dedicated improvements within the meaning of §1.263(a)-4(d)(8)(iv), are indirect costs that may be capitalized into the basis of the Project's residential rental buildings and included in eligible basis.

The IRS also ruled that costs to relocate an easement as required by a city for issuance of permits are indirect costs that may be included in eligible basis.

In general offsite costs and fees that are required in order for a project to be built may be included in eligible basis. *However, roads, utility lines, etc. that are used by non-residents may not be included in eligible basis.*

Federal Historic Tax Credits

Key Issues Relating to the 24-Month Period

- In order to claim a Historic Tax Credit, a property must be substantially rehabilitated. During a 24-month period selected by the taxpayer, rehab expenditures must exceed the greater of the adjusted basis of the building and its structural components, or $5,000. The basis of land is not taken into consideration.
    - *Note – any expenditure incurred by the taxpayer before the start of the 24-month period will increase the original adjusted basis.*
    - "Adjusted Basis:" the cost of the property (excluding land) plus or minus adjustments to basis. Increases to basis include capital improvements, legal fees incurred in perfecting title, zoning costs, etc. Decreases to basis include deductions previously allowed or allowable for depreciation.
    - The date to determine the adjusted basis of the building is the first day of the 24-month measuring period or the first day of the taxpayers holding period of the building, whichever is later.
        - Generally the holding period is deemed to begin the day after acquisition.
- If the rehab is completed in phases, the 24-month rule is replaced by a 60-month rule. This is available only if the project meets three conditions: (1) There is a written set of architectural plans and specifications for all phases of the rehab; (2) The written plans must be completed before the physical work on the rehab begins, and it is reasonable to expect that all phases of the rehab will be completed; and (3) The property must be placed in service.

Placed in Service

- If the substantial rehab test has not been met at the time a building, or some portion of the building is actually placed in service, the building does not meet the definition of a qualified rehabilitated building.
- Placed in service is deemed to be at the point in time when the substantial rehab test is actually met. *See IRC §47(b)(1) and 47(c)(1)(C) and Treasury Regulation 1-48-12(f)2(2) and 1.48-12(c)(6).*
- Generally speaking, the 24-month measuring period ends sometime during the year the property is placed in service.
- The expenses accrued over the 24-month period must end with or within the tax year the credit is claimed. **An exception to this rule exists if the building is never taken out of service during rehab. Then, only the substantial rehab test must be met.**
- In an elected 60-month phased rehabilitation, the court has ruled that the tax credit cannot be claimed on "assumed" eligibility. The substantial rehab test must be met. See *Ford v. U.S. 93-1 USTC.*

Note on the 60-Month Period

- In order to use the 60-month measuring period for a phased project, the project must be phased from the beginning. ***So, if the taxpayer fails to meet the minimum expenditure test within the 24-month period, the 60-month election may not be made at that time.***
- A phasing plan, showing the work that will be completed during each phase of the project, must be submitted before work begins.
- *Recommendation: Submit a phasing plan at the start of a project, even if there is a possibility the project can be completed within 24 months. This will "hold open" the 60-month time period but does not obligate the taxpayer to take that long to complete the project.*

Adaptive Re-Use

Adaptive reuse is the process of taking an old building or site and reusing for a purpose other than for which it was designed. Typically, it is closely related to historic preservation or conservation around cities with rich history.

A common adaptive reuse in the multifamily housing industry is turning an old school building into senior housing or warehouses into family housing.

Unlike a typical acquisition/rehab of an existing apartment building, first year credits for adaptive reuse projects are determined in much the same way as new construction.

First Year Credit Calculation – Section 42(f)(2)

Credits for the First Year of the Credit Period are calculated based on the average low-income occupancy for the year by determining the Applicable Fraction at the end of each month. In all other years of the credit period, the applicable fraction is determined on the last day of the tax year.

Any annual credit not taken in the first year due to this "first year calculation" is taken in year 11 of the compliance period.

January	0%	July	70%
February	0%	August	85%
March	15%	September	98%
April	30%	October	100%
May	45%	November	100%
June	56%	December	100%

Note: No credit in a building during the first year may be taken for any month unless the building has been in service for the full calendar month.

Using the chart above, assume annual credits for the building of $900,000 with eligible basis of $10,000,000.

- Step One: Add all percentages together for a total of 699;
- Step Two: Divide 699 by 12 to obtain average low-income occupancy for the year = 58.25%;
- Step Three: Multiply $10,000,000 X .5825 = $5,825,000. This is the amount of qualified basis that may be used in year one for purposes of the credit calculation.
- Step Four: $5,825,000 X 9% = $524,250 – this is the first-year credit.

Remaining amount of the annual credit ($375,750) will be claimed in year 11.