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Tax Symposium: An Overview of the Low Income Housing Tax Credit

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AN OVERVIEW OF THE LOW INCOME HOUSING TAX CREDIT

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I. INTRODUCTION

Section 252 of the Tax Reform Act of 1986 (the "TRA'86")[1] introduced a tax credit available to owners of certain low income housing projects. Congress created the credit to address a growing concern that existing subsidies were not successfully addressing the housing needs of low to moderate income individuals. This article examines the operation of the low income housing tax credit and discusses the practical considerations that must be addressed by taxpayers desiring to utilize the credit.

II. CONGRESSIONAL CONCERNS

Prior to the enactment of the low income housing tax credit, several tax incentives were available to owners of low income housing projects. These incentives included allowing the owners of certain low income housing projects to: (i) finance the construction or acquisition costs of such projects with tax-exempt bonds (typically at significantly lower interest rates than those available through conventional financing), thus reducing the interest expense associated with such costs;[2] (ii) claim a current deduction for interest expense and real property taxes accruing during the construction period, which expenses would otherwise be capitalized and amortized over a ten-year period;[3] and (iii) claim accelerated cost recovery deductions for the depreciable basis of the low income project over fifteen years, rather than over a nineteen-year period.[4]

The enactment of the low income housing tax credit reflected a Congressional concern that the federal tax subsidies existing prior to the

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter the "TRA'86"].
2. Such financing could be obtained if, among other requirements, at least 20% of the units in the project were occupied by individuals whose income did not exceed 80% of the area median income at the time such individuals initially occupied the low income housing units. *See* I.R.C. § 103(b) (1982) (amended 1986). Under current law, in order to qualify for tax-exempt financing, owners of residential rental projects must set aside either (i) 20% of the units for tenants whose income is 50% or less of area median income (adjusted for family size) or (ii) 40% of the units for tenants whose income is 60% or less of area median income (adjusted for family size). This set-aside requirement is the same as that described herein applicable to the low income housing tax credit. *See id.* § 42(d). Unless otherwise indicated, all references are to the Internal Revenue Code of 1986.
3. *See* I.R.C. § 189(d) (1982) (repealed 1986).
4. *See id.* § 168(b)(4) (1982) (amended 1986). Under current law, all residential rental property is depreciated over a 27.5 year period. *Id.* § 168(c) (West Supp. 1988).

TRA'86 were not effectively addressing the housing needs of low to moderate income individuals.[5] The pre-TRA'86 system was criticized for, among other things, not being targeted to persons of truly low income.[6] For example, under the definition of "low income" for purposes of the tax-exempt financing provisions, individuals with income levels as high as 80% of area median income could qualify.[7] In addition, for purposes of the tax-exempt financing provisions, area median income, which is based on a family size of four, was not adjusted.[8] Thus, for example, a single person with no dependents could qualify a unit as a low income unit while earning as much as 80% of the area median income specified for a family of four. By contrast, the low income housing tax credit requires adjustment of the income threshold to reflect family size.[9] Thus, the income earned by the single person in the above example would have to be substantially lower to qualify the unit as a low income unit.

Second, the existing tax subsidies did not encourage owners to increase the number of units rented to low income individuals beyond the minimum threshold required for qualification of the project as a low income project. Under the pre-TRA'86 provisions, once the threshold was satisfied, the subsidy amount was fixed; thus, the owner of the project would not qualify for any increased subsidy by renting more units to low income tenants.[10] By contrast, the value of the low income housing tax credit to the owner is directly tied to the number of units actually rented to low income individuals, thereby encouraging owners to rent more units to such individuals.[11]

Third, under the pre-TRA'86 tax-exempt financing provisions, a project was required to retain its low income character for a period of only ten years.[12] The low income housing tax credit, however, requires low income compliance for fifteen years.[13]

Finally, the pre-TRA'86 system of incentives lacked any restriction on the amount of rent that could be charged to the qualifying low income tenants. The General Accounting Office, in its study on tax-exempt fi-

5. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 758 (1986), which states that the prior subsidies "operate in an uncoordinated manner, result in subsidies unrelated to the number of low-income individuals served, and fail to guarantee that affordable housing will be provided to the most needy low-income individuals."
6. *Id.*
7. I.R.C. §§ 103(b)(4)(A), 103(b)(12)(C) (1982) (repealed 1986).
8. *Id.* § 103(b)(12)(C) (1982) (repealed 1986) contained no provision requiring adjustment for family size.
9. *Id.* § 42(g)(4) (West Supp. 1988) (cross-referencing *id.* § 142(d)(2)).
10. For example, under the pre-TRA'86 tax-exempt financing provisions, the applicable minimum threshold required 20% of the units to be rented to low income tenants. *Id.* § 103(b)(4) (1982) (repealed 1986). Thus, once 20% of the units were rented to such tenants, the project could qualify for tax-exempt financing. Typically, owners would rent the remaining 80% of the units in the building to higher income individuals and would charge higher rents for such units.
11. *See Id.* § 42(c) (West Supp. 1988).
12. *Id.* § 103(b)(12)(B) (1982) (repealed 1986).
13. *Id.* § 42(i)(1) (West Supp. 1988).

nanced residential rental property, found that while the amount of rent paid annually by the majority of non-qualifying tenants constituted less than 30% of their annual income, the amount of rent paid annually by over 60% of the low to moderate income tenants exceeded 30% of their annual income.[14] Thus, in federally subsidized projects prior to the TRA'86, low income tenants were required to pay rents that were high relative to their disposable income levels. The low income housing tax credit limits the amount of rent that may be charged to qualifying tenants to a percentage of their income, thus attempting to ensure that subsidized housing will be affordable to low income individuals.[15]

III. QUALIFYING LOW INCOME HOUSING PROJECTS

A. *In General*

The low income housing tax credit is available only for "qualified low income housing projects."[16] Generally, residential rental property may qualify as such a project while commercial property may not.[17] A building that consists partially of residential rental property and partially of commercial property may qualify as a low income housing project, but only that portion of the building allocable to the residential rental property would be eligible for the credit.[18] The credit is available without regard to whether the buildings comprising the project provide multi-family or single-family housing.[19]

In order to be eligible for the credit, the rental units in the project must be "for use by the general public" on "a non-transient basis."[20] A

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14. *See* United States General Accounting Office, *Report to the Chairman, Joint Committee on Taxation, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds,* GAO/RCED-86-2, February 1986.
15. I.R.C. § 42(g)(2) (West Supp. 1988).
16. *Id.* § 42(a), (c)(2), (g).
17. Residential rental property includes the residential rental units, any facilities for use by the tenants of such units, and other facilities reasonably required by the project. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 4075, II-89 (1986) [hereinafter "CONFERENCE REPORT"].
18. The legislative history to the TRA'86 indicates that any method may be used to allocate basis between the residential and commercial portions of the property, provided that the allocation properly reflects the proportionate benefit to be derived from each. CONFERENCE REPORT, *supra* note 17, at II-90. It is not clear whether the Conferees intended the allocation to be made in accordance with economic benefit (*e.g.*, by revenues derived) or in accordance with structural benefit (*e.g.*, by floor space or area used). It appears that a combination of such methods would be required. *See* Prop. Treas. Reg. § 1.103-8(b)(4)(v), 50 Fed. Reg. 46303 (1985).
19. In addition, single room housing may qualify for the credit even if dining, cooking, and bathroom facilities are provided on a common basis. CONFERENCE REPORT, *supra* note 17, at II-95.
20. CONFERENCE REPORT, *supra* note 17, at II-95. The legislative history specifically provides that hospitals, nursing homes, sanitariums, lifecare facilities, retirement homes and trailer parks are not eligible for the credit. *Id.* The explanation of H.R. 3838 prepared by the Joint Committee on Taxation states that factory-made housing may qualify for the credit if it is permanently affixed to the real property. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION

rental unit would not be considered to be "for use by the general public" if only specific persons could qualify for leases.[21] For example, if the units were provided by an employer only to its employees or by a social organization only to its members, the units would not qualify as low income units.[22] In general, a unit would be considered as used on a "nontransient basis" if the initial lease term is greater than six months.[23]

B. New Buildings

The Internal Revenue Code ("the Code") divides property eligible for the credit into two categories: new buildings and existing buildings.[24] It is important to determine the characterization of a building as new or existing since the value of the credit for new buildings is generally higher than that for existing buildings.[25]

A new building is defined as any building, the original use of which begins with the taxpayer, while an existing building is defined as any building other than a new building.[26] Although the legislative history does not provide any guidance on this issue, under the statutory language, it appears that a purchased building that was never used by its prior owner for rental or any other purposes may qualify for the higher credit percentage applicable to new buildings. In order to ensure that the higher credit percentage may be claimed, taxpayers who are considering the purchase of a new building should obtain representations from the previous owner stating that the owner had not rented any units or derived any other income from the project prior to the date of the sale.

In certain situations where existing buildings are substantially rehabilitated, the rehabilitation expenditures themselves may qualify as a "new" building.[27] Thus, while the cost of purchasing the shell structure of an existing building would not qualify for the higher credit percentage, the costs associated with the rehabilitation expenditures would be treated as new costs eligible for the higher credit amount.[28] In order for rehabilitation expenditures to be treated as a new building, the qualified cost

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OF THE TAX REFORM ACT OF 1986, 164 (Comm. Print 1987) [hereinafter "GENERAL EXPLANATION"]. In determining whether such housing is affixed to the real property, the General Explanation references Treas. Reg. § 6a.103A-2(d)(4)(i), which provides that the determination of whether factory-made housing is permanently affixed to real property is made on the basis of the facts and circumstances presented in each case. *Id.* Since the General Explanation is not considered legislative history for these purposes, however, further clarification on this point by regulation or legislation may be necessary.

21. CONFERENCE REPORT, *supra* note 17, at II-95.
22. *Id.*
23. *Id.*
24. I.R.C. § 42(i) (West Supp. 1988).
25. *Id.* § 42(b)(1).
26. *Id.* § 42(i)(4), (5).
27. *Id.* § 42(e).
28. *Id.* § 42(e)(4)(B).

basis of such expenditures[29] in any twenty-four month period, when divided by the number of low income units in the building, must be two thousand dollars or more.[30] In determining whether the two thousand dollar threshold has been met, rehabilitation expenditures allocable to rental units which are not low income units and which are "above the average quality standard" of the low income units must be excluded from the calculation of qualified cost basis.[31]

For purposes of determining whether a unit is "above the average quality standard," the legislative history provides only a subjective rule that "[u]nits are of comparable quality if the construction or acquisition costs are comparable and if such units are provided in a similar proportion for both the low-income and other tenants."[32] This rule is of little assistance for owners who intend to rehabilitate both market rate rental units and low income units since no safe harbor is provided within which any cost differential between such units would be considered insubstantial. Both the House and Senate versions of the Technical Corrections Bill of 1988 (the "Technical Corrections Bill") contain provisions that would provide an objective rule that a unit would not be considered above average quality if (i) the cost per square foot of the market rate rental unit does not exceed by 15% the average cost per square foot of the low income units, and (ii) the excess cost is excluded in calculating qualified basis.[33] If both of these conditions are satisfied, only the portion of the rehabilitation expenditure allocable to the excess cost would be excluded in calculating the qualified cost basis of improvements for purposes of determining whether the two thousand dollar threshold has been satisfied.[34] In order to ensure that at least the portion of the rehabilita-

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29. Generally, the qualified cost basis equals the total cost of the improvements multiplied by the lesser of (i) the proportion of floor space allocable to low income tenants or (ii) the proportion of units allocable to low income tenants. *Id.* § 42(c) (West Supp. 1988). Thus, if $100,000 is expended and 50% of the units and 40% of the floor space is allocable to low income tenants, the qualified basis of the improvements would be $40,000 ($100,000 × 40%).

30. *Id.* § 42(e)(3) (West Supp. 1988). Thus, in the example in the previous footnote where the qualified cost basis of the improvements is $40,000, the rehabilitation expenditure would be a "new building" if there are no more than 20 low income units in the building (*i.e.*, $40,000 divided by 20 units is greater than or equal to $2,000).

31. In the previous example, if $5,000 of the rehabilitation expenditures were attributable to market rate rental units which are "above the average quality standard" of low income units, then the qualified basis of the improvements would be only $38,000 (*i.e.*, ($100,000 − $5,000) × 40%).

32. CONFERENCE REPORT, *supra* note 17, at II-89.

33. TECHNICAL CORRECTIONS BILL OF 1988, H.R. 4333/S. 2238, 100th Cong., 2d Sess. § 102(l)(4) (1988) [hereinafter "TECHNICAL CORRECTIONS BILL"]; *see also* GENERAL EXPLANATION, *supra* note 20, at 158. As of the writing of this article, the Technical Corrections Bill has not been enacted into law.

34. For example, assume that a total of $150,000 was expended for improvements and that $50,000 is allocable to market rate rental units. Of the $50,000, only $10,000 is allocable to improvements in excess of the average cost per square foot of low income units. If the total cost per square foot of the market rate units does not exceed

tion costs of market rate units not in excess of the average low income unit costs may be counted, taxpayers that are rehabilitating units should meet the 15% guideline.

C. *Existing Buildings*

The acquisition of an existing building may only qualify for the credit if three conditions are satisfied: (i) the building is purchased from an unrelated party;[35] (ii) a period of at least ten years has expired between the date of the current acquisition and the date the building was last placed in service or substantially improved;[36] and (iii) the building has not been previously placed in service by the taxpayer or certain related persons.[37]

IV. QUALIFICATION REQUIREMENTS

A. *Minimum Set-Aside Requirement*

In order to obtain the credit, the owner must meet one of two minimum "set-aside" requirements throughout the fifteen-year compliance period.[38] Congress structured the set-aside options to address concerns

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15% of the average cost per square foot of low income units, in determining whether the $2,000 threshold has been satisfied, $140,000 of the improvement expenses would be includible in qualified basis. By contrast, if the 15% guideline was violated, only $100,000 would be includible because *all* amounts allocable to the above standard units would be excluded.

35. *See* I.R.C. §§ 42(d)(2)(B)(i) (West Supp. 1988), 179(d)(2) (1982).

36. A building would be considered "substantially improved" if (i) during any 24-month period the improvement expenditures equaled or exceeded 25% of the adjusted basis of the building immediately prior to such expenditures and (ii) either I.R.C. § 168 (as in effect prior to the enactment of the TRA'86) applied to such expenditures or the taxpayer made an election to accelerate the depreciation of the rehabilitation expenditures under I.R.C. § 167(k). *Id.* § 42(d)(2)(D)(i) (West Supp. 1988).

A building would not be considered as previously placed in service if such placement occurred in connection with an acquisition, such as a tax-free exchange, in which the basis of the acquiring party was determined in whole or in part by reference to the adjusted basis of the transferor. In addition, the Technical Corrections Bill contains provisions which would disregard certain placements in service for purposes of the ten year rule, including: (i) placements in service in connection with transfers upon death, (ii) acquisitions by governmental units or 501(c)(3) organizations, which acquisitions occur at least 10 years after the previous placement in service and (iii) foreclosures occurring at least ten years after the previous placed-in-service date, provided the property is resold within 12 months of the foreclosure. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(h)(3).

Proposed and temporary regulations recently promulgated by the Department of Treasury provide for a waiver of the 10-year rule in the case of certain federally assisted projects where the acquisition is required to avoid an assignment of the mortgage on a building to HUD or FHA, or to avert a claim against a federal mortgage insurance fund with respect to such a mortgage. Temp. Treas. Reg. § 1.42-2T (1987).

37. I.R.C. § 42(d)(2)(B)(iii) (West Supp. 1988).

38. *Id.* § 42(i)(1). The compliance period is the 15-year period which commences with the year the taxpayer first claims a credit with respect to the project. Thus, if the

that the definition of low income individuals was overly broad under the existing tax subsidies.[39] The following two options are available to owners of residential rental projects for purposes of the credit: (i) 20% or more of the units in the project must be occupied by individuals whose income is not greater than 50% of area median gross income (adjusted as described below), or (ii) 40% or more of the units in the project must be occupied by individuals whose income is not greater than 60% of area median gross income (adjusted as described below).[40]

The determination of area median gross income will be made by the Secretary of the Treasury in a manner consistent with such determinations under section 8 of the United States Housing Act of 1937.[41] In this regard, the Department of Housing and Urban Development ("HUD") publishes annually the area median gross income for each metropolitan area and for the non-metropolitan or rural portion of each of the fifty states.[42]

For these purposes, area median income is adjusted to reflect family size.[43] For example, if the taxpayer elects the 20/50 alternative, a family of four will be eligible if its income is 50% or less of area median income;

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taxpayer makes an election under I.R.C. § 42(f)(1) to defer claiming the credit until the taxable year following the taxable year in which the project is placed in service, the compliance period will begin with the taxable year following the placed-in-service year.

39. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 758 (1986).

40. I.R.C. § 42(g)(1) (West Supp. 1988).

41. *Id.* § 42(g)(4), which cross-references I.R.C. § 142(d)(2)(B).

42. In certain metropolitan areas, HUD's determination of area median income takes into account income levels in the surrounding suburban areas, while in other metropolitan areas HUD's determination does not take into account suburban incomes. In metropolitan areas where the area median gross income is determined without taking into account suburban incomes, concerns were raised that the area median gross income for such areas would be too low, since income levels in suburban areas are typically higher than those in cities. H.R. REP. NO. 391, 100th Cong., 1st Sess. 1521 (1987). A miscellaneous tax provision contained in both the House and Senate versions of the Omnibus Budget Reconciliation Act of 1987 would have partially addressed this concern by allowing the owner of a project to elect either HUD's determination of area median gross income for the metropolitan area or the median income of the state in which the project is located. *See* S. 1920, 100th Cong., 1st Sess. § 6792 (1987); H.R. 3545 100th Cong., 1st Sess. (1987). These provisions have not been enacted into law, nor are any similar provisions currently under consideration.

43. I.R.C. § 42(g)(1) (West Supp. 1988) (cross-referencing *id.* § 142(d)(2)(B)). Under the adjustment for family size made by HUD in 1987, for example, the following percentages would apply:

	Percent of Area Median Income at:	
Size of Household	50% of Median Income Standard	60% of Median Income Standard
One Person	35%	42%
Two Persons	40	48
Three Persons	45	54
Four Persons	50	60

a family of three will be eligible if its income is 45% or less.[44]

The set-aside requirement must be satisfied during each year in the fifteen-year compliance period.[45] Accordingly, owners must monitor the income of the project's low income tenants to ensure continued compliance since an increase in a tenant's income could disqualify that tenant for purposes of the set-aside test. The legislative history provides a *de minimis* rule under which the income of a qualifying tenant is permitted to increase to a level which does not exceed the elected qualifying median income amount by more than 40%.[46]

As previously discussed, Congress was also concerned that the current system of subsidies did not restrict the amount of rent that could be charged by owners of low income housing projects.[47] Accordingly, for purposes of the credit, a rental unit will not count towards meeting the set-aside requirement if the gross rent charged to the tenant exceeds 30% of the elected qualifying median income amount, as adjusted.[48] Therefore, if the 40/60 set-aside test is elected, higher rents may be charged on the low income units than if the 20/50 set-aside test is elected.[49]

For these purposes, gross rent includes utility costs paid directly by a low income tenant.[50] Therefore, in determining what rental amount may be charged, owners must estimate the cost for tenant utilities.

Gross rent does not include, however, federal rent subsidies paid directly to the owners.[51] Although Code section 42(g) literally includes state and local rental assistance payments in the calculation of gross rent, the General Explanation to the TRA'86 indicates that the congressional

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		(a)		(b)
Five Persons	54	64.8	or	63.75
Six Persons	58	69.6	or	67.5
Seven Persons	62	74.4	or	71.25
Eight Persons	66	79.2	or	75.0

(a) Based on HUD adjustment factor at 50% of median income level; most likely to be used.

(b) Based on HUD adjustment factor at 80% of median income level.

44. CONFERENCE REPORT, *supra* note 17, at II-94.
45. I.R.C. § 42(c)(2), (g), (i)(1) (West Supp. 1988).
46. CONFERENCE REPORT, *supra* note 17, at II-93.
47. *See supra* note 14 and accompanying text.
48. The Technical Corrections Bill would add a provision which provides that, under certain circumstances, the gross rent paid by the tenant may exceed 30% of the applicable income limit. Under this provision, if a federal rental assistance payment is made under a statute which requires that the federal assistance be reduced and that the gross rent paid for that unit increase as the tenant's income increases then the gross rent paid by the tenant may exceed the 30% limitation on gross rent to the extent required by the federal statute. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(l)(11).
49. Although somewhat higher rents may be charged on the low income units, twice as many units would be subject to the rent restriction and set aside requirements under the 40/60 election.
50. The legislative history indicates, however, that payments for telephones will be excluded from gross rent. CONFERENCE REPORT, *supra* note 17, at II-94.
51. I.R.C. § 42(g)(2)(B)(i) (West Supp. 1988).

intent was to exclude such amounts.[52]

For projects consisting of only one building, the minimum set-aside requirement must be met within twelve months after the date the building is placed in service.[53] Projects consisting of multiple buildings placed in service at different times, however, are subject to a special rule which provides that at any time a new building in the project is placed in service, two requirements must be met: (i) the project (without regard to the new building) must meet the set-aside requirement as of the date the new building is placed in service; and (ii) the project as a whole (including the new building) must meet the requirement within twelve months from the date the new building is placed in service.[54]

If two buildings are placed in service less than twelve months apart, this provision would appear to accelerate the compliance date for the building placed in service earlier.[55] Both the legislative history and the General Explanation indicate that Congress did not intend such a result.[56] The Conference Report indicates that for multiple building projects, the set-aside requirement must be met for the first building within twelve months from the date it is placed in service regardless of when later buildings are completed. When another building is subsequently placed in service, the set-aside requirement for the project as a whole must be met within twelve months from the date such subsequent building is placed in service.[57] The project as a whole must continue to

52. GENERAL EXPLANATION, *supra* note 20, at 163. The Technical Corrections Bill would implement this change. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(l)(10). In addition, because median income levels in economically distressed areas (where low income housing is most needed) are so low, it has been argued that projects located in such areas are economically unfeasible since permissible rents are tied to such income. H.R. REP. NO. 391, 100th Cong., 1st Sess. 1521 (1987). Proposals to alleviate this problem include the adoption of the definition of median income as the higher of area median income or statewide median income. *See supra* note 39 and accompanying text.

53. I.R.C. § 42(g)(3)(A) (West Supp. 1988). Presumably, the term "placed-in-service" will have the meaning given that term in Treas. Reg. §§ 1.167(a)-11(e)(1) and 1.46-3(d)(1)(ii) which provide generally that "property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function. . . ."

54. I.R.C. § 42(g)(3)(B) (West Supp. 1988).

55. For example, if the first building is placed in service on January 1, 1987 it ordinarily would not be required to meet the set-aside standard until January 1, 1988. However, if a second building is placed in service on July 1, 1987, under the statutory provision, the first building would have to be in compliance as of that date (*i.e.*, 6 months prior to the time it would have to comply were the second building not placed in service).

56. *See generally* CONFERENCE REPORT, *supra* note 17, at II-92; GENERAL EXPLANATION, *supra* note 20, at 161.

57. For example, if Building 1 is placed in service on January 1, 1987, Building 2 is placed in service on July 1, 1987, and Building 3 is placed in service on October 1, 1987, the following are the applicable compliance dates: January 1, 1988 - Building 1 must meet the set-aside standard; July 1, 1988 - Buildings 1 and 2 (in the aggregate) must meet the set-aside standard; October 1, 1988 - Buildings 1, 2, and 3 (in the aggregate) must meet the set-aside standard.

comply until fifteen years have expired from the date the last project building was placed in service.[58]

The General Explanation rule presents a slight variation from the rule suggested in the Conference Report. The General Explanation states that:

> Congress intended that if within twelve months of the date a first building is placed in service, (1) the first building does not meet the set-aside requirement with respect to the first building and (2) a second building is placed in service, then the project is a qualified low-income project if the set-aside requirement is satisfied with respect to both buildings within 12 months of the placed-in-service date of the first building.[59]

This interpretation would appear to allow project owners to rent units in initial buildings at market rates to non-low income tenants provided that, within one year, the minimum set-aside is met for the project as a whole. The Technical Corrections Bill would adopt a modified version of the provision in the General Explanation, allowing taxpayers to elect whether or not to aggregate buildings as described in the General Explanation or to utilize the rule described in the Conference Report.[60]

In summary, it is not clear when the minimum set-aside rules must be met with regard to multiple building projects. As currently drafted, the Code imposes harsh results when a second building is placed in service months or even weeks after an earlier building, since the earlier building must meet the set-aside requirement within such month or week long period. Until such time as the Code is amended, taxpayers may guard against this possibility by first placing in service those buildings with higher proportions of low income tenants.

B. State Allocation Requirement

The Code imposes a ceiling on the aggregate credit amount for any taxable year that may be claimed by all taxpayers with respect to projects located within the same state.[61] A state is permitted to allocate a maximum yearly credit amount equal to $1.25 multiplied by the state population.[62] A state allocation must be obtained for the year a project is

58. CONFERENCE REPORT, *supra* note 17, at II-93.
59. GENERAL EXPLANATION, *supra* note 20, at 161 n.17. Thus, if Building 1 were placed in service on January 1, 1987 and Building 2 were placed in service on July 1, 1987 then the project would qualify if the set-aside requirement were met for the project, as a whole, on January 1, 1988.
60. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(l)(12).
61. I.R.C. § 42(h) (West Supp. 1988).
62. *Id.* § 42(h)(3)(C). The State of Maryland has, by executive order, allocated its entire credit amount to the Department of Economic and Community Development located in Annapolis. This authority will evaluate project applications and allocate the credit to qualifying projects.

placed in service.[63] Subsequent to the placed-in-service year, an additional allocation is required only in respect of additional credit amounts permitted due to an increase in qualified basis.[64]

The Code provides that a state may allocate its housing credit dollar amount for any calendar year only to buildings placed in service before the close of such calendar year.[65] The legislative history indicates that credits may not be allocated before the calendar year in which the building is placed in service.[66] This provision could pose problems for owners of low income housing projects in numerous instances. For example, if the owner receives an allocation in year one, but unexpected problems delay placement in service until year two, it would appear to require a new state allocation.

The Technical Corrections Bill would clarify the congressional intent with respect to this provision. The general rule would remain that a credit allocation must be made in the calendar year during which a building is placed in service. Two special rules, however, would be provided. First, in those circumstances where, due to unforeseen circumstances, a building cannot be placed in service in the year for which an allocation is received, the Secretary of the Treasury may approve use of the allocation in the following year.[67] Second, the Technical Corrections Bill would permit a state housing credit agency to make a binding commitment to allocate a credit currently for buildings to be placed in service in future years.[68] If a building is placed in service earlier than expected, the allocation will be valid, but will reduce the allocation limit for the later year.[69]

V. THE AMOUNT OF THE CREDIT

If a project qualifies under the eligibility standards and state allocation requirements described above, the owner of the project is entitled to a low income housing tax credit for the project.[70] The credit amount is calculated for each individual building in accordance with a formula which takes into account the character of the investment and the portion

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63. *Id.* § 42(h)(2). If the project is financed through the use of tax-exempt bonds subject to the state volume cap under § 146, however, no allocation is required. *Id.* § 42(h)(4).
64. No additional allocation should be required, however, if the original state allocation was sufficiently large to include the additional qualified basis amount.
65. *Id.* § 42(h)(6).
66. CONFERENCE REPORT, *supra* note 17, at II-98.
67. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(l)(17). No guidelines are provided as to what would be a permissible delay for these purposes. In all likelihood, typical construction delays due to labor strikes, supply shortages or inclement weather would qualify.
68. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(1)(14); *see also* GENERAL EXPLANATION, *supra* note 20, at 167.
69. GENERAL EXPLANATION, *supra* note 20, at 167.
70. A building within a project will not qualify if § 201(a) of the TRA'86 (with regard to ACRS changes) does not apply.

of the building devoted to low income tenant housing.[71]

As discussed above, the value of the credit is higher for new buildings (including rehabilitation expenditures treated as new buildings) that are not federally subsidized (e.g., for buildings placed in service in 1987, 9% per year for ten years) than it is for federally subsidized new buildings or for the purchase of existing buildings (e.g., for buildings placed in service in 1987, 4% per year for ten years).[72] For these purposes, a building is considered federally subsidized if, with respect to such building there is outstanding (i) any below market rate federal loan or (ii) any other obligation the interest on which is exempt from taxation under Code section 103.[73] Taxpayers may elect, however, to exclude from the eligible basis of the building (as defined below) an amount equal to the outstanding balance of the federally subsidized obligations, in order to qualify for the higher credit percentage.[74] Taxpayers should calculate the value of the credit under a reduced basis scenario to determine whether this election should be made. In general, if the outstanding balance of federally subsidized loans is low in relation to the total basis of the project, the election should be made.

The General Explanaton indicates that Congress intended to treat a building as non-subsidized if all below market loans are repaid and all tax-exempt bonds are redeemed prior to the placed-in-service date.[75] In such a situation, the amount of the credit would be calculated in accordance with the higher credit percentage. The Technical Corrections Bill would adopt this change in the case of subsidized construction financing.[76] If this provision is enacted, taxpayers should determine if the increased credit amount would offset the increased financing costs associated with market rate loans.

For buildings placed in service after 1987, the credit percentages will be adjusted monthly to result in a credit equal to the present value of 70% of the qualified basis of a non-subsidized new building and equal to the present value of 30% of the qualified basis of other buildings.[77] The applicable percentage is determined on the date a building is placed in service.[78] Thus, different buildings in a multiple building project could be subject to different percentage amounts. The General Explanation indicates, however, that Congress intended to allow taxpayers to elect irrevocably for the entire project the credit percentage in effect on the date

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71. I.R.C. § 42(f)(2)(A) (West Supp. 1988). A portion of the credit for the first year is deferred when a project is placed in service in the middle of the owner's taxable year. This deferred portion may be claimed by the taxpayer in the eleventh year of the credit period. *Id.* § 42(f)(2)(B).
72. *Id.* § 42(b)(1).
73. *Id.* § 42(i)(2)(A).
74. *Id.* § 42(i)(2)(B).
75. GENERAL EXPLANATION, *supra* note 20, at 160.
76. TECHNICAL CORRECTION BILL, *supra* note 33, § 102(1)(20).
77. I.R.C. § 42(b)(2) (West Supp. 1988).
78. *Id.*

the taxpayer receives a binding commitment from the state housing credit agency for a state allocation.[79] In the case of tax-exempt bond financed projects that do not require a state allocation for the credit, the General Explanation indicates that the taxpayer may elect the credit percentage in effect on the date the tax-exempt bonds are issued.[80] If this change is adopted, owners could project the economic viability of a project prior to the placed-in-service date and thus could avoid uncertainties with respect to the credit percentage associated with fluctuations in interest rates.

To determine the total amount of the credit, the applicable percentage is multiplied by the sum of the "qualified basis" amounts for each building in the project.[81] In general, the starting point for determining qualified basis is a building's "eligible basis." For a new building, eligible basis is equal to the building's adjusted cost basis on the date it is placed in service. A building's adjusted cost basis would include construction costs and other costs for depreciable property attributable to the building but would exclude the cost of the land.[82]

For existing buildings, eligible basis generally equals the acquisition cost. In addition, any capital expenditures incurred during the first year a credit is claimed on the existing building[83] are included in eligible basis.[84] Costs allocable to "above standard" market rate units, however, are excluded.[85] Taxpayers who intend to qualify for the credit through the acquisition of an existing building would be advised to time the acquisition as early in their taxable year as possible in order to maximize the inclusion of capital expenditures in eligible basis.

In order to determine the "qualified basis" for a building, eligible basis is multiplied by the lesser of (i) the percentage of units devoted to low income tenants, or (ii) the percentage of floor space devoted to low income tenants.[86] These percentages are determined on the last day of the taxable year during which the building is placed in service or, at the

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79. GENERAL EXPLANATION, *supra* note 20, at 155. The Technical Corrections Bill would adopt this change. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(1)(1).

80. GENERAL EXPLANATION, *supra* note 20, at 155; TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(l)(1).

81. I.R.C. § 42(a) (West Supp. 1988).

82. GENERAL EXPLANATION, *supra* note 20, at 157.

83. If an election is made to defer the use of the credit for one year, capital expenditures during the first year of the elected credit period would be counted. I.R.C. § 42(d)(2)(A)(i)(II) (West Supp. 1988).

84. *Id.* § 42(d)(2)(A). For example, if the acquisition cost of the building was $500,000 and capital expenditures of $50,000 were incurred during the first year of the credit period, the basis amount on which the credit is calculated would equal $550,000.

85. *See supra* text accompanying notes 31-33, regarding "above standard" units in the context of rehabilitation expenditures treated as new buildings. In addition, the eligible basis for any new or existing building must be reduced by the value of any federal grants made in respect of such building. I.R.C. § 42(d)(5)(B) (West Supp. 1988).

86. *Id.* § 42(c). For purposes of calculating these percentages, the numerator accounts

election of the taxpayer, on the last day of the following taxable year.[87] Taxpayers would be advised to make such an election if either (i) a building is placed in service late in the taxable year such that the percentages would be low at the close of the first taxable year or (ii) it is expected that the percentages will be substantially higher at the close of the second year than they were at the close of the first (e.g., if the projected rent-up period extends well beyond the close of the first year).

If qualified basis later increases by virtue of an increase in the percentage of units or floor space rented to low income tenants, only a portion of the additional credit amount attributable to such increase may be claimed.[88] In such a case, the credit amount is increased by the product of (i) the increase in qualified basis and (ii) two-thirds of the percentage used in calculating the credit amount (e.g., for buildings placed in service in 1987, two-thirds of 9% for new buildings and two-thirds of 4% for existing buildings or federally-assisted new buildings).[89] In order to claim a credit in respect of such increase, a new state allocation may be required.

If the qualified basis amount decreases,[90] or if the set-aside requirement is not met at any time during the fifteen-year compliance period, the taxpayer will be subject to a recapture of a portion of the credit claimed.[91] A decrease in qualified basis or a failure to comply with the

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only for units occupied by low income tenants whereas the denominator accounts for all units, including unoccupied units. *Id.*

87. *Id.* § 42(f)(1). If the taxpayer elects to apply the subsequent year percentage amount, however, the credit would be deferred until such subsequent year.
88. *Id.* § 42(f)(3).
89. *Id.* For example, assume the following facts. A building is constructed for $100,000. It consists of 100 units, 40 of which are rented to low income tenants. In addition, it consists of 200,000 square feet of apartment floor space of which 80,000 square feet are devoted to low income tenants. In the first year, the owner may claim a credit of 9% (*i.e.*, the applicable percentage for new buildings) of a qualified basis of $40,000 ($100,000 × 40% based on number of units and floor space) or $3,600. If, in year two, as a result of additional low income tenants, the percentage of both floor space and units devoted to low income tenants equals 50%, the qualified basis would increase by $10,000 to $50,000. In this case, the owner may increase his $3,600 credit by the product of the additional $10,000 basis and 2/3 of the applicable percentage of 9% for an increase in credit of $600.
90. The General Explanation indicates that a *de minimis* decrease in qualified basis attributable to decreases in the percentage of floor space rented to low income tenants would not trigger recapture. GENERAL EXPLANATION, *supra* note 20, at 167. No objective standard is provided as to what constitutes *de minimis* for these purposes. The Technical Corrections Bill provides that the Secretary of the Treasury may, by regulation, allow for such *de minimis* decreases. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(1)(21).
91. I.R.C. § 42(j) (West Supp. 1988). In determining whether a decrease in qualified basis has occurred, any decrease attributable to a previous increase in qualified basis (as discussed above), for which only two-thirds of the otherwise applicable credit was claimed, is not counted. *Id.* § 42(j)(4)(C). For example, in 1987, an owner claims a credit based on 25% of the units having been rented to low income tenants. In 1988, as a result of additional rentals to low income tenants, the owner claims a credit based on 35% of the units having been rented to low income tenants (only 2/3 of the increased credit amount is claimed). If, at the close of 1989, only 25% of

set-aside requirement is determined at the close of each taxable year for which the credit is claimed.[92] Thus, owners should closely monitor the qualified basis amount throughout the taxable year, in order to avoid recapture. If the taxpayer cannot prevent a decrease in qualified basis by the close of the taxable year, the legislative history indicates that the taxpayer will be permitted a "reasonable time" after the close of the taxable year to do so.[93] In this regard, the legislative history indicates that during a period of decreased basis or noncompliance, the owner must rent any available units comparable in size to low income units only to low income tenants.[94] If any such unit is rented to a tenant other than a low income tenant, the "reasonable time" grace period will be considered to have expired.[95]

The concept underlying the recapture provision is that the low income housing tax credit is an "accelerated" credit in that the benefits accrue over ten years whereas compliance is required for fifteen years. In this regard, where recapture is triggered the Code requires the taxpayer to recapture the "accelerated portions" of the credit claimed for all prior years.[96] The first step in calculating the accelerated portion for any year is to determine the amount by which the qualified basis has decreased.[97] Next, the total value of the credit claimed in respect of such basis as of the date recapture is triggered is determined. This value is compared with the total value of the credit which would have been claimed through such date had the credit been taken over a fifteen-year period.[98] The difference between the ten-year and fifteen-year amounts is the accelerated portion subject to recapture.[99]

Generally, any change in ownership of a building subject to the

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the units are rented to low income tenants, no recapture would be triggered since the entire decrease is attributable to a prior increase. By contrast, if only 20% of the units were rented to low income tenants at the close of 1989, recapture would be triggered to the extent of the overall 5% decrease from the initial 25% low income rental rate.

92. *Id.* § 42(j)(1).
93. CONFERENCE REPORT, *supra* note 17, at II-97.
94. *Id.*
95. *Id.*
96. I.R.C. § 42(j)(2) (West Supp. 1988).
97. *Id.* § 42(j)(3)(A). For a building which fails to meet the minimum set-aside requirements, this amount would be the entire qualified basis of such building exclusive of any decreases attributable to previous increases because it is no longer a qualified building so its eligible basis would be zero.
98. *Id.* § 42(j)(3)(B).
99. *Id.* § 42(j)(2), (3). For example, consider a new building with a qualified basis of $100,000. In year four, the qualified basis decreases by $10,000. With respect to that $10,000 decrease, a total of $2,700 in credits was claimed for years one through three (*i.e.*, 3 × 9% × $10,000). If the credit had accrued over 15 years instead of 10, the applicable percentage would have been 6% rather than 9% (*i.e.*, in order to claim a total credit of 90% over 15 years, 6% per year would be claimed). Thus, if the credit had been claimed over a 15-year accrual period, a total of $1,800 would have been claimed for years one through three (*i.e.*, 3 × 6% × $10,000). Therefore, the amount of credit recaptured would equal $900 (*i.e.*, $2,700 − $1,800).

compliance period is also a recapture event.[100] Thus, if an owner sells a building prior to the end of the fifteen-year compliance period, recapture is triggered on the date of the sale in an amount equal to the accelerated portion of the entire qualified basis. A limited exception to this rule is provided if (i) the taxpayer provides a bond in an amount and for a time period satisfactory to the Secretary of the Treasury and (ii) it is reasonably expected that the building will be maintained as a qualified low income building for the duration of the compliance period.[101]

Since any change of ownership of a building is a recapture event, generally any sale of a partnership interest in a partnership claiming a low income housing credit would trigger recapture. A limited exception is provided, however, if the owner of the project is a partnership comprised of thirty-five or more individuals. In such case, the partnership may elect a special rule whereby the sale of a partnership interest will not be considered a recapture event as long as the partnership does not terminate under section 708(b) as a result of such sale.[102] Thus, for example, if a limited partnership comprised of at least thirty-five individuals owns the low income housing project, the partnership interests may be freely traded without triggering recapture, provided the election is made and a section 708(b) termination is not effected. The Technical Corrections Bill would expand the exception to include partnerships that include one or more corporate partners, provided that at least 50% of the partnership is owned by thirty-five or more individuals.[103]

VI. PRACTICAL LIMITATIONS ON THE USE OF THE CREDIT

A. At-Risk Limitation

In determining the qualified basis with respect to which the credit may be claimed, rules similar to the investment tax credit at-risk limitations applicable to non-recourse financing will apply.[104] For purposes of the credit, the qualified basis must be reduced by any "non-qualified non-recourse financing."[105] Non-recourse financing is qualified only if the lender is a "qualified person" or the government.[106] For these purposes, a qualified person is (i) an entity regularly engaged in the business of

100. CONFERENCE REPORT, *supra* note 17, at II-96.
101. I.R.C. § 42(j)(6) (West Supp. 1988). It is unclear from the legislative history if the required bond would equal the potential recapture liability or some smaller amount. CONFERENCE REPORT, *supra* note 17, at II-96.
102. I.R.C. § 42(j)(5) (West Supp. 1988). In general, § 708(b) provides that a partnership shall be terminated if the partnership ceases to operate or if, within a 12-month period, there is a sale or exchange of 50% or more of the total interests in the partnership capital and profits.
103. TECHNICAL CORRECTIONS BILL, *supra* note 33, § 102(1)(22).
104. I.R.C. § 42(k) (West Supp. 1988); *see also id.* § 46(c)(8) (1982 & West Supp. 1988), (9), 47(d)(1) (1982 & West Supp. 1988).
105. *Id.* § 46(c)(8) (West Supp. 1988).
106. *Id.* § 46(c)(8)(D)(iv).

lending money (which entity is not the seller of the property) or (ii) a qualified non-profit organization.[107]

B. Investor Limitations

With regard to individuals and closely held subchapter C corporations, the Code restricts the amount of any credit attributable to a "passive activity" that may be utilized in a particular taxable year.[108] Since any rental activity would constitute a passive activity for these purposes,[109] the low income housing tax credit would fall within the category of credits subject to the statutory restriction.

In general, credits attributable to passive activities may only be used to offset tax liability attributable to income from passive activities.[110] In the case of rental real estate activities, however, the Code provides a special rule under which a taxpayer is permitted to offset up to $25,000 of non-passive income through the use of deductions and credits attributable to such rental real estate activities, but only if the taxpayer "actively participates" in such rental activities.[111] This limited offset of non-passive income is phased out by 50% of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $100,000.[112] With respect to the low income housing tax credit, however, the $25,000 offset is permitted without regard to the taxpayer's active participation in either the rental activity or the activity to which the income is attributable.[113] In addition, the $25,000 offset is phased out by 50% of the amount by which the adjusted gross income of the taxpayer exceeds $200,000 (as opposed to $100,000) for the taxable year.[114]

The Code also restricts, for any taxable year, the portion of a taxpayer's tax liability that may be offset by business credits, including the low income housing tax credit.[115] For these purposes, the limitation is equal to the lesser of: (i) the portion of the taxpayer's regular tax liability equal to $25,000 plus 75% of any tax liability in excess of $25,000 or (ii) the excess of regular tax liability over tentative minimum tax liability

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107. A "qualified non-profit organization" is a § 501(c)(3) or (c)(4) organization, an exempt purpose of which is the fostering of low income housing. The loan must be secured by the project, must not constitute more than 60% of the financing, and must be fully repaid at the earliest of its maturity, a sale or refinancing, or three months following the close of the compliance period. *Id.* § 42(k)(2). Unlike the general at-risk limitation, for purposes of the low income housing tax credit, the non-recourse financing may exceed 80% of the credit base of such property. *Id.* § 42(k)(1) (excluding the application of § 46(c)(8)(D)(ii)(II)).
108. *Id.* § 469 (West Supp. 1988). These restrictions do not apply to subchapter C corporations which are not closely held. *Id.*
109. *Id.* § 469(c)(2).
110. *Id.* § 469. To the extent the use of such credits is limited by the passive loss rules, they may be carried over indefinitely. *Id.*
111. *Id.* § 469(i).
112. *Id.* § 469(i)(3)(A).
113. *Id.* § 469(i)(6).
114. *Id.* § 469(i)(3).
115. *Id.* § 38 (West Supp. 1988).

for the taxable year.[116] Any credit that may not be used in a particular taxable year may be carried forward indefinitely.

VII. CONCLUSION

The complexity of the low income housing tax credit provisions coupled with the glitches in the statute noted above (some of which still need to be addressed legislatively) caused the credit to be utilized sparingly during 1987. The volume of low income housing tax credit projects increased in 1988, however, because developers and investors had become more familiar with the requirements and benefits of the credit. Currently, because of high utilization of the credit, many states are expected to exhaust their volume allocations for 1988 and 1989.

Unfortunately, while the volume of low income housing tax credit projects has increased, the states' volume allocation authority is set to expire on December 31, 1989. Although the House Ways and Means Committee approved a measure that would extend state allocation authority through December 31, 1990,[117] as of the writing of this article, the Senate Finance Committee has yet to approve the extension. Unless Congress ultimately passes an extension, the low income housing tax credit will be of little use to developers who expect to place projects in service after 1989.

116. *Id.* § 38(c)(3). For example, if a taxpayer's total tax liability is $100,000 and his tentative minimum tax is $10,000, the maximum allowable credit would be $81,250 ($25,000 + .75 × $75,000). By contrast, if the taxpayer's tentative minimum tax were $25,000, the maximum allowable credit would be $75,000. For these purposes, minimum tax would be calculated in accordance with the rules set forth in I.R.C. § 55 (1982).

117. H.R. 4333, 101st Cong., 1st Sess. (1988). The Miscellaneous Revenue Act of 1988, passed by the House Ways and Means Committee on July 15, 1988.