PKF O'CONNOR DAVIES
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The Life Cycle of Low-Income Housing Tax Credits (LIHTC)

Part 3 – First Year and Beyond

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In earlier articles on this topic, we have taken our readers through the formation and development stages of **The Life Cycle of Low-Income Housing Tax Credits.** This third and final installment on the subject covers the years following development.

Now that the property is occupied and we have a cost certification, we can move on to calculating the tax credits. In order to calculate the annual credits, we will need:

- Eligible Basis of Property – from the Cost Certification
- Tax Credit Rate
- Tax Credits Awarded

Eligible Basis

As discussed in a previous article, eligible basis is the depreciable basis of residential rental property. From this amount, we back-out any federal financing. We then apply the following percentages: applicable fraction and percentage of units qualifying for the tax credits because, as such, they are rent restricted. This percentage is calculated as the lower of square footage or number of units.

We then also may apply a "basis boost." In areas deemed "difficult to develop" projects are eligible for a bump-up in basis in connection with the calculation of credit. All of NYC has been deemed difficult to develop for 9% projects by HPD (credit agency for NYC). Bond projects (4% deals) must be in a HUD-designated DDA (demand deposit account) or QCT (qualified census tract) to qualify for the basis boost.

Once we apply these percentages, we have our qualified basis. We then apply the credit rate and, in the case of 9% credits, compare it to the maximum credits awarded by the state agency.

One thing to note here is that developments using bond financing, which only garner 4% credits, are not allocated a maximum number of credits. These projects are allowed to take as much credit as their calculation results.

First-Year Credit

Once we have the annual amount calculated, we take it a step further and calculate the first-year credit. The LIHTC is a 15-year credit taken over 10 years at a set annual amount. In practice, it is an 11-year credit as the first year is pro-rated based on move-ins. The tax credit "meter" starts running when the first eligible tenant moves into a unit in a tax credit property. The 11th year is when the remainder of the initial year's credit is taken.

Although the credit is taken over 10-11 years – the compliance period for this credit is 15 years. It is during these 15 years that the Investors/Syndicators are most involved and keep a close eye on the fiscal activities of the project(s).

In order to calculate the first-year credit, we will need a:

- Placed-in-Service Date (typically we use the Temporary Certificate of Occupancy date)
- Schedule of Move-Ins

The first-year credit is limited based on the speed of the initial rent-up of the units. A percentage of the actual occupancy versus a full-year occupancy is applied to the full credit to come to the first-year amount. This calculation is also performed using square footage of the units. The lower of the calculated fractions for each month is to be used to calculate the initial credit.

In order to begin taking credits, a unit must be in service for the entire month. For example, if the building was placed in service in the middle of February, the credits wouldn't begin until March. However, a qualified tenant needs only to move in during the month in order for that unit to count as occupied for the calculation.

Timing is key. If the property is not fully rented by the end of the year, the credits related to the unrented units would be delayed one year and could not be taken over 10 years but would be taken over the 15-year compliance period.

IRS Form 8609

The filing of the tax return, including the first year credit, can be a challenge – not only because of the required calculation. IRS Form 8609, *Low Income Housing Credit Allocation and Certification*, must be physically received before credits can be taken. It also is required to be paper filed with the IRS – one time only.

Furthermore, if Form 8609 is not received by the extended due date of the tax return for the initial credit year, the partnership **cannot** claim the credits.

This issue has been exacerbated by the 2015 Bipartisan Budget Act which effectively got rid of the amending of large partnership returns and replaced it with the Administrative Adjustment Request (or AAR).

If you were to file an AAR to pick up the initial year credits, you would actually be required to take the credits in the year you file the AAR. You cannot go back to the prior year.

Conversion of Construction to Permanent Debt

The final C is conversion of construction to permanent debt.

It is at this time you will typically see large equity installments coming in to take out a major portion of the construction loans. It is a debt structure like this – heavy on the equity and non-amortizing loans and light on the interest-bearing amortizing mortgages – that helps keep these projects afloat. If you compare the two structures, you will see the debt service burden lessens dramatically with the infusion of equity which translates into more operating cash available.

When you are looking at a rent-restricted property, you need all the available cash you can get.

From year 2 through year 14, the property operates as any other rental property. Each year the investors require audit reports and taxes drafted typically by mid- to late February. As these are considered lower tier partnerships the tight deadlines are expected.

K-1s issued by these projects roll up into the investment partnerships and ultimately to the corporate investors.

Investor Exit

Now we have reached the point where the tax credit compliance period is coming to an end and the Investors are ready to get out. While we waited until the end of this article to talk about the investor exit, this should be discussed with all parties involved much earlier.

By starting the conversation when the project hits year 11 or 12, it gives all parties the chance to vet all options and do a bit of tax planning.

There are different paths that can be taken to facilitate the Investor exit. Two common paths are

- Outright Sale of the Property, and
- Sale of the Investor's Interest in the Partnership

The choice of path depends upon the Sponsor entity's future plans and what was set forth in the original partnership agreement. While each agreement has its own nuances, a few items should be considered, including:

- With an outright sale, the value of the property can be affected by land use and deed restrictions.
- While the tax credit compliance period runs for 15 years, many of these projects have additional income restrictions in place that extend to 30, 40, or even 50 years.
- Depending on the debt encumbering the property, there may also be approvals required before any sale can occur.

With the sale of the Investor interest, the first considerations are the terms of the partnership agreement including:

- What is outlined as far as calculating the value of the interest?
- If the Investor has negative basis and/or exit taxes, who is responsible to pay them?

With both the sale of property or sale of interest, a bargain sale to a nonprofit should also be considered. Under a bargain sale agreement, the building or partnership interest would be sold to a nonprofit at a below market price with the differential being recognized by the seller as a charitable contribution.

This will require a third-party appraisal to be performed, but is a particularly attractive option when the property has appreciated significantly and has extended use restrictions.

Contact Us

We have taken you full circle – from Development to Operations to Year 15 – of the low-income housing tax credit program. If you have any questions or need additional information, please contact the partner in charge of your account or Jennifer M. Galasso, CPA, Partner at jgalasso@pkfod.com.