PRESENT LAW AND LEGISLATIVE BACKGROUND RELATING TO THE LOW-INCOME HOUSING TAX CREDIT

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on May 1, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

The Oversight Subcommittee of the House Committee on Ways and Means has scheduled a public hearing on May 1, 1997, on the administration of the low-income housing tax credit. (This hearing is a continuation of a hearing held on April 23, 1997.)

This document,[1] prepared by the staff of the Joint Committee on Taxation in connection with the May 1 Subcommittee hearing, provides a description of present-law low-income housing tax credit provisions (Part I) and a brief legislative background of the credit (Part II).

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Legislative Background Relating to the Low-Income Housing Tax Credit* (JCX-13-97R), April 30, 1997.

I. DESCRIPTION OF PRESENT-LAW PROVISIONS

A. Overview

Present law provides a tax credit (the "low-income housing credit") that may be claimed over a 10-year period by owners of certain residential rental property occupied by low-income tenants (Code sec. 42).

The credit percentage for newly constructed or substantially rehabilitated housing that is not federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value equal to 70 percent of the total qualified expenditures. The credit percentage for new or substantially rehabilitated housing that is federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value equal to 30 percent of qualified expenditures. For 1987, the first year the credit was available, these percentages statutorily were set at 9 percent and 4 percent, respectively. For property placed in service in April, 1997, the applicable credit percentages are 8.57 percent and 3.67 percent, respectively.

The amount of credit that may be claimed equals the applicable credit percentage of the qualified basis of each low-income building. Qualified basis is the portion of a building's eligible basis that is attributable to low-income residential rental units.

In general, for a project to qualify for the credit, a minimum number of units must be occupied by low-income tenants and rents must be restricted throughout a 15-year compliance period. In addition, a project must be subject to a 30-year extended low-income use agreement.

The owner of property eligible for the low-income housing credit generally must obtain a credit allocation from the appropriate State or local government credit authority. However, if the property is substantially financed with the proceeds of tax-exempt bonds issued subject to the Code's private activity bond volume limitation, then no allocation is required.

Each of these requirements is explained further in the following sections.

B. Low-Income Housing Credit Percentages

1. Applicable credit percentages

Generally, the applicable low-income housing credit percentage depends on the nature of the expenditures and the existence of any Federal subsidy. A 70-percent present value credit (the so-called "9-percent credit") is available for qualified new construction and substantial rehabilitation expenditures that are not federally subsidized. Rehabilitation expenditures qualify for the 9-percent credit only if the amount of such expenditures exceed the greater of: (1) 10 percent of the adjusted basis of the building, or (2) $3000 per low-income unit. A 30-percent present value credit (the so-called "4-percent credit") is available for the costs of acquiring existing buildings and for new construction and rehabilitation expenses that are federally subsidized. In the case of buildings located in qualified census tracts or difficult development areas, the maximum present value credit effectively may be increased to 91 percent and 39 percent, respectively.

A taxpayer's low-income housing credit amount for a taxable year is computed by applying the appropriate credit percentage to the building's qualified basis, as defined below. The nominal percentages used in calculating the low-income housing credit are adjusted monthly by the Treasury Department. Treasury's monthly adjustments of the percentages are determined on a discounted after-tax basis, based on the average of the annual applicable Federal rates (the "AFR") for mid-term and long-term obligations for the month a building is placed in service. The after-tax interest rate is computed as the product of: (1) the average AFR and (2) 0.72. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building (even within a single project).

The applicable percentage is the appropriate percentage for the earlier of the month the building is placed in service, or at the election of the taxpayer, the month the taxpayer and the allocating agency enter into an irrevocable binding agreement as to the housing credit dollar amount to be allocated to such building. For bond-financed projects, the building owner can elect to use the applicable percentage for the month in which the bonds were issued. Once set, the applicable percentage applies for the full 10-year credit period.

2. Effect of Federal subsidies

If a building is Federally subsidized, it is eligible only for the 4-percent credit, unless such Federal subsidies are excluded from eligible basis. A Federal subsidy is defined as any obligation the interest on which is exempt from tax under Code section 103 or a below-market Federal loan (defined as a Federal loan on which the interest rate is less than the applicable Federal rate) the proceeds of which are, or were, used directly or indirectly with respect to the building or operation thereof. For this purpose, loans that would be below market Federal loans solely by reason of assistance provided under sections 106, 107, or 108 of the Housing and Community Development Act of 1974 are not below-market Federal loans. Similarly, loans that would be below-market Federal loans solely by reason of assistance provided under the HOME Investment Partnership Act are not treated as below-market Federal loans, provided that 40 percent of the units are set aside for tenants with incomes of 50 percent or less of area median income.[2] Such HOME-assisted buildings are not eligible for the enhanced credit for buildings located in qualified census tracts and difficult development areas. In addition, certain loans provided by the Federal Emergency Management Agency, as well as loans funded with funds from an Affordable Housing Program under section 721 of the Financial Institutional Reform

[2] For projects located in New York City, the 40 percent requirement is reduced to 25 percent.

Recovery and Enforcement Act of '89 (FIRREA) also do not constitute below-market Federal loans.

The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made. For example, outstanding Federal loans or tax-exempt bond financing that are continued or assumed upon purchase of existing housing are disregarded for purposes of determining if a building is federally subsidized. Further, tax-exempt financing or a below market loan used to provide construction financing for any building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (e.g., tax-exempt bond) is redeemed before the building is placed in service.

3. 10-year rule for acquisition of existing buildings

Under present law, no low-income housing credit is allowed for acquisition of existing buildings unless the buildings are substantially rehabilitated.[3] Thus, rehabilitation costs must exceed the greater of: (1) 10 percent of the unadjusted basis of the building, or (2) $3,000 per low-income unit. If this minimum rehabilitation requirement, as well as other applicable requirements, are satisfied (and there is no Federal subsidy), then all rehabilitation expenditures qualify for a 9-percent credit, and the eligible building acquisition costs qualify for a 4-percent credit.

The 4-percent acquisition credit may not be claimed on a building if the building or a substantial improvement (a capital expenditure of 25 percent or more of the adjusted basis of the building) to the building has been previously placed in service within the 10 years immediately preceding the acquisition of the building. In addition, the building must be acquired by purchase within the meaning of Code section 179(d)(2). The Treasury Department may waive the 10-year requirement for any building that is substantially assisted, financed or operated under certain Federal housing programs -- section 8 of the U.S. Housing Act, HUD section 221(d)(3) and section 236 programs, or the Rural Housing Service section 515 program -- to avert an assignment of the mortgage secured by property in the project to HUD or the Rural Housing Service or to avert a claim against a Federal mortgage insurance fund. A Treasury Department waiver also may be granted, in the case of any building substantially assisted, financed or operated under the section 221(d)(3) or section 236 programs, or under the Rural Housing Service section 515 program if the mortgage on such building is eligible for prepayment under subtitle B of the Emergency Low Income Preservation Act of 1987 or under section 502(c) of the Housing Act of 1949 at any time within one year after the date of application for such waiver. This waiver is allowed only if: 1) there is a reasonable expectation that, if it were not granted, the building would cease complying with its low-income occupancy requirements, 2) the eligibility to prepay such mortgage without the approval of the Secretary of HUD or Secretary of

[3] Prior to 1990, a taxpayer could claim the 4-percent credit for acquisition of an existing building even if no substantial rehabilitation was performed on the building.

Agriculture, as applicable, is waived by all persons who are so eligible, and 3) such waiver is binding on all successors in interest. Finally, this 10-year requirement may be waived by the Treasury Department for any building acquired from an insured depository institution in default (as defined under section 3 of the Federal Deposit Insurance Act) or from a receiver or conservator of such an institution. No waiver will be granted if a prior owner was allocated a low-income housing credit.

4. Credit period

The 10-year period over which a building owner can claim a low-income housing tax credit commences either (1) with the tax year in which the building is placed in service, or (2) at the election of the taxpayer, the succeeding taxable year. The building must be a qualified low-income building (i.e., it must comply with the minimum set-aside and other requirements, described below) as of the close of the first year of such period.

C. Low-Income Housing Credit Base

1. Qualified basis

The low-income housing credit is calculated annually by multiplying the applicable percentage for a building by the building's qualified basis. Qualified basis is the applicable fraction of the "eligible basis" of a low-income building that is attributable to the low-income residential rental units.[4] This applicable fraction is the lesser of (1) the proportion of units occupied by qualified low-income tenants to all residential rental units in the building, or (2) the proportion of floor space of the units occupied by qualified low-income tenants to the floor space of all residential rental units. A building's qualified basis generally is determined as of the close of the first year of the credit period.

The qualified basis of a building may be increased above the initial determination only by reason of an increase in the number of low-income units or in the floor space of the low-income units (as opposed to by reason of increases in the cost basis of the building). Low-income housing credits claimed on such additional qualified basis are determined using a low-income housing credit percentage equal to two-thirds of the applicable credit percentage allowable for the initial qualified basis. As described below under the description of the State credit volume limitations, an allocation of low-income housing credit authority must be received for low-income housing credit credits claimed on additions to qualified basis. Unlike low-income housing credit credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually for the portion of the 15-year compliance period remaining after eligibility for such credits arises, regardless of the year the additional qualified basis is determined.

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[4] Qualified basis also includes that portion of the building, not to exceed 20 percent, which is used to provide supportive services in transitional housing for the homeless.

2. Eligible basis

In general

Eligible basis is the adjusted basis of the building determined at the end of the first year of the credit period. It consists of: (1) the cost of new construction, (2) the cost of rehabilitation, or (3) the cost of acquisition of an existing building if the minimum rehabilitation requirements are met. Only the adjusted basis of depreciable property may be included in eligible basis; the cost of land is not includable. Generally, the eligible basis of a building is determined at the time the building is placed in service. For this purpose, rehabilitation expenditures are treated as placed in service at the close of a 24-month rehabilitation period.

In general, adjusted basis includes only property that is "residential rental property." For this purpose, the term "residential rental property" generally has the same meaning as under the private activity tax-exempt bond rules of Code section 142(d).[5] Thus, residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. Eligible basis includes the adjusted basis or property used in common areas and may include the cost of amenities (e.g., stoves, refrigerators, air conditioning units) provided to all residential rental units in the building only if the included amenities are comparable to the amenities in the non-low-income units. Additionally, the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas, may be included in eligible basis provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project.

The costs of the residential rental units in a building which are not low-income units generally may be included in eligible basis only if such units are not above the average quality standard of the low-income units. Similarly, rehabilitation expenditures may not be included in eligible basis if the expenditures improve any unit in the building beyond comparability with the low-income units. Units are considered to be 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. At the election of the building's owner, the cost of a unit which would otherwise be excluded from eligible basis may be included in eligible basis if (1) the excess cost of such unit over the average cost of the low-income units does not exceed 15 percent of the average cost of the low-income units and (2) the excess cost is excluded from eligible basis.

Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for a commercial purpose; however, no portion of the cost of such nonresidential rental property included in a project may be included in eligible basis.

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[5] See, however, the discussion below on certain single room occupancy housing as property eligible for the low-income housing credit (but not for tax-exempt bond financing).

Treatment of Federal grants

Generally, eligible basis is reduced by the portion of any grant made with respect to a building or the operation thereof that is funded with Federal funds. Examples of grants which may which reduce eligible basis include Community Development Block Grants, Urban Development Action Grants, and Rental Rehabilitation Grants. However, Federal rental assistance payments made to the owner of a building on behalf of low income tenants under sections 8 and 9 of the U.S. Housing Act of 1937 are not Federal grants that require a reduction in eligible basis. Similarly, Federal Emergency Management Agency grants to the owner of a low-income credit building damaged by disaster to restore the building to its pre-casualty condition do not reduce eligible basis.

Special rules for qualified census tracts and difficult development areas

As described above, in the case of any building located in a qualified census tract or difficult development area, the 70-percent present value credit and the 30-percent present value credit may be increased to 91 percent and 39 percent, respectively. This increase is accomplished by increasing the eligible basis of the building to 130 percent of the amount of eligible basis otherwise computed.

The term "qualified census tract" means any census tract which is designated by the Secretary of Housing and Urban ("HUD"), if at least 50 percent of households in that tract have household income of less than 60 percent of the area median gross income for the most recent year in which such information is available from decennial census data. The portion of a metropolitan statistical area (MSA) that can be designated cannot exceed an area having more than 20 percent of the population of such MSA. For these purposes, each MSA is treated as a separate area, and all the nonmetropolitan areas in a State are treated as one area.

The term "difficult development area" means an area designated by HUD as an area with high construction, land and utility costs relative to area median gross income. As with qualified census tracts, the portion of an MSA that may be designated as a difficult development area may not exceed 20 percent of the MSA, by population. A comparable rule applies to nonmetropolitan areas.

D. Qualified Low-Income Housing Credit Buildings and Projects

1. Minimum set-aside for low-income tenants

A residential rental project qualifies for the low-income housing credit only if at least (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median gross income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median gross income, as adjusted for family size.[6] This requirement is referred to as the "minimum set-aside" requirement. Project owners generally elect the applicable minimum set aside at the time of application for low-income housing credits. In general, the minimum set-aside requirement must be satisfied by the end of the first year of the credit period.

An alternative minimum set-aside may be elected for projects that serve lower income tenants and that significantly restrict the rents on the low-income units relative to rents on the other residential units in the building (the "deep-rent skewing" set-aside). Projects qualify for this alternative set-aside if, as part of the general set-aside requirement, 15 percent or more of all low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median gross income, and the average gross rent charged to tenants in the residential rental units which are not low-income units is at least 200 percent of the average gross rent charged to low-income tenants for comparable units.

The determination of whether a tenant satisfies the applicable income limitations is made on a continuing basis throughout the 15-year compliance period (as well as the 30-year extended use period) both with regard to the tenant's income and the area median gross income, rather than only on the date the tenant initially occupies the unit. Thus, an increase in a tenant's income (or decrease in area median gross income) may result in a unit ceasing to qualify for the low-income housing credit. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this exception, a tenant who satisfies the applicable income limitations when initially occupying a rental unit generally is treated as continuing to satisfy such limitations provided his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size.

If the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling,[7] that tenant's unit is no longer counted in determining whether the project satisfies the set-aside requirement, and no credit is allowed with respect to the basis of that housing unit, <u>unless</u> each subsequent residential rental unit that becomes vacant (of comparable or smaller size to the unit no longer satisfying the applicable income requirement) is rented to tenants satisfying the qualifying income limitation (the so-called "available unit rule").[8]

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[6] In addition, projects located in New York City can elect a special set-aside requirement providing that 25 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income.

[7] In the case of projects electing the deep-rent skewing set-aside, a tenant's income may increase to 70 percent more than the maximum qualifying income.

[8] For deep rent skewed projects, the available unit rule applies with respect to <u>any</u> subsequent unit that becomes vacant, not merely those of smaller or comparable size.

2. Rent restrictions

The gross rent charged for units with respect to which a low-income housing credit is claimed may not exceed 30 percent of the imputed income limitation applicable to such unit. The rent limit is not based on family actual size, but rather is based on deemed family size determined by the number of bedrooms in the rental unit. The size of the family deemed to occupy the unit is 1 person for a unit without bedrooms and 1.5 persons for each bedroom in a unit with bedrooms. Thus, the gross rent cannot exceed 30 percent of area median gross income, adjusted for deemed family size. The gross rent limitation does not decrease even if the area median gross income decreases.

Gross rent includes the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is to be reduced by any utility allowance (e.g., HUD, FmHA utility allowances). Gross rent does not include payments under section 8 of the U.S. Housing Act of 1937 or comparable rental assistance programs, rental payments under section 525 of the Housing Act of 1949, and certain fees for supportive services.

3. Other requirements

Qualifying low-income units must be suitable for occupancy, available for use by the general public, and used on a nontransient basis. A unit is generally suitable for occupancy if it is subject to Federal, State or local regulations that require it to be maintained in a safe, decent, and sanitary condition. To be for use by the general public, a unit must be rented in compliance with HUD housing policy or nondiscrimination. If a unit is provided only for members of a social organization or provided by an employer for its employees, it is not available to the general public. Similarly, no hospital, nursing home, sanitarium, life care facility, retirement home providing significant services other than housing, dormitory, or trailer park is for use by the general public. Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater. However, certain transitional housing for the homeless as well as certain single room occupancy units rented on a month-to-month basis can qualify as nontransient housing eligible for the credit.

Generally, a building with four or fewer units cannot qualify for the credit if the owner (or a relative) occupies any of the units.[9] In addition, housing units are not considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under Code section 151(c)(4)), no one of whom is entitled to file a joint income tax return. An exception applies to housing units occupied entirely by full-time students, if the students are either: (1) single parents and their minor children and none of the occupants is the dependent of another individual, or (2) married and file a joint return.

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[9] A special exception applies if the acquisition or rehabilitation of such a building is part of a development plan sponsored by a State or local government or nonprofit organization.

A qualified low-income housing project includes other property that is functionally related and subordinate to the function of providing residential rental units. A project may include multiple buildings having similarly constructed housing units, provided the buildings are located on the same tract of land, are owned by the same person for Federal income tax purposes, and are financed pursuant to a common plan of financing. A scattered-site project also may qualify as one project if 100 percent of the dwelling units are qualified low-income units and there is a common plan of financing. No credit may be allocated to any building that received moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937.[10]

E. Low-Income Use Restrictions

1. Compliance period and penalty for noncompliance

As described above, residential rental projects for which the low-income housing credit is claimed must satisfy the minimum set-aside requirement and rent restrictions throughout a prescribed compliance period. The compliance period for any building is defined as the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set-aside requirement or the rent restriction during the 15-year compliance period is recapture of the accelerated portion of the low-income housing credit, with interest, for all prior years.[11] Generally, any change in ownership by a taxpayer of a building during the compliance period also is a recapture event. An exception is provided if the seller posts a bond with the Treasury Department (in an amount prescribed by Treasury) and provided it can reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period.[12] No credit is allowed in the year of a recapture event.

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[10] However, assistance provided under the Stewart B. McKinney Homeless Assistance Act does not disqualify a building from being eligible for the credit.

[11] The accelerated portion is the excess of the amount claimed over what would have been claimed were the low-income housing credit taken in equal amounts over 15 years rather than a 10-year period. Credits claimed on additions to qualified basis are paid ratably over the remainder of the compliance period (the credit percentage is two-thirds of the otherwise applicable percentage); therefore, there is no accelerated portion of credits attributable to additions to qualified basis and, therefore, no recapture of these amounts.

[12] For partnerships consisting of more than 35 partners, at the partnership's election, the partnership will be treated as the owner for purposes of claiming the credit. Thus, dispositions of partnership interests will not constitute recapture events provided that at least 50 percent (in value) of the original ownership is unchanged within a 12-month period .

The penalty for a decrease in the qualified basis of a building, while still remaining part of a qualified low-income project, is recapture of the credits with respect to the accelerated amount claimed for all previous years on the amount of the reduction in qualified basis, unless the noncompliance is corrected within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any such noncompliance is corrected within a reasonable period, there is no recapture. Tenants may not be evicted to return a project to compliance. Rather, each residential rental unit of comparable or smaller size that becomes vacant while a project is not in compliance must be rented to a tenant having a qualifying income before any units in the project are rented to tenants not so qualifying. In general, therefore, the event that gives rise to the penalty for noncompliance (i.e., recapture or a reduction in the allowable credit) will be rental of a unit to a tenant other than a low-income tenant (on other than a temporary basis) during any period when the project does not comply with the applicable set-aside requirement or with the qualified basis amounts on which the credit is computed (or would not qualify as a result of that rental).

There is no recapture for *de minimis* changes in the qualified basis by reason of changes in the floor space fraction. A reduction in qualified basis by reason of a casualty loss is not a recapture event provided such property is restored by reconstruction or replacement within a reasonable period.

2. Extended use agreement

In general

The owner of a qualified low-income housing credit building must enter into a 30-year extended use agreement with the applicable housing credit agency. This agreement must be in effect for each taxable year during which a credit is claimed and must provide that, during the extended use period -- which begins on the first day of the compliance period and ends on the later of the date specified by the State housing agency or the date which is 15 years after the close of the compliance period, the owner must continue to comply with the minimum set-aside and rent restriction requirements for at least an additional 15 years.[13] The agreement must be recorded, pursuant to State law, as a restrictive covenant against the property and must be binding against all successors to the owner. It must allow any prospective, present, or former tenant the right to enforce the agreement in any State court. It also must provide that no existing low-income tenant may be evicted other than for good cause, and prohibit increases in gross rent above that which is otherwise allowable under Code section 42. The agreement must prohibit the disposition to any person of any portion of the building unless all of the building to which the restriction applies is disposed of to such person. Finally, the agreement must not allow the refusal of a lease to any holder of a voucher or certificate of eligibility under section 8 of the

[13] During the period after the 15-year compliance period, a building owner may apply for an additional credit allocation provided the minimum rehabilitation requirements are satisfied.

United States Housing Act of 1937 because of the status of that prospective tenant as holder of that voucher or certificate.

Generally, the extended use requirement for any building may terminate before the end of the 30-year extended use period in either of two ways. First, the agreement may terminate on the date the building is acquired in foreclosure (or instrument in lieu of foreclosure) unless the Treasury Department determines that the acquisition is part of an arrangement to terminate the 30-year extended use period. Second, the agreement may terminate one year after the owner gives written notice to the allocating agency of its intent to dispose of the property. This notice may be given at any time after the 14th year of the compliance period. The allocating agency may avoid such termination by finding an eligible buyer at a specified price based on outstanding indebtedness and investor equity contributions. If no buyer is located, the building may be converted to market rate use with the qualifications that for three years after the termination: (1) no existing low-income tenant may be evicted other than for good cause, and (2) there may be no increase in gross rent above that which would have been allowable in the absence of the termination.

3. Rights of first refusal

The allowance of a right of first refusal to purchase a qualified low-income building after the close the 15-year compliance period to qualified persons for a price which is not less than the minimum purchase price does not affect the otherwise allowable flow of tax benefits under the credit to the owner of the building. Similarly, the grant or exercise of such a right of first refusal does not cause a building owner to fail to meet the requirements of the applicable extended use agreement. Qualified persons mean the tenants of the building (in cooperative form or otherwise), a resident management corporation of the building, a qualified nonprofit organization, or a government agency. The minimum purchase price is an amount equal to the sum of the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the five-year period ending on the date of sale to the tenants) and all Federal, State and local taxes attributable to such sale.

F. Low-Income Credit Allocations

1. Allocation of credit

In general, to claim low-income housing credits, project owners must receive an allocation of credit from a State or local housing credit agencies. However, no allocation is required for buildings at least 50 percent financed with the proceeds of tax-exempt bonds that received an allocation pursuant to the private activity bond volume limitation of Code section 146. Such projects must, however, satisfy the requirements for allocation under the State's qualified allocation plan, described below.

A building generally must be placed in service during the calendar year in which it receives an credit allocation. However, a housing credit agency can make a binding commitment, not later than the year in which the building is placed in service, to allocate a specified credit dollar amount to such building beginning in a specified later year. In addition, a project can receive a "carryover allocation" if the taxpayer's basis in the project as of the close of the calendar year the allocation is made is more than 10 percent of the taxpayer's reasonably expected basis in the project, and the building is placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made. For purposes of the 10-percent test, basis means the taxpayer's adjusted basis in land and depreciable real property, whether or not these amounts are includible in eligible basis. Finally, an allocation of credit for increases in qualified basis may occur in years subsequent to the year the project is placed in service.

2. State credit authority

Authority to allocate credits remains at the State (as opposed to local) government level unless State law provides otherwise.[14] Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of: (1) credits claimed on additions to qualified basis; (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

Each State annually receives low-income housing credit authority equal to $1.25 per State resident for allocation to qualified low-income projects.[15] In addition to this $1.25 per resident amount, each State's "housing credit ceiling" includes the following amounts: (1) the unused State housing credit ceiling (if any) of such State for the preceding calendar year;[16] (2) the amount of the State housing credit ceiling (if any) returned in the calendar year;[17] and (3) the amount of the national pool (if any) allocated to such State by the Treasury Department.

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[14] For example, constitutional home rule cities in Illinois are guaranteed their proportionate share of the $1.25 amount, based on their population relative to that of the State as a whole.

[15] A State's population, for these purposes, is the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies. Also, for these purposes, the District of Columbia and the U.S. possessions (i.e., Puerto Rico, the Virgin Islands, Guam, the Northern Marianas and American Samoa) are treated as States.

[16] The unused State housing credit ceiling is the amount (if positive) of the previous year's annual credit limitation plus credit returns less the credit actually allocated in that year.

[17] Credit returns are the sum of any amounts allocated to projects within a State which fail to become a qualified low-income housing project within the allowable time period plus any amounts allocated to a project within a State under an allocation which is canceled by mutual consent of the housing credit agency and the allocation recipient.

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a State which, with respect to the previous calendar year allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1, of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the fraction that a State's population enjoys relative to the total population of all qualified States for that year.

3. Set-aside for qualified nonprofit organizations

Ten percent of each State's $1.25 per resident annual low-income housing credit authority is set aside for allocation to projects involving qualified nonprofit organizations. For a project to qualify for this nonprofit set-aside, a qualified nonprofit organization must own an interest in the project (directly or through a partnership) and materially participate in the development and operation of the project throughout the compliance period. In addition to the special set-aside, qualified nonprofit organization projects may be allocated any additional amount of a State's remaining credit authority.

To qualify for the nonprofit set-aside, an organization must be a tax-exempt organization described in Code section 501(c)(3) or 501(c)(4), one of the exempt purposes of which includes the fostering of low-income housing, and such organization must not be affiliated with, or controlled by, a for-profit organization.

4. State allocation plans; credit administration

Qualified allocation plans

Each State must develop a qualified allocation plan containing selection criteria for evaluating projects applying for credit allocations. This plan must be designed to ensure that (1) tax credits are awarded to qualifying projects that meet priority housing needs in the State, and (2) the amount of credits awarded each project does not exceed the minimum amount necessary to provide financial viability to the project throughout the credit period.

The qualified allocation plan must: (1) set forth selection criteria to be used to determine housing priorities; (2) give preference to projects serving the lowest income tenants and projects obligated to serve qualified tenants for the longest periods; and (3) provide a procedure for the allocating agency to monitor noncompliance with the low-income housing credit provisions and to notify the Internal Revenue Service of any noncompliance.

The project selection criteria must include project location (e.g., broad geographic distribution, designated targeted areas such as inner cities, Community Development Block

Grant neighborhoods, distressed communities, pockets of poverty, and rural areas), housing needs characteristics (e.g., low vacancy rate, income mix of tenants within the project, and meeting State, regional, or local housing needs and priorities), project characteristics (e.g., whether the project increases the stock of low-income housing, whether substantial rehabilitation expenditures are needed by the project, energy conservation, quality of units, and type of financing), sponsor characteristics (e.g., nonprofit sponsorship and minority participation in development and management), participation of local tax-exempt organizations, tenant populations with special housing needs (e.g., elderly, handicapped, disabled, homeless, large families, and displaced), and public housing waiting lists (e.g., preferential treatment of prospective tenants on other public housing waiting lists).

States cannot allocate tax credits to a project in excess of the amount necessary to ensure the project's financial feasibility throughout the credit period. In making this determination States must consider: (1) the sources and uses of the funds; (2) the total financing planned for the project as well as the proceeds or receipts expected to be generated by reason of tax benefits; (3) the percentage of the low-income housing credit dollar amount used for project costs other than the cost of intermediaries (unless application of this factor would impede the development of projects in hard-to-develop areas), and (4) the reasonableness of the developmental and operational costs of the project.

Monitoring and reporting requirements

The allocation plan must contain provisions for monitoring project compliance with low-income credit requirements. Treasury regulations identify certain records that the plan must require project owners to maintain. In addition, the plan must require a project owner to certify at least annually to the State agency with respect to the following items:

- the project met the applicable minimum set-aside requirements;
- there was no change in the applicable fraction, or a description of the change;
- the owner received an annual income certification from each low-income tenant;
- each low-income unit was rent-restricted;
- all units in the project were for use by the general public on a nontransient basis;
- each building was suitable for occupancy;
- either there was no change in the eligible basis of the building or, if there was a change, the nature of the change;
- all tenant facilities included in the eligible basis of any building were provided on a comparable basis to all tenants without charge;
- if a low-income unit became vacant during the year, reasonable attempts were made to rent it or a comparable (or smaller) unit to low-income tenants before any units were rented to non-low-income tenants;
- if the income of a low-income tenant rose above the allowed limit, the next available comparable or smaller unit in the project was or will be rented to low-income tenants;
- an extended low-income housing commitment was in effect (if required).

Building owners also are required to make certain certifications and reports to the Secretary of Treasury containing information regarding a project's compliance with the requirements of Code section 42.

Agencies allocating credits must conduct annual reviews and inspections of low-income projects to which credits have been allocated. In addition, allocating agencies must submit annual reports to the Treasury Department specifying: (1) the amount of housing credit amount allocated to each building for such year; (2) sufficient information to identify each building and the taxpayer with respect thereto; and (3) such other information as the Secretary may require.

G. Coordination with Other Tax Provisions

The low-income housing credit is a component of the general business credit. Thus, a taxpayer's ability to claim the credit is limited based on current year tax liability. Unused credits may be carried back three years and carried forward 15 years.

Property with respect to which a low-income housing credit is claimed is subject to an at-risk limitation similar to the prior-law investment tax credit at-risk rules in the case of nonqualified nonrecourse financing. Thus, if the building is financed with a nonrecourse loan from other than a commercial lender or government agency, the qualified basis of the building generally has to be reduced. However, for purposes of the low income housing credit, a lender who otherwise meets the requirements of a qualified person in Code section 49(a)(D)(iv) may be related to the owner of the low-income housing property. In addition, the general investment tax credit at-risk rule limiting the amount of nonrecourse financing to 80 percent of the credit base of the property does not apply in the case of low-income housing credit property.

A further exception from the at-risk limitations is provided for financing (including seller financing) provided by section 501(c)(3) and 501(c)(4) organizations whose exempt purpose includes fostering low-income housing. The financing must be secured by the qualified low income property, and not more than 60 percent of the eligible basis of the qualified low income building can be attributable to such financing. If the rate of interest for any financing qualifying for this exception is lower than the rate that is one percentage point below the applicable Federal rate at the time the financing is incurred, then the qualified basis to which such financing relates must be reduced to reflect the present value of the payments of principal and interest. If the financing provided by the organization is not repaid within a specified period of time (generally, the end of the compliance period), then a portion of the credit previously allowed is included in income in the year in which the failure to pay occurs.

The passive loss rules generally limit the deductions and credits taxpayers can claim from passive activities. Rental real estate investments are treated as passive activities. However, under a special rule, the low-income housing credit is treated as arising from rental real estate activities in which the taxpayer actively participates, and low-income housing credits may be used to offset tax on up to $25,000 of nonpassive income without regard to the taxpayer's income.

In addition, the hobby loss rules of Code section 183 do not operate to disallow losses, deductions or credits attributable to the ownership or operation of a low-income credit project.

The basis of property for purposes of depreciation is not reduced by the amount of low-income housing credits claimed.

II. LEGISLATIVE BACKGROUND

The low-income housing credit was enacted in the Tax Reform Act of 1986, with a scheduled expiration date of December 31, 1989. The Technical and Miscellaneous Revenue Act of 1988 modified the credit carryforward rules for the year of its expiration, included technical corrections, and made certain other changes.

The Omnibus Budget Reconciliation Act of 1989 (the "1989 Act") extended the low-income housing credit for one year (through December 31, 1990), but reduced the per capita allocation amount from $1.25 per resident to $0.9375 per resident. The 1989 Act also included several amendments to the credit. For example, the 30-year extended low-income use restriction and right of first refusal rules were enacted in the 1989 Act, as was the restriction that no credit is allowed to an existing building unless the building is substantially rehabilitated. The bill increased the minimum qualifying expenditure threshold, adjusted the rent-restriction rules, and modified the passive loss restrictions applicable to the low-income housing credit. The maximum credit was increased for buildings located in qualified census tracts and difficult development areas. Further, the 1989 Act required States to establish allocation plans and limited the housing credit dollar amount that could be allocated to a building to the amount necessary to ensure the financial feasibility of the project. The bill included a number of other amendments to the credit as well.

The Omnibus Budget Reconciliation Act of 1990 (the "1990 Act") retroactively restored the 1990 per capita credit amount of $1.25 and extended the low-income housing credit for one year, imposed through December 31, 1991. The 1990 Act also included certain clarifying amendments to the credit. The Tax Extension Act of 1991 extended the credit for 18 months (through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") restored the credit retroactive to July 1, 1992, and made the credit permanent. The 1993 Act also made certain other changes, including requiring State allocation plans to take into account certain development and operation costs and modifying the tenant occupancy and income certification rules.