

Reduce Cost of Ownership with the Tax Credit Program

By Steven M. McDonald, CPM®

What is the Tax Credit Program? You may have heard it called by different names: Section 42 Housing, Housing Credit, Low-Income Housing Tax Credit.

The Tax Credit Program was created by Congress in the Tax Reform Act of 1986 and implemented in the Internal Revenue Service (IRS) Tax Code as Section 42 (Low-Income Housing Tax Credit) to provide tax incentives for owners to construct and preserve affordable housing. The IRS offers tax credits to owners of rental property that meet certain criteria. In exchange, the owner must agree to maintain compliance with the tax credit program requirements in conformance with its regulatory restrictions.

How Does the Program Make Rents Affordable?

By providing tax credits to owners, debt on the property is reduced or eliminated, which enables the owner to offer lower, affordable rents and still maintain his yield. Tax Credits provide a reduction in income taxes the owner must pay, which effectively reduces the cost of ownership and lowers the amount of equity needed.

The Program has many compliance issues that require on-site staff or management to be specially trained in order to keep the owner out of trouble. That is, if compliance is not maintained, the owner is at risk of losing the tax credits and is vulnerable to an IRS audit and possible tax recapture, penalty and fines.

Management and Compliance

An owner must agree to maintain compliance with the tax credit program requirements for a minimum of 15 years. Property management must meet the compliance requirements of the program. Should management fail in that task, the California Tax Credit Allocation Committee can (and probably will) report the noncompliance to the IRS. This report of non-compliance places the owner at risk of losing some or all of its credits, and is vulnerable to recapture, fines and penalties. It is management's responsibility to avoid this. Consequently, Tax Credit management requires a thorough understanding of the laws and rules governing the program and work to keep the site in compliance.

Residents Must Meet Specific Income Limits

A Tax Credit property is limited to whom it can rent an apartment because of "set-aside" or minimum set-aside requirements. This means that the site must set a minimum number of units aside for low-income residents. Tax Credit housing equals affordable housing or low-income housing; thus, the residents must meet certain income limitations and must qualify as a low-income housing residents. These rules apply when low-income families move in, move out, transfer to another unit, and to vacancies in units that have never been occupied by a low-income household.

Management Calculates and Verifies Household Income to Determine Eligibility

Based on the property specific set-aside criteria, management must determine whether a household is low-income by calculating its income in accordance with the rules established by the U.S. Department of Housing and Urban Development (HUD). The household's income (plus any income from the household's assets) is then compared to the income limits established that year by HUD for that household size. If the total household income is below the published income limits for the household size, the household qualifies as a low-income, Tax Credit eligible household. This income certification process is repeated each and every year for every resident.

Low-Income Households Pay Restricted Rents

The rents charged to residents in a Tax Credit property are restricted to 30% of the applicable income limit. This keeps rent affordable. The Tax Credit rules tell us how to calculate the restricted rent, which is based on the number of bedrooms in the unit and the applicable income limit.

This is only a partial list of the restrictions placed upon the owner and management of an apartment property financed with Tax Credits. Below is a series of questions to test your knowledge of the federal low-income housing tax credit program. Choose the best answer to each question by circling the correct letter or the word "true" or "false".

1. Management must maintain compliance with the provisions of the tax credit program until:
 - a. Five years after the credit period.
 - b. Ten years after the credit period.
 - c. The owner sells the property.
 - d. The IRS code is changed.

2. The applicable fraction for a mixed-income property is 100%.

True False

3. A building can be placed in service only when:
 - a. Its low-income units are occupied.
 - b. Its low-income units are ready for occupancy.
 - c. The owner instructs you to do so.
 - d. The credit period has commenced.

4. A property with several buildings may have a different placed-in-service date for each building:

True False

5. The minimum set-aside is the minimum percentage of units reserved for:
 - a. Qualified residents.
 - b. The maximum income level for qualified residents
 - c. Both a. and b.
 - d. Neither a. or b.

Because the Low-Income Housing Tax Credit (LIHTC) program is an IRS program administered by states, each state may have interpreted the provisions of the IRS code section 42 a little differently. Although there is little wiggle room with many of the provisions regardless of the state, certain deviations from certain provisions may exist from state to state.

This writing is specific to the state of California and may not necessarily apply to other states or all properties with LIHTC funds.

Answers to Tax Credit Management Test

1 (a); 2 (False); 3 (b); 4 (True); 5 (c).

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