

Learn the Basics Housing Tax Credits "101"

Compliance & Occupancy

1. The Six Requirements

When it comes to compliance, there are **six** basic requirements:

- ▶ **Income:** LIHTC units may only be rented to households with incomes at or below certain limits. The limits are based upon the "Area Median Income" as defined by HUD and vary from county to county throughout the United States. The permissible limits are usually referred to as a percentage of area median income. Most properties are either "50%" or "60%" properties, meaning that the allowable income is either 50% or 60% of the median income. Allowable income in any particular locale also varies depending upon the size of the household.
- ▶ **Rent:** LIHTC units may only be leased at or below Program-defined maximum rents. The rent limits are also based upon the median income for the area and will vary based upon the size of the apartment (number of bedrooms) and the specific utilities included in the base rent. Properties which were allocated credits before 1990 are subject to a different formula for determining maximum rents based upon the number of members of the household.
- ▶ **Students:** With some exceptions, LIHTC units may not be rented to households comprised entirely of full-time students.

- ▶ **Units in Program:** Once established, the number of units (and square footage) reserved for LIHTC households must be maintained. Special rules exist for “transfers” and for households which recertify at incomes above the initial allowable limits. Some of these restrictions must be met on a “property” basis; others must be met on a “building-by-building” basis. The property must be able to track at all times which units in the property are Program units.

- ▶ **Prove it!** Each LIHTC file must contain adequate documentation to support the conclusion that the household is qualified. Although all the first four requirements may be met, if the documentation is not adequate, the household can be determined to be non-qualified.

- ▶ **Be Prompt:** Dates are very important in the Program. Some events must occur before others (but not too far in advance!); others must occur after. Whether dealing with tenant recertifications, other file-related procedures, or the periodic reports which must be submitted to the State agency, timeliness is extremely important. Tardy paperwork can ruin an otherwise perfect file.

2. The Minimum Set-Aside

In the development phase, decisions for the "operating election", "set-aside", and "applicable fraction" determine the percentage of units in each building (and on the property as a whole), that must be LIHTC units. Each of these components is chosen during the development phase, and once set, is permanent and cannot be changed. The final determination represents the tax credit universe for your property.

The "40/60" and "20/50" Operating Election (Minimum Set-Aside)

When your property is conceived, ownership will be required to make a one-time irrevocable decision to meet either the "40/60" test or the "20/50" test. This operating election determines both the minimum percentage of units in the property that must be rented to tax credit residents and the maximum income level (adjusted for family size) for all tax credit qualified households at the property. Since rents are based upon allowable incomes, the operating election directly impacts the maximum allowable rent as well. With the exception of special rules which apply for properties in New York City, owners have two choices for the operating election:

- ▶ **The "40/60" election** which requires the continual rental, at restricted rents, of at least 40% of all units to households earning 60% or less of the area median income.

- ▶ **The "20/50" election** which requires the continual rental, at restricted rents, of at least 20% of all units to households earning 50% or less of the area median income.

Note that a property may be required to provide more than the minimum number of units. Even though many properties are 100% tax credit, this operating election must still be made.

Tip: *Unless required for additional points in a competitive allocation, or if a property intends to have at least 20% of the units but not more than 39.99% of the units designated as tax credit units, ownership should*

always make the 40/60 election. Making the 40/60 election does not prevent a property from offering units at a lower median income. However, if the 20/50 election is made, no Program units may be offered to households at incomes above 50% nor may rents in excess of the "50% rents" be charged. Thus if a property is going to be 100% tax credit but is financed with tax exempt bonds which require that 20% of the units be rented to 50% households, ownership should still make the 40/60 election. Failure to do so would prohibit renting to tenants with incomes above 50% on the remaining 80% of the units.

The Set-Aside

In real estate, this phrase may have a variety of meanings. In tax credits, the term "set-aside" generally refers to the total percentage of units on the entire property to be held or reserved for a certain type of qualifying resident. The primary set-aside must always be at least equal to the operating election.

Some properties may have multiple set-asides. For example, some properties require that all units on the property be rented to residents earning 60% or less of the area median income and that 20% of those units be rented to residents earning 50% or less of the area median income. It is not uncommon for properties to have set-asides at incomes below 50% of median as well. Similarly, owners may participate in a Program which specifies a certain non-income set-aside; examples include housing set-aside for the handicapped, large families, victims of domestic violence or the elderly.

Properties may also have "targets". Targets differ from set-asides in that the requirement is not absolute. For example, if a unit were set-aside for a large family and none could be found, the unit would have to remain vacant. However, if the unit were targeted for a large family and none could be found (after a reasonable and documented effort to locate such a household), the unit could be rented to a non-target family. Managers should be sure to understand whether leasing profiles (particularly non-income related) are *set-asides* or *targets*.

If units are determined to be out of compliance at any time during the Compliance Period and does not meet the required set-aside, then the property is said to have a

reduction in "qualified basis". Should this occur, ownership may lose a portion of the annual credits until the problem is corrected. However, if the reduction in qualified basis results in a decrease so great that the property no longer satisfies the operating election, then all credits are lost until the problem is corrected.

Tip: *For properties which have set-asides equal to the operating election, management should seriously consider allocating a few extra non-restricted units to the Program. Consider a property with 100 units, 20% of which are restricted to households at 50% of median. If exactly 20 units are rented to tax credit households, one single error could result in the loss of all credits to the property. However, if management allocated 22 units to the Program, there would be room for two errors without jeopardizing the total credits. As long as there were 20 good files, the owner would not be in jeopardy. Thus, when the set-aside and operating election provide for the same number of units, a few units of "wiggle room" should be considered.*

The Applicable Fraction

The term "applicable fraction" means the percentage of the total "eligible basis" (roughly the cost to build the property) which qualify for tax credits. This percentage is calculated as the lesser of the following two fractions:

- ▶ LIHTC units as a percentage of the total number of units
- or
- ▶ LIHTC square footage as a percentage of the total amount of rentable (residential) square footage.

Generally, if half of your property has tax credit units, half of your cost will receive tax credits. The applicable fraction rules are designed to discourage owners from assigning the smaller units to the Program and thereby retaining the more desirable larger units at market rates.

Although overall set-asides are determined on a *property* basis, applicable fraction calculations are made on a *building-by building* basis. Thus, a property which is 100% tax credit will always have an applicable fraction of 1.00 on all of the buildings at the

property. This means that 100% of the units in each building will be held for tax credit tenants as will 100% of the rentable square footage. While the applicable fraction is clear and easy to compute on a 100% tax credit property, it is not as simple with “mixed-income “ communities which contain both restricted tax credit units and non-restricted market rate units.

Tip: For LIHTC purposes, each “building” has its own 8609 (certification of authority to claim credits) and associated credit stream. In general, each 8609 will correspond with a physical building; however, this is not necessarily the case. For example, a single structure could be condominiumized, creating several different “buildings” under the same roof. Managers should check with ownership to see if their property has any unusual characteristics in this regard.

As a result, the applicable fraction need not be the same for each building. Each building or “BIN” at a tax credit property will have an applicable fraction – even if it is 0%. It is important to note that tax credits cannot be transferred or blended with other buildings. For example, assume a property has two buildings with 100 one-bedroom units in each building. The applicable fraction for building A may be set at 90% while the applicable fraction for building B may be set at 20%. On a *property* basis, the set-aside is 110/200 or 55%. However, the Applicable Fractions are 90% and 20%, respectively. Therefore, at least 90 units in building A must always be occupied by LIHTC residents, and at least 20 units in building B must always be occupied by LIHTC residents. It is not permissible to allow the number of units in either building to fall below these levels, even if there is a corresponding increase in another building. Moving units between buildings would violate the applicable fraction rules and could result in the loss of credits.

Tip: Whenever possible, it is best to make a building either 100% tax credit or 100% market. Consider a property with a 75% set-aside which is comprised of 10 buildings of 10 units each. The best allocation of units would be to have 7 buildings which are 100% tax credit (applicable fraction of 1.00), 2 buildings which are 100% market (applicable fraction of 0.00), and one building with 5 out of 10 units as tax credit (applicable fraction of .50). There is no Federal requirement that every building have tax credit and market rate units in proportion to the 75% set-aside. As discussed in Section IX, to the extent that we can reduce the number of

mixed-income buildings, administration of the Available Unit Rule will become significantly easier.

Tip: *Under certain circumstances, ownership may wish to allocate all the smaller units to the program, leaving the larger units unrestricted. There is no prohibition against making such an allocation. The amount of credits will be reduced because the square footage fraction will fall below the unit fraction; however, the additional revenues which may be available may outweigh the loss of credits. Additionally, developmental factors not addressed in this manual (e.g., changes in the credit percentage or cost overruns) may permit a weighted allocation without the loss of any credits.*

It is interesting to note that the Operating Election and minimum set-aside is a *unit only* test – the size of the units does not matter. Thus it may be possible for a property to meet its minimum set-aside (20% at 50% or 40% at 60%) and have an applicable fraction lower than this number. Mixed-income properties which have buildings with applicable fractions less than 100% should implement controls to insure that the applicable fraction percentage is never violated.

Example: *A 100 unit property with one building could have made the 40/60 election and have 40 units at 60% and thereby meet the minimum operating election requirements. However, they could then assign all of the one-bedroom units to the Program and none of the larger two- and three-bedroom units. The result would be a property which met the 40/60 requirement, but had an applicable fraction of less than 40%. Although the amount of credits might be diminished, this structure might have significant advantages from a marketing perspective.*

Secondary Set-asides

Depending upon the specific rules for the state in which your property is located, the applicable fraction rules may not apply to secondary set-asides. If, for example, 80% of the property is tax credit and 20% is market, the applicable fraction must be calculated on each building to insure that 80% of the *overall* rentable square footage is tax credit. If, however, a portion of the tax credit units were further restricted, it is not clear that the applicable fraction rules would apply to the secondary set-aside. Thus, if half of the tax

credit units were restricted to households at (say) 35% of median, we know that 40% of the total units would be so limited; however, in most states, it need not be 40% of the rentable square footage as well. Properties operating with secondary set-asides should determine whether the State agency views the restriction solely on number of units or considers income as well.

The steps associated with swapping tax credit units and market rate units are complex and are addressed in Chapter IX. This chapter also addresses how changes in a tenant's income can impact *which* level of set aside should be assigned to that tenant. Generally speaking, however, secondary set-asides are generally infinitely swappable across buildings. In the above example, the split between the tax credit units and market rate units (i.e., 80% tax credit and 20% market) is established on a building-by-building basis. However, the allocation of those 80% tax credit units between the secondary set-aside can be made (and changed) in any manner which the owner chooses.

Tip: *By regulation, weighted allocation strategies (i.e., one building all tax credit and another all market) are not available to properties having HOME funds.*

Tip: *Properties with secondary restrictions such as tax exempt bonds may be obligated to allocate tax credit and market rate units proportionally by building.*

3. The Next Available Unit Rule

Once the number of tax credit units and square footage in a building has been determined, this number is cast in stone and cannot be changed. Tax credit and market rate units may be "swapped" within that building, but not between buildings. Note, however, that if a swap is made that care should be taken to assure that the applicable fraction rules have not been violated.

The rules for "swapping" LIHTC units between multiple state set-asides units vary from state to state. Some states permit swapping between buildings, some do not. Properties with multiple state set-asides should consult with their state agency for direction on swapping units. See further discussion in this section.

When an LIHTC household's income exceeds 140% of the current maximum allowable, the resident is not forced to vacate the unit or move from the property. However, in order to maintain compliance, the next available market rate unit (or units), of the comparable size or smaller, in the same building, must be converted to an LIHTC unit and rented to an LIHTC qualified applicant. In other words, the next available market rate unit, in that building, must be rented, at LIHTC restricted rents, to an LIHTC qualified applicant, and not at a market rate rent to a market rate applicant. This policy must continue until the number of units and square footage of tax credit units is restored to the initial applicable fraction.

In these situations, until a market rate unit is converted and **a binding lease commitment has been made** with an LIHTC household, the over 140% unit is still considered a tax credit unit, and is reported to the state housing agency as such. While it may seem that reporting an over-income unit as in compliance unit is wrong, it isn't as long as every legitimate attempt is made to convert the next available market rate unit of a comparable or smaller size to an LIHTC unit. When the converted market rate unit is rented to an LIHTC household, the over-income unit may be converted to a market rate unit and the rent may be raised from restricted to market.

If the next available market rate unit is the same size as the LIHTC unit that became over-income, then both the next available unit and the applicable fraction have been maintained. If the next available market rate unit is smaller than the LIHTC unit that became over-income, then both that unit and the subsequent available market rate unit must be rented to an LIHTC qualified applicant so that the square footage element of

the applicable fraction will be satisfied.

***Tip:** If you wish to reduce the possibility of losing two units for one, you are welcome to swap with a larger unit if it becomes available. Assume a two-bedroom unit becomes available and the next unit to become available is a one-bedroom. Assume further that there is already a vacant three-bedroom unit which was not subject to the Available Unit Rule. In this case, management **could** effect the swap with the three-bedroom unit. Although they would lose some square footage to the Program, they would not lose a second unit.*

The following tables illustrates the process:

TABLE 1

Unit #	1	2	3	4	5	6	7	8
Unit Size	1 BED	1 BED	1 BED	1 BED	1 BED	1 BED	1 BED	1 BED
Unit Type	LIHTC	LIHTC	LIHTC	LIHTC	MARKET RATE	MARKET RATE	MARKET RATE	MARKET RATE
June		O/I ¹						
July			V ²					
Aug			TC ³					
Sept						V ⁴		
Oct		Raised to MKT ⁵				TC ⁵		

TABLE 2

Unit #	1	2	3	4	5	6	7	8
Unit Size	1 BED	2 BED	1 BED	2 BED	1 BED	2 BED	1 BED	2 BED
Unit Type	LIHTC	LIHTC	LIHTC	LIHTC	MARKET RATE	MARKET RATE	MARKET RATE	MARKET RATE
June		O/I ⁷						
July					V ⁸ TC			
Aug						V ⁹		
Sept		Raise to MKT ¹⁰				TC ¹⁰		

Explanatory notes:

Table 1

- General. Building has 8 units, all of which are the same size one-bedroom units. 50% of the units and 50% of the rentable square footage is tax credit. The applicable fraction is therefore 50%.
1. June 1, unit #2 goes over-income. The unit is still "needed" to meet 50% applicable fraction requirement. Over-income resident may remain in unit at LIHTC rents, but "next available unit" light is on.
 2. July 1, unit #3 goes vacant. Unit #2 is still needed to meet 50% applicable fraction requirement. Unit #3 is a "qualified vacant" and can be counted towards set-aside.
 3. August 1, unit #3 is rented to a tax credit household. Unit #2 is still required to meet 50% set-aside. Unit #2 must remain at tax credit rents and "next available unit" light stays on.
 4. September 1, unit #6 goes vacant. Although now held for a tax credit household, until occupied unit remains an "unqualified vacant". Unit #2 must remain at tax credit rents and "next available unit" light stays on.
 5. October 1, unit #6 is rented to a tax credit household. Unit #2 is no longer needed to meet 50% applicable fraction (satisfied by #1, #3, #4, and #6). The rent on unit #2 may be raised to market rates. The "next available unit" light is now off.

Table 2

- General. Same scenario as table #1 except that building is comprised of 4 one-bedroom and 4 two-bedroom units. There are 2 "ones" and two "twos" occupied by tax credit households. The applicable fraction for both unit fraction and square footage fraction is still

50%.

7. June 1, unit #2 goes over-income. The unit is still "needed" to meet 50% applicable fraction requirement. Over-income resident may remain in unit at LIHTC rents, but "next available unit" light is on.
8. July 1, market unit #5 goes vacant and is immediately occupied by a tax credit resident. Although there are now 4 tax credit units (excluding #2) which satisfy the unit fraction, the square footage requirement is not satisfied (3 one-bedroom units and 1 two-bedroom unit is not 50%). Hence unit #2 is still required. Unit remains at tax credit rents and "next available unit" light remains on.
9. August 1, market unit #6 goes vacant. Although held for tax credit household, until occupied unit remains on "unqualified vacant". Unit #2 is still required to meet 50% applicable fraction. Unit #2 remains at tax credit rents and "next available unit" light remains on.
10. September 1, unit #6 is occupied by a tax credit unit. The square footage requirement is now satisfied. The unit test is more than satisfied (5 out of 8). The rent for unit #2 can be raised to market and the "next available unit" light can be turned off.

Note: *There is now an "extra" one-bedroom unit in the Program. The next one-bedroom tax credit unit which becomes available may now be "reclaimed" to market.*

Tracking the Next Available Unit

When a unit in a mixed-income property goes over-income, the next available market unit of the same size or smaller must be made available to a tax credit qualified resident until the applicable fraction is restored. For properties with multiple buildings, the rule applies on a building-by-building basis **not** on a property basis. When this happens, it is

incumbent upon management to track the "swap". This process may be completed by preparing a three-part NCR form indicating:

- ▶ the LIHTC unit going over-income
- ▶ the size of the unit
- ▶ the date on which it went over-income
- ▶ the market-rate unit which was then "loaned" to the program
- ▶ the size of the loaned unit
- ▶ the date on which the loaned unit became available
- ▶ the date on which the loaned unit was occupied by a tax credit eligible resident

Note that the critical factor in the swapping process is *availability*, not *vacancy*. The Available Unit Rule requires that management effect a swap when a unit becomes available which is not necessarily when it becomes vacant. This distinction can work in both directions.

Example: LIHTC unit #1 goes over-income on January 1st. At that date, Market unit #2 is vacant; however, the unit has been leased and management has already committed to a lease with a non-qualified household. Even though this unit will be subsequently occupied by a non-qualified household, no violation of the Available Unit Rule has occurred.

Example: LIHTC unit #1 goes over-income on January 1st. At that date, market rate unit #2 is occupied by a tenant who has given notice of intent to move-out on the 10th. Since this unit is now technically available for rental, it must be converted to a Program unit and marketed to a qualified household.

Copies of this tracking form should be filed in the resident file of the unit which went over-income, the "loaner" unit, and chronologically by building. A sample form for tracking the Next Available Unit is included in Section XII.

TIP: If any LIHTC units in a mixed-income building have tenants with delinquent recertifications, no market units (of the same size or smaller) in

that building should be rented to market tenants until the late recertification has been completed. The reason for this policy stems from the fact that there is always the potential that the late recertification unit will recertify over-income. In such an event, the unit will be considered as over-income as of the date the recertification was due thereby creating a violation of the Available Unit Rule.

As an example., consider a building with a unit whose recertification was due on June 30th but was not completed until August 1st. In the interim, on July 15th a market-rate unit in the building is rented to a market tenant. However, when the delinquent recertification is completed on August 1st, that unit is determined to be over-income. That over-income determination would be retroactive to June 30th. The rental of a market-rate unit on July 15th would be considered a violation of the Available Unit Rule.