

BREAKING TAX NEWS BULLETIN

Congress Passes Major Enhancement To Low-Income Housing Tax Credit

The Housing and Economic Recovery Act of 2008 (HR 3221) (the "Act") was passed by the U.S. House of Representatives on July 23, 2008 and by the U.S. Senate on July 26, 2008. President Bush signed the bill into law this morning, July 30, 2008.

This Bulletin summarizes and provides commentary on the major portions of the Act that relate to the Low-Income Housing Tax Credit ("LIHTC" or "Credit") under Section 42 of the Internal Revenue Code of 1986 (the "Code"). Some of the major enhancements include:

- Increasing Credit amounts by 10% in 2008 and 2009
- Increasing tax-exempt volume cap in 2008 by \$11 billion for certain housing related purposes
- Temporarily fixing LIHTC rates at 9% for new construction and rehabilitation costs that do not employ tax-exempt bond financing
- Eliminating restrictions on below-market federal loans
- Clarifying that projects can target or have preferences for certain types of tenants
- Allowing states to designate individual buildings as eligible for the 130% basis boost
- Eliminating the recapture bond requirement, and
- Allowing LIHTC and historic rehabilitation credits to be used against the Alternative Minimum Tax ("AMT") and exempting interest on certain housing bonds from AMT.

A copy of the Act, as well as The Report by Joint Committee on Taxation ("JCT Report"), is available at <http://www.att-law.com/publication.html>. Section references in this Bulletin refer to the Section of the Act and "Code" refers to the Internal Revenue Code of 1986 as amended.

Additional Information – For questions related to the new legislation, please contact Glenn Graff at 312-491-3313 or ggraff@att-law.com.

Tax Opinion Disclaimer – Please note that this Bulletin is only a summary of a long and complex bill. Please contact your tax advisor with respect to applying the new rules. This Bulletin is not intended to be used, and may not be used by any direct or indirect recipient, for the purpose of (i) avoiding any penalties that may be imposed on such recipient, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Applegate & Thorne-Thomsen, P.C.

322 South Green Street, Suite 400
Chicago, IL 60607
312-421-8400
312-421-6162 fax
www.att-law.com

ANALYSIS OF H.R. 3221

EFFECTIVE DATE – Unless specifically stated otherwise below, provisions of the Act are applicable to buildings that are placed in service after date the bill is enacted into law, i.e. after July 30, 2008. Because the Act is generally effective for buildings placed in service after July 30, 2008, buildings which have already received a reservation of carryover allocation of LIHTC but have not yet been placed in service may still benefit from a number of the provisions discussed below.

ANALYSIS

1. **Increase in State LIHTC Amounts (Section 3001)** – For 2008 and 2009, each State will receive an additional 10% allocation of LIHTCs.

Comment – The state allocating agencies will need to put a procedure in place to use the additional Credits. Quick action will be needed by the State allocating agencies to allocate the additional 2008 Credits before December 31, 2008.

Comment – States will be able to choose whether to use the additional Credits to (i) allocate more Credits to projects that already have a Credit allocation but may have a financing gap due to the current reduction in equity pricing, (ii) allocate Credits to new projects, or (iii) use a combination of (i) and (ii).

2. **Temporary 9% Credit Rate Floor for Buildings That are not Federally Subsidized (Section 3002(a))** – For new construction and substantially rehabilitated buildings that are not Federally subsidized, the applicable percentage (i.e. Credit rate), is temporarily increased to no less than 9%. As discussed in more detail below, the definition of federally subsidized buildings is now limited to buildings financed with tax-exempt bonds.

Effective Date – This provision is effective for buildings placed in service after enactment of the Act and before December 31, 2013.

Comment – This change results in an almost 14% increase the amount of LIHTC that a building's eligible basis could support. This increase can significantly help projects overcome a funding gap if they are allocated sufficient Credits to use the higher amount. For projects that have a funding gap and already have received a carryover allocation of Credits which is fully utilized under the prior law, such projects would now be able to support more Credits and could request an additional allocation of Credits from the state credit agency.

Comment – It appears that the new 9% floor for the applicable percentage should apply even if a building has previously locked the applicable percentage under Code Section 42(b), as long as the building is placed in service after the date of enactment and before December 31, 2013.

Comment – The provision does not fix the applicable percentage for acquisition costs or for buildings that obtain their LIHTC through the issuance of tax-exempt bonds. Thus a rate lock will continue to be important for such projects and project owners need to evaluate the current applicable percentage and the expectation for the future applicable percentage in deciding whether or not to lock the credit rate. However, for new construction or rehabilitation projects without tax-exempt bond financing it is recommended that such projects choose not to lock their credit rate while the monthly applicable percentage is below 9%. While it is unlikely, it is possible for an unexpected but very large increase in interest rates to result in the applicable percentage exceeding 9% by the time a building is placed in

service. Therefore while the monthly credit rate is below 9%, the only impact of a rate lock election for a new construction or rehabilitation project would be to prevent the project from taking advantage of a rise in the credit rate above 9%.

3. Change in Definition of Federally Subsidized Building (Section 3002(b)) – The concept of below-market Federal loans has been removed. The only financing that will now cause a project to be considered Federally subsidized is tax-exempt bonds.

Comment – The JCT Report clarifies that Federal grants can be loaned in to a project at any interest rate and that no basis reduction will be required. Thus loans derived from Federal funds no longer need to be loaned in at the Applicable Federal Rate (“AFR”) in order to avoid being considered federally subsidized. This should be of substantial help to projects that have a significant amount of Federal loans but had difficulty demonstrating an ability to repay the principal amount of such debt plus interest at AFR. Now such projects can carry the loans at a lower interest rate or no interest at all. This provision will significantly reduce the complexity of LIHTC projects that will no longer need to struggle to carry federal loans at AFR.

4. States Can Designate Buildings to be Treated as if in a Difficult to Develop Area (Section 3003(a)) – Under the Act, state housing credit agencies now have the ability to designate any building regardless of location as eligible to receive the 130% basis boost and that such buildings will be treated as if they are in Difficult to Develop Area (“DDA”). The agency must find that the basis boost is necessary for the project’s financial feasibility. The basis boost is not available for projects receiving their Credits through the use of tax-exempt bonds.

Comment – How this provision will be implemented by State credit agencies is unclear. The JCT Report states that it is expected that the State allocating agencies shall set standards for determining which areas shall be designated difficult development areas. However, the Act indicates that it is buildings that will be subject to the DDA designation. The JCT report also states that it is expected that the agency shall publicly express its reasons for such area designations and the basis for allocating additional credits to a project.

Comment – Because such designated buildings are deemed to be in a DDA, such projects will not qualify for the additional basis due to the inclusion of a community service facility.

5. Increase in Minimum Rehabilitation Requirement (Section 3003(b)) – In order for the rehabilitation of an existing building to be eligible for LIHTC, the minimum rehabilitation requirement has been increased to the greater of (i) 20% of the adjusted basis of the building, or (ii) \$6,000 per unit. For buildings placed in service after 2009, the \$6,000 requirement will be indexed for inflation.

Effective Date – For projects receiving Credits allocated from the State credit agency, this provision is effective for buildings receiving allocations after the date of enactment of the Act. For buildings receiving Credits through the issuance of tax-exempt bonds, the provision applies to buildings financed with bonds issued pursuant to allocations made after the date of enactment. See comment below regarding “allocations”.

Comment – Most projects have rehabilitation expenditures that exceed even the revised requirements and therefore the impact of this provision will be limited. However, because the minimum rehabilitation requirement is inflation indexed and is linked to the date of placement in service, a delay in placement in

service could result in an unexpected increase in the minimum rehabilitation requirement and could impact a project which involved a “light” rehabilitation.

Comment – In applying the effective date rule to tax-exempt bond projects, it is not clear when a bond is considered to have a tax-exempt bond “allocation”. The date of the actual allocation could vary depending on the practice of a state or locality with some of the possible allocation dates being the date an ordinance is issued regarding the volume cap up through the date the bonds are actually issued.

6. Community Service Facility Increase in Allowable Basis (Section 3003(c)) – Projects in a Qualified Census Tract (“QCT”) are allowed to include in eligible basis the costs of a community service facility. The amount of community service facility basis allowed under this rule was previously limited to 10% of the project’s eligible basis. The provision increases the limitation to 25% of the first \$15,000,000 of eligible basis of the project plus 10% of additional amounts.

Comment – The provision only applies to projects in a QCT. Thus projects in a DDA or which are designated by a State as in a DDA as described above are not permitted to include the cost of a community service facility in eligible basis.

7. Clarification of Treatment of Federal Grants (Section 3003(d)) – This provision provides that eligible basis cannot include any costs financed with the proceeds of a Federal grant. This provision also eliminates the prior requirement that eligible basis be reduced for grants used for operations.

Comment –The JCT Report also clarifies that operating assistance, rental assistance and interest reduction payments are not considered Federal grants that must reduce eligible basis.

Comment – The provision also clarifies that grants that are used to finance eligible basis must be subtracted from basis even if the grant is received prior to the start of the compliance period.

8. Simplification of Related Party Acquisition Credit Rules (Section 3003(e)) – The prior acquisition credit limitation that the buyer and seller of a building cannot be related by more than 10% has now been increased to 50%.

Comment – This provision should significantly help preserve buildings which had previously received tax credits. Because of the limited number of tax credit investors, it was becoming difficult for some tax Credit projects which had completed their 15-year compliance period to find an unrelated investor for the acquisition and rehabilitation of the building using a new allocation of LIHTC. By raising the relatedness standard to 50%, investors who had a previous minority interest in a project are now able to invest in the acquisition and rehabilitation of the project.

9. Exception to 10-Year Non-Acquisition Rule for Acquisition Credit Projects (Section 3003(f)) – Under the Act the prior acquisition credit requirement that a building may not have been placed in service during the 10 years prior to the relevant acquisition now does not apply to any “Federally or State assisted building”. Federally or State assisted buildings include buildings receiving HUD assistance or Rural Housing Service assistance or buildings that are substantially assisted, financed or operated under State law similar in purpose. A waiver may also be requested for buildings that are being acquired from an FDIC insured depository institution that is in default.

Comment – This provision allows buildings that receive Federal or State assistance to qualify for acquisition credits even though they were placed in service within the 10 years preceding the acquisition. For example, a project receiving HUD Section 8 assistance could be purchased and obtain acquisition credits even though it was placed in service in the last 10 years.

10. Moderate Rehabilitation (Section 3004(a)) – The prohibition against using LIHTC with buildings that receive moderate rehabilitation assistance under the McKinney Act is repealed.

Comment – Some projects continue to receive Section 8 payments related to a prior McKinney Act moderate rehabilitation. Under prior law, the continuation of the Section 8 payments disqualified the project for Credits. The repeal of this provision allows LIHTC to be generated on projects that continues to receive the Section 8 payments related to the prior moderate rehabilitation.

11. Extension of Timing for Meeting 10% Carryover Requirement (Section 3004(b)) – For projects receiving a carryover allocation, the timing requirement for incurring 10% of project costs has been extended from 6 months after the date of the carryover allocation to one year from the date of the carryover allocation.

Comment – This provision should help many projects which have received a carryover allocation of Credits but that have been delayed in starting construction due to delays in obtaining financing or necessary government approvals. As a result, hopefully most projects will no longer be forced to begin work or acquire project assets at a time earlier than otherwise makes sense given the project's progress in achieving the necessary financing and approvals.

Comment – Although the relaxation of the 10% requirement is effective for buildings placed in service after enactment of the Act, 2008 carryover allocations which already have been received likely have an explicit requirement that the carryover allocation be met within 6 months or in some states even earlier. In such a case the building owner should contact the State credit agency and request that the 10% deadline be extended to be consistent with the new Act.

12. Repeal of Recapture Bond Requirement (Section 3004(c)) – There will be no recapture of Credits if a building (or an interest therein) is disposed of within the 15-year LIHTC Compliance Period if it is reasonably expected that such building will continue to be operated in compliance the LIHTC requirements for the remainder of the Compliance Period. However, the recapture bond requirement is replaced with an extension of the statute of limitation to 3 years after the IRS is notified of the recapture event.

Effective Date – The repeal of the recapture bond requirement is effective for transfers after the date of enactment. However, a taxpayer can elect to have the provision apply to prior transfers of interests in buildings if it is reasonably expected that the building will continue to be operated in accordance with Code Section 42 for the remainder of the Compliance Period.

Comment – It is hoped that the repeal of the bonding requirement will make the Credit attractive for more investors. Under the prior law, investors could not dispose of an interest in an LIHTC project prior to the end of the 15-year compliance period without posting an expensive recapture bond. Thus many investors chose not to invest in LIHTC projects because 15 years was too long of an investment horizon. The removal of the recapture bond requirement will allow an investor to dispose of its interest at any time so long as it is expected that the project will continue to comply with the LIHTC requirements. Thus investors with shorter time horizons may be willing to invest in LIHTC projects. However, it should be noted that the provision does not eliminate recapture liability for projects that become non-conforming.

Comment – Projects which have previously had a transfer on an interest in a building and have purchased a recapture bond can now elect to not require the recapture bond. This could provide significant savings from having to make the annual payments for the cost of the bonds.

13. Consideration of Energy Efficiency and Historic Nature of Buildings (Section 3004(d)) – State qualified allocation plans are now required to consider both the energy efficiency and historic nature of a project.

Effective Date – Effective for allocations made after December 31, 2008

Comment – The JCT reports lists “encouraging rehabilitation of certified historic structures under [Code] Section 47(c)(3)” as an example of the historic criteria. This refers to projects that are on the National Register of Historic Places or which are in a registered Historic District and are determined to be significant to such district by the Secretary of the Interior. However, the statute appears to be broad enough to allow State credit agencies to consider the historic nature of buildings which may have historic qualities (e.g. on a State list of historic places) but do not meet the Federal definition of a certified historic structure.

14. Students Who Were Previously Under Foster Care (Section 3004(e)) – The provision adds an exception to the general rule disallowing student housing. The exception permits units to be occupied by students who previously received foster care.

Effective Date – Effective for determinations after enactment.

15. Treatment of Rural Projects (Section 3004(f)) – Rural projects (as defined in Section 420 of the Housing Act of 1949) which are not tax-exempt bond financed will now have tenant income measured by the greater of the area median income of such area or the national non-metropolitan median income.

Effective Date – Effective for determinations after enactment.

Comment – This provision could allow projects in rural areas to use a higher non-metropolitan median income. This could make rural projects more viable from a financial perspective by allowing higher tenant income and rent.

16. Clarification of General Public Use Requirement (Section 3004(g)) – The general public use (“GPU”) requirement is clarified to confirm that otherwise qualifying buildings will not be considered to fail GPU solely because of occupancy restrictions or preferences that favor the following classes of tenants: (1) tenants with special needs; (2) tenants who are members of a specified group under a Federal program or a State program or policy that supports housing for such a specified group; or (3) tenants who are involved in artistic or literary activities.

Effective Date – Applies to buildings placed in service before, on, or after the date of enactment.

Comment – In a significant victory for the housing industry this provision reverses a recent IRS audit position that projects that involve tenant targeting or preferences violate the requirement that projects be available for general public use and thus do not qualify for any Credits. Such a position was in conflict with both IRS regulations and the treatment of such housing for over 20 years. The Congressional confirmation of prior industry practice removes a significant impediment for a number of types of housing

such as housing for veterans, farm workers, first responders, teachers, artists, low-income parents attending college, pregnant or parenting teens, and domestic abuse victims.

Comment – The reference to state policy appears to allow states to include preferences in their Qualified Allocation Plans for certain types of projects without raising a General Public Use issue.

17. Coordination of Tax-Exempt Bond Rules for Credit Projects (Section 3008) – For projects with both tax-exempt bonds and LIHTC, a number of tax-exempt bond rules are modified to mirror the LIHTC rules. The next available unit rule (“NAUR”) under the tax-exempt bond rules is modified to apply on a building basis rather than a project basis. Also the bond rules are modified for LIHTC projects to allow student tenants and single-room occupancy (“SRO”) units to the same extent as allowed under the LIHTC rules.

Effective Date – Applies to determinations of the status for periods beginning after the date of the enactment with respect to bonds issued before, on, or after such date.

Comment – The NAUR change resolves a conflict between the tax-exempt bond rules and the LIHTC rules. Because the bond rules applied the NAUR on a project basis whereas the Credit rules applied the NAUR on a building basis, the result was that in certain circumstance the number of units required to be rented to low-income persons could “creep up” over time.

Comment – Previously SRO projects were not allowed in tax-exempt bond transactions. This change will allow SRO projects where both Credits and tax-exempt financing are present.

18. Hold Harmless for Reductions in Area Median Income (Section 3009) – General Rule – For projects financed with tax-exempt bonds and/or Credits, the area median gross income (“AMI”) determination for a project after 2008 shall not be less than the income determination for the preceding year. Income Increase for HUD Hold Harmless Projects – For projects subject to the HUD hold harmless policy, AMI will be no less than the prior HUD hold harmless amount for 2008 plus any increase in AMI after 2008.

Effective Date – applies to determinations of AMI for calendar years after 2008.

Comment – The General Rule prevents projects from having a decrease in tenant income and rents if there happens to be a decrease in AMI in a future year. This will eliminate the risk that project rents could decrease thereby jeopardizing a project’s financial viability.

Comment – Due to a change in HUD methodology, AMI decreased in a number of areas of the country. HUD issued a hold harmless policy providing that projects in such areas could continue to use the prior AMI. The new AMI increase rule provides that the AMI for such projects will be no less than the 2008 HUD hold harmless AMI amount plus any change to AMI in the area. For example, if AMI had decreased from \$40,000 to \$38,000 due to HUD methodology changes, under the hold harmless rule projects could continue to use the \$40,000 AMI amount. If AMI in the next year went up to \$38,500, then a hold harmless project’s AMI would be \$40,500 (the \$40,000 hold harmless amount plus the \$500 increase in AMI). However a new project in the same area that was not subject to the HUD Hold Harmless policy would have to use the \$38,500 AMI. As a result the new project would have a lower income and rent than the old project.

19. No Annual Recertification for 100% Low Income Projects (Section 3010) – The annual tenant income recertification requirement for tax-exempt bond and LIHTC projects is waived as long as all new project tenants are income qualified.

Effective Date – Applies to years ending after the date of enactment

Comment – The new provision does not modify other HUD rules that may apply to a particular project. Therefore some projects may need to continue annual recertification to comply with HUD rules that apply to a project apart from LIHTC concerns.

20. \$11 Billion Increase in Housing Bond Volume Cap (Section 3021(a)) – The tax-exempt bond volume cap for 2008 is increased by \$11 Billion. Such increase can be carried forward through 2010. The additional volume cap can be used for qualified residential rental projects (including LIHTC projects) as well as a qualified mortgage issue (including the refinance of a sub-prime loan).

Effective Date – Applies to bonds issued after the date of enactment.

Comment – This is a substantial amount of additional bond volume cap and should make it easier for an LIHTC project to obtain the volume cap necessary to finance 50% of the project's land and building costs and thus obtain an automatic allocation of LIHTC.

21. Alternative Minimum Tax Changes (Section 3022) – LIHTC and historic and “old building” rehabilitation credits under Code Section 47 are now allowed against the alternative minimum tax (“AMT”). Interest on tax-exempt bonds used for qualified residential rental projects (including LIHTC projects) is also exempt from AMT.

Effective Date – For LIHTC projects, the provision applies to buildings placed in service after December 31, 2007. For rehabilitation credits under Section 47, the provision applies to the extent the credit is attributable to qualified rehabilitation expenditures incurred after December 31, 2007. For bond interest, the provision applies to bonds issued after the date of enactment.

Comment – Some large LIHTC investors are thought to be subject to AMT and have therefore dropped out of the LIHTC investment market. It is hoped that the allowance of LIHTC against AMT will allow such investors to re-enter the market and stop the current drop in LIHTC pricing. In addition, it is hoped that new investors may come into the market because they know that if in the future they become subject to AMT, they will still be able to use the Credit.

Comment – The rules will create different kinds of LIHTC and bond interest. For projects completed prior to the effective date, such Credits and bond interest will not be exempt from AMT. However, newer projects will be exempt. As a result, the price paid for new Credits and new bonds may be higher than that paid for older projects with the AMT restriction.

22. Historic Rehabilitation Tax-Exempt Use Safe Harbor (Section 3025) – For Projects receiving credits for the rehabilitation of historic buildings under Code Section 47, such projects are now allowed to lease up to 50% of the property to tax-exempt entities in disqualified leases rather than the prior 35% maximum.

Effective Date – Effective for expenditures properly taken into account for periods after December 31, 2007.

Comment – One type of disqualified lease involves a situation where a tax-exempt entity previously owned and used a building and then sells the building but then leases back a portion of the building. Under the new provision such tax-exempt entities can sell a building to a taxpayer that will perform the historic rehabilitation and then the seller can lease back up to 50% of the building space. Similarly, tax-exempt entities will now be able to lease up to 50% of project space in leases which have terms longer than 20 years or have a fixed or determinable purchase option.

23. **Waiver of GO Zone Depreciation Deadline (Section 3082(b))** – Prior law required that in order to obtain the 50% bonus depreciation for residential rental property buildings located in the GO Zone, construction of such buildings had to begin by December 31, 2007. The provision removes the commencement date deadline.

Effective Date – Applies to property placed in service after December 31, 2007.

Comment – Congress previously extended the placement in service deadline from December 31, 2008 to December 31, 2010 for buildings in certain specified areas of the GO Zone. However, at that time Congress did not extend the December 31, 2007 deadline by which construction needed to commence. Due to the many difficulties in the GO Zone, many projects unexpectedly did not commence construction by December 31, 2007 although they expected to be completed on time. Such projects were relying on the additional investor equity generated by the GO Zone depreciation to make them financially feasible and the failure to meet the commencement deadline resulted in the likely failure of such projects. By eliminating the commencement deadline for all areas of the GO Zone, the provision allows such projects to obtain the GO Zone depreciation while still completing the project within existing requirements.