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Maximizing the Low-Income Housing Credit in Combination With Government Subsidies

Although Federal loans and grants will result in a reduced credit, there are other incentives and financing techniques available to developers.

BY WILLIAM R. CULP, JR.

One of the major uncertainties concerning the operation of Section 42[1] is the technical and economic relationship of various Federal, state and local subsidies to the low-income credit. The issue is critical because although the credit standing alone appears substantial, in many cases it does not provide sufficient economic incentive to justify the private investment necessary to use it.

Viability of Using Credit

There are two limiting factors inherent in Section 42. The first is the restriction on rent levels. This limitation is at the heart of the new credit, which is intended to compensate investors for the lower rents. Unfortunately, without additional subsidies the low-income credit in many situations does not provide sufficient compensation. The second factor is the limited number of investors who can take advantage of the low-income credit. The passive loss rules severely limit the use of the credit by wealthy individuals who are traditional tax shelter investors. The credit can only offset individuals' passive income or offset the tax on $25,000 of nonpassive income. The $25,000 allowance is phased out between $200,000 and $250,000 of income.

WILLIAM R. CULP, JR., is a member of the Charlotte, North Carolina, office of the law firm of Culp, Underwood, Elliott & Marsh. He is also a CPA. A prior JOURNAL author, Mr. Culp has also written for TAXATION FOR ACCOUNTANTS.

In practice, this limitation leaves as potential investors C corporations and investors with incomes below $200,000 who are "non-accredited" under "Reg. D." The possibility of using investors with incomes below $200,000 is limited because no more than 35 non-accredited investors can invest in a private Reg. D offering. Furthermore, in order to use the low-income credit, individual investors must expect their income to remain below $200,000 for the full ten-year credit period. The number of C corporations available as investors may be limited by the fact that many closely held C corporations are converting to S status. Traditionally, larger C corporations have not been interested in investing in low-income deals and other tax shelters because of undesirable consequences to their income statements and balance sheets.

Although these investor limitations can be onerous, it appears promoters are beginning to successfully target corporate investors for funds and promoters have been able to sponsor successful public partnerships.[2] Even though these low-income credit restrictions can be overcome, they put pressure on the economics of the deal that makes other subsidies an essential tool of the promoter.

Overview of Credit

Section 42(b)(1)(A) provides a credit each year for ten years of 9% of the qualified basis (as defined in Section 42(c)) for new buildings placed in service during 1987 that are *not* Federally subsidized. Under Section 42(b)(1)(B), the credit allowed for each of ten years is 4% of the qualified basis for both new buildings that are Federally subsidized (including substantial rehabilitations under Section 42(e)) and existing buildings placed in service during 1987.

For buildings placed in service *after* 1987, Section 42(b)(2) provides that the credit percentage will be adjusted monthly to yield over ten years amounts of credit that have a present value equal to (1) 70% of the qualified basis of new construction that is not Federally subsidized and (2) 30% of the qualified basis of either new construction that is Federally subsidized or existing buildings. In lieu of reducing the credit percentage from 9% to 4%, under Section 42(i)(2)(B) a taxpayer can elect to exclude from qualified basis the amount of any loan that caused the property to be deemed Federally subsidized.

Section 42(d)(5)(B) provides that if a grant is made with respect to any building or its operation during any taxable year of the compliance period and any portion of the grant is Federally funded, the eligible basis of the building must be reduced by the portion of the grant that is so funded.

Federally subsidized. Under Section 42(i)(2)(A), a new building will be Federally subsidized for any taxable year if at any time during that year there is outstanding either of the

following loans, *and* the proceeds are used (directly or indirectly) with respect to the building or its operation:

1. A loan the interest on which is exempt under Section 103.

2. Below-market Federal loan.

However, neither tax-exempt financing nor a below-market loan will be treated as a Federal subsidy if the loan is repaid and any underlying obligation (*e.g.*, tax-exempt bond) is redeemed before the building is placed in service.[3]

Section 42(i)(2)(c) provides that a below-market Federal loan is a loan funded in whole or in part with Federal funds if the interest rate on the loan is less than the applicable Federal rate in effect under Section 1274(d)(1) as of the date on which the loan is made. The Conference Report[4] defines a Federal subsidy to include a direct or indirect Federal loan if the interest rate on the loan is less than the applicable Federal rate (for example, a Federal loan under the Farmers' Home Administration section 515 program or a reduced interest rate loan funded, in part, through a Federal grant). 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 for which the expenditures are made.[5]

The legislative history uses the Section 42(i)(2)(A) language describing "Federally subsidized" to define the term "Federal subsidy." This causes confusion because not all Federal subsidies reduce the credit. Federal assistance that does not reduce the credit percentage will be referred to herein as a Federal incentive, while assistance that does reduce the credit will be referred to as a Federal subsidy.

Federal grants. Section 42(d)(5)(B) provides that the eligible basis of property must be reduced by any Federal grants used on the property. The term Federal grant is not defined. The Conference Report states that "a Federal grant includes any grant funded in whole or in part by the Federal government, to the extent funded with Federal funds." Examples of grants that may not be included in eligible basis include: Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.[6]

Planning Opportunities

A recent letter ruling illustrates the planning opportunities surrounding the use of Federal subsidies and grants. *Ltr. Rul.* 8813024 involved a limited partnership formed to develop a low-income housing project qualifying under Section 42. A portion of the construction financing was to be provided by a loan from the city in which the project was located. The loan would be funded by a U.S. Department of Housing and Urban Development (HUD) grant. The grant required that the limited partnership restrict the project to certain low-income standards, but it did not impose any restrictions on the relationship between the city and the limited partnership.

Thus, the city could make the Federal funds available to the limited partnership as a (1) below-market rate loan, (2) a market rate loan, or (3) as a grant. The city initially planned to make the loan at a below-market rate, but the rate was later increased to market. The loan from the city was secured by a second mortgage on the property. The first mortgage was provided under a HUD co-insurance program at a market rate. The HUD grant to the city did not require repayment. The letter ruling addressed the following issues:

1. Is a Federal grant to a city which is in turn loaned to a developer a Federal grant to the developer under Section 42(d)(5)(B)?

2. If a Federal grant is loaned by the city to a developer at market rates, is it treated as a below-market loan, causing new construction funded with such loan to be Federally subsidized?

Service rules for taxpayer. The ruling held in favor of the taxpayer on both issues. On the first issue, the IRS concluded that the two-step character of the transaction (the grant to the city followed by the loan to the developer) had to be respected for purposes of Sections 42(d)(5) and 42(i)(2), and prevented characterization as a Federal grant. This was so because a grantor other than the Federal government could make a grant consisting partly of Federal funds and partly of other funds. Further, a recipient of a Federal grant could make those funds available to a developer as a market rate loan, so that the funds would not be a Federal subsidy.

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1 For a discussion of the background and mechanics of the credit, see Callison, "New Tax Credit for Low-Income Housing Provides Investment Incentives," 66 JTAX 100 (February 1987); Strobel and Childs, "Recent Regulations and the Blue Book Clarify Low-Income Housing Rules," 67 JTAX 400 (December 1987).

2 See Wertlieb, "IRS Safe Harbors Ease Burdens for Some Publicly Traded Partnerships," page 140, this issue.

3 Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, p. 160.

4 H. Rep't No. 99-841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4) CB 91 (Conference Report).

5 One planning opportunity would be to use a Federal loan to acquire the building (4% credit) and land (no credit). The Conference Report, *supra*, provides that a Federal loan or exempt bond financing that is continued or assumed upon purchase of existing housing is not taken into consideration for purposes of the credit on rehabilitation expenditures under Section 42(e).

6 See Conference Report, *supra* note 4.

7 In order to avoid recapture, the property must be maintained as a "qualified low-income building" for a 15-year compliance period. See Sections 42(c)(2)(A) and 42(i)(1).

8 See Conference Report, *supra* note 4, at II-86.

9 According to the Conference Report, *supra* note 4, at II-89, only the adjusted basis of the building may be included in eligible basis. The adjusted basis is determined by taking into account the adjustments of Section 1016 (as modified), including the basis adjustment provided in Section 48(q).

10 Prior to TRA '86, certain rehabilitation expenditures could be depreciated over 60 months. See Section 167(k)(1).

11 Under prior law, construction period interest and taxes could be deducted as paid or incurred and were not subject to amortization. See pre-TRA '86 Section 189(d)(2). See also Shapleigh and McLeod, "Applying the Uniform Capitalization Rules to Real Estate," 69 JTAX 92 (August 1988).

12 The loan amounts were determined assuming an annual net operating income of $133,632 (before debt service) that exactly equals the debt service. The loan amortization constant on the $1.6 million loan is 8.352 and the constant on the $1,198,700 loan is 11.148.

13 The example ignores the effects of tax losses and ignores benefits or losses after year ten.

Examining the financial arrangement between the city and the limited partnership, the Service ruled that the city loan was to be used for construction of the project and was wholly funded by Federal funds. Because it was a loan, Section 42(d)(5)(B) did not apply.

According to the ruling, the determination of whether the loan was a below-market Federal loan depended solely on the interest rate charged. The ruling approved a modification of the note that was made to ensure that the loan was not below market for any of the taxable years during the project's 15-year compliance period.[7] The modifications provided that the interest rate would be the applicable Federal rate in effect under Section 1274(d)(1) as of the date the loan was made, and that interest would accrue during the construction period. After the construction period, specified monthly payments of principal and interest would be made until the loan was repaid. The amount of the payments was limited to 100% of the surplus cash for the first 17 years, and 80% of the surplus cash thereafter. Any accrued interest and unpaid principal would be paid in a balloon payment at the end of the 40th year from the date of the loan. Because of the modifications ensuring a market interest rate, Section 42(i)(2)(C) did not apply.

The ruling illustrates that there is room for significant planning when dealing with a Federal grant to a local entity where the funds are subsequently loaned by the local entity to a developer. Historically, it has been common practice for HUD grants to cities to be loaned to developers at below-market rates. This arrangement provides the developer with a significant benefit through reduced debt service. The city also benefits from the new development, and it will be allowed to keep the funds which are repaid by the developer. Economically, payment of a higher interest rate on the loan may actually be more attractive to the developer, since a market rate loan will allow use of the 9% credit.

Other Subsidies

While the credit is reduced for new buildings which are Federally subsidized, the full credit can be used with other types of financial incentives and subsidies. The following may be combined with use of the credit:

1. State or locally subsidized loans.
2. Federal, state or local incentives.
3. State or local grants.
4. The Federal Historic Credit (Section 48(g)).
5. State or local credits.

State and locally subsidized loans. Probably the most common non-Federal incentive, a state or local low-interest rate loan will not reduce the credit as long as the loan proceeds are not Federally funded (*e.g.*, through tax-exempt financing or a Federal grant). If a state or local government plans to issue a debt instrument to fund the loan, such instrument cannot be tax-exempt or the loan will be deemed Federally subsizied.

Eligible basis is reduced by the amount of Federal grants, a term that is undefined.

Rent subsidies, such as contracts under section 8 of the U.S. Housing Act of 1937, will not reduce the low-income credit since they are not Federal subsidies or grants. The original Senate proposal[8] on the low-income credit would have provided certain additional restrictions on projects using section 8 subsidies; however these restrictions were not included in the final version of TRA '86 as enacted.

Another Federal incentive that can be used in conjunction with the low-income credit is the historic rehabilitation credit (Section 46(b)(4)(A)(ii)). This credit does not reduce the Section 42(b)(1) credit percentages, but it does reduce eligible basis to the extent of the credit taken.[9] The basis reduction will lower the amount of the Section 42 credit. However, the benefit of the full historic rehabilitation credit in the first year is much greater than the loss of the low-income credit from the basis reduction, for two reasons. First, the historic credit is fully allowable in the first year, while the low-income credit is taken over ten years. Second, the low-income credit that is lost is less than the historic credit that is allowed.

Economic Factors

In planning possible funding structures, there are several important factors to consider, primarily maximizing both the credit and leverage. Leverage is generally desirable in a low-income credit situation because the credit is based on cost, not cash invested. Thus, the larger the credit in relation to cash invested, the better. Also, the less cash invested in relation to cost, the greater the return. Under prior tax incentives for low-income housing, taxpayers were allowed to maximize depreciation[10] and other deductions[11] so as to maximize losses. This structure did much to maximize leverage. Under Section 42, it is not always possible to maximize both leverage and the credit percentage; thus, a proper balance must be achieved to maximize return.

Leverage is generally increased by (1) lowering expenses (including interest), (2) increasing rents, (3) deferring interest or (4) extending the term of the financing. If it is assumed that operating expenses have been minimized and the term of the financing has been extended, then leveraging can be accomplished by lowering interest expense, deferring interest or increasing rents.

Lowering the interest rate. If the objective is to lower the interest rate, exempt financing and Federally funded low-income loans may not be attractive since the credit has to be reduced. The reduction in rate must be weighed carefully against the credit reduction.

EXAMPLE: A new construction project costs $2 million, including a land cost of $100,000. The project can be financed two ways: with $400,000 in cash and a $1.6 million, 8% Federally subsidized loan, or with $801,300 in cash and an 11% (market rate) loan for $1,198,700.[12] The net operating income of the pro-

ject will equal the debt service. If the 8% loan is used, the low-income credit would be $76,000 per year ($1,900,000 × 4%) for ten years. If the 11% loan is used, the credit would be $171,000 ($1,900,000 × 9%) for ten years.

Clearly, a $171,000 credit arising from an $801,300 investment is better than a $76,000 credit resulting from a $400,000 investment. The internal rate of return on an investment of $801,300 that yields $171,000 annually for ten years is 16.64%; the internal rate of return on an investment of $400,000 that yields $76,000 annually for ten years is 13.77%.[13]

The example illustrates that a higher return on investment and higher credit percentage is possible with a market rate loan for a lower amount. The lower leverage requires that more cash be invested, but the use of the 9% credit versus the 4% credit on the full construction cost provides a higher return. The higher equity required is well suited to public partnerships, but may not be advisable for all types of entities.

Using a below-market rate loan. From the standpoint of long-term return on investment, use of a below-market Federal loan may not be attractive, although a careful analysis is required. In at least two situations, however, a below-market Federal loan and a 4% credit would be attractive even if, under a present value analysis, market rate financing and a 9% credit provide a higher return. The first situation is one in which it is either not (1) economically feasible or (2) economically desirable to raise more equity. That is, the additional equity capital may not be available, or it may not be desirable to put additional equity into a project because of conflicts over control or the allocation of economic benefits to additional investors.

The other instance where a below-market Federal loan and 4% credit are indicated occurs where the long-term economic viability of the project is in question and the developer wants a highly leveraged deal. This type of "worst case" analysis assumes that the wear and tear of the tenants will cause the project to go into foreclosure sometime after the 15th year.

An alternative is to use a below-market Federal loan and exclude the loan proceeds from basis altogether. In that case, no credit would be available for the amount excluded from basis. This approach may be attractive when the amount of the Federal loan is relatively low. However, careful analysis is required.

When attempting to maximize the leverage and the credit percentage where a Federal grant is involved, the use of a market-rate city loan of Federal grants funds (as described in *Ltr. Rul.* 8813024) should be considered. The higher interest rate will generally be outweighed by the higher credit. The negotiations with the city might include the issue of abatement of real estate taxes or a reduction in the cost of city services. For example, the city might charge $48,000 per year more in interest, but $48,000 per year less in real estate taxes.

Finally, in regard to subsidies and incentives that do not reduce or eliminate the low-income credit, the general rule is, the more incentives, the better. The higher the rent (through rental subsidies) and the lower the expenses (through low-interest loans), the higher the leverage and credit per investment dollar. Also, in the acquisition of existing housing, the use of Federally subsidized financing is desirable since the maximum credit is 4%.

Conclusion

The structure of the low-income credit makes it highly desirable to use government subsidies in conjunction with it. Congress specifically limited the use of the credit with Federal grants and new buildings financed by Federally subsidized loans, but effectively approved use of all other subsidies. In order to structure transactions for maximum benefit, tax advisors must understand the technical and economic effects of using the low-income credit in connection with these other subsidies. ☐

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