# NAHMAnalysis™

NATIONAL AFFORDABLE HOUSING MANAGEMENT ASSOCIATION

## Ensuring NAHMA Members Receive the Latest News and Analysis of Breaking Issues in Affordable Housing

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August 4, 2008 NAHMAnalysis reference # 2008 - 0803

## Section 42 Utility Allowance (UA) Regulations Update

### Effective Date

The new regulations[1] took effect July 29, 2008. They are applicable as of the first day of the owner's taxable year beginning on or after July 29, 2008.

### Background

Over the past 20 years, the Section 42 Low Income Housing Tax Credit (LIHTC) Program has helped finance nearly two million affordable apartments for low-income families. The program is widely considered one of the most successful public-private partnerships the federal government has ever created.

The utility allowance (UA) is part of the gross rent formula for the Section 42 program. This makes the UA a key factor which affects viability of Section 42 housing. As the UA increases, the net rent to the property owner decreases. Because the LIHTC program is intended to serve low income families, there are limited options for increasing cash-flow. Operating margins are thin, and are further eroded by inaccurate, outdated or artificially high utility allowances. To help improve the overall financial condition of the properties, a multifamily industry coalition requested that the IRS update its UA rules to expand the options for achieving a more accurate, stable utility allowance.

The final rule was the result of more than four years of effort by industry representatives. In February, 2004 an industry coalition met with IRS officials to discuss the problems inaccurate UAs were causing tax credit properties. A proposal to update the UA was suggested by the coalition in February 2005. The IRS published a proposed rule in June 2007, and the final rule was issued July 29, 2008.

NAHMA remained an active partner in support of updating these important regulations. We filed comments on the proposed rule in September 2007, which are available on NAHMA's website.
Our testimony on the proposed rule was delivered by NAHMA President Michelle Norris on October 9, 2007. Ms. Norris discussed changes in the proposed rule that NAHMA supported, including two new

[1] Section 42 Utility Allowance Regulations Update, Final Regulations. [TD 9420] RIN 1545-BC22. Internal Revenue Service (IRS), Treasury. *Federal Register*: July 29, 2008 (Volume 73, Number 146), Pages 43863-43868.

options to calculate UA using a state agency estimate or the HUD Utility Schedule Model. Norris noted another positive aspect of the proposed rule allowed owners to stabilize occupancy before implementing UA changes. She also urged IRS and Treasury officials to give greater consideration to how UA estimates could be obtained in deregulated jurisdictions where there are multiple providers. Finally, she strongly urged IRS-Treasury to add three essential provisions which were not included in the proposed rule before releasing the final regulation. First, she called for giving owners an option to calculate UAs by using utility consumption model estimates performed by a State-certified engineer or other qualified professional. Another appropriate modification, Ms. Norris explained, would allow owners to use different calculation options for different utilities. Finally, the rule should simplify implementation of utility allowance changes by making them effective at the time of other annual rent adjustments.

Most recently, NAHMA took the opportunity to restate the importance of releasing the final rule to update Section 42 UAs in public comments submitted to the IRS on May 15, 2008. NAHMA recommended that IRS add finalizing the UA update (with our requested changes) to its Guidance Priority List for 2008-2009.

## Summary

In a huge victory for the multifamily industry, the new rule creates three new options to estimate UAs. The new options include: 1.) an agency estimate, 2.) the HUD Utility Schedule Model and 3.) an energy consumption model.

1.) The rule stipulates that the **agency estimate** must come from the agency with jurisdiction over the building. Required components of this estimate must take into account the local utility rates data, property type, climate variables by region in the State, taxes and fees on utility charges, and property building materials and mechanical systems. An agency could also use actual utility company usage data and rates for the building;

2.) **The HUD Utility Schedule Model**, which is available on the Low-Income Housing Tax Credits page at http://www.huduser.org/datasets/lihtc.html (or successor URL). This model incorporates building location and climate. It is based on the Department of Energy's Residential Energy Consumption Survey (RECS), which provides energy consumption data by structure for heating, air conditioning, cooking, water heating, and other electric functions such as lighting and refrigeration.

3.) The final new option is an **energy consumption model** used by a qualified professional to calculate utility estimates. IRS laid out several stipulations for information that the model must include, qualifications of the professional who calculates the estimates, and notice requirements. IRS explained,

> "The use of this new option is subject to several special rules. First, the energy consumption model must, at a minimum, take into account specific factors including, but not limited to, unit size, building orientation, design and materials, mechanical systems, appliances, and characteristics of the building location. Second, the utility estimates must be calculated by either (1) a properly licensed engineer or (2) a qualified professional approved by the Agency that has jurisdiction over the building (together, qualified professional). The qualified professional and the building owner must not be related within the meaning of section 267(b) or 707(b). Third, the building owner must furnish a copy of the estimates derived from the energy consumption model to the Agency and make copies of the estimates available to all tenants in the building. Finally, the building owner must pay for all costs incurred in obtaining the utility

> estimates from the qualified professional and providing the estimates to the Agency and tenants."[2]

Owners are not required to use these new estimates. The previously available options, public housing authority allowance or local utility company estimates, are left in place. Owners who are satisfied with them may continue using these estimates.

## Positive Aspects of This Policy/Proposal

NAHMA's written comments and public testimony last fall specifically requested that the final rule include options for owners to use an agency estimate, the HUD Utility Schedule Model, and Utility consumption model estimates performed by a State-certified engineer or other qualified professional. We are extremely pleased that IRS agreed with our recommendations.

Another very positive change supported by NAHMA allows properties to achieve financial stability at the beginning of their operations before implementing UA changes. Owners are not required to review UAs or implement new UAs, until the earlier of the date the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period.

NAHMA raised concerns about the practically of a section in the proposed rule which seemed to require owners to obtain cost estimates from each utility provider (when there are multiple utility services in deregulated jurisdictions) to calculate the UA. NAHMA offered an example to illustrate the administrative difficulty what the IRS initially proposed:

> A LIHTC community in a western suburb of Atlanta has only 88 units, and it has eight potential electric suppliers--all with slightly different rate schedules--from which residents can choose. With such a small property, no supplier has a dominant position. The work required to produce the utility allowance analysis under these circumstances is overly complex and very time consuming.

Fortunately, the final rule addressed our concerns. In deregulated areas with multiple providers, an estimate from only one utility company is necessary, provided that utility company offers utility services to the building and the estimate includes all component charges for providing the utility service.

IRS rejected comments which would have required owners to update the UA more than once a year, based on changes in utility rates. IRS acknowledged this requirement would have placed an unwarranted additional burden on owners because utility rates generally change once a year. The final rule requires owners to calculate the UA only once per calendar year, although they are *permitted* to calculate it more frequently as long as they comply with the new rules.[3]

Finally, the new rule excludes cable, phone and Internet costs from the UA.

## Issues of Concern to NAHMA

Unfortunately, not all properties with LIHTCs will be able to utilize the new UA options. In the new rule, Section 1.42-10 paragraph (b)(4) makes clear that the UA options are available to a Section 42 property if

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[2] *Federal Register*, pgs. 43864-43865.

[3] The new rule stipulates how old the data used to calculate the UA can be, as well as notification requirements to tenants and the Agency.

“is neither an RHS-assisted nor HUD-regulated building, and no tenant in the building receives RHS tenant assistance.”[4]

Similarly, the allocation agency option may be limited in its availability. This option will not be available in states where the agency with jurisdiction chooses not to issue its own estimate. The state agencies are not required to provide this estimate. IRS added the option for owners to retain qualified professionals to calculate energy estimates with energy consumption models in part to address this concern.

NAHMA would have preferred more affirmative language on our other two requested additions to the final rule. We had requested that the final rule specify owners may use different calculation options for different utilities. IRS’ summary of comments and explanation of changes stated the final regulations “neither prohibit using different options for different utilities nor prohibit changing the options used for calculating utilities.” If the owner understates the UA under the calculation option and the building's units are not rent-restricted as a result, the Agency must report the noncompliance on Form 8823.[5] Also, NAHMA’s comments and public testimony strongly urged IRS to simplify implementation of UA changes by “making them effective at the time of other annual rent adjustments.” IRS rejected a requirement that UA changes coincide with HUD’s income limit publications, but provided, “Building owners…may choose to implement any new utility allowances on the section 42 effective date of HUD’s income lists.”[6]

Some NAHMA members expressed concern that the new rule requires owners to bear the costs incurred to obtain estimates from the allocation agencies, the HUD Utility Schedule Model, and energy consumption models in addition to the costs of providing estimates to Agencies and tenants. NAHMA does not have specific data to estimate the costs owners would incur under each option. We expect costs of the energy consumption model performed by an engineer or qualified professional could exceed one thousand dollars. NAHMA will work with interested industry partners to ensure the new rule is implemented cost-effectively and does not result in undue burdens to owners. In the meantime, options to use the PHA allowance or local utility estimates remain in place.

The new rule should provide for more accurate UA calculations—especially in newer construction properties which were built with more energy-efficient materials. Because of the relationship between UAs and rents, it is important to prevent inaccurate overestimates for the UA. However, a more daunting question is how to ensure long-term viability of all LIHTC properties if utility costs continue to skyrocket and depress rents over time.

## NAHMA’s position

Overall, NAHMA supports the new Section 42 UA regulations. It is admittedly not a “silver bullet” for solving all of the challenges associated with rapidly increasing utility and operating costs across the LIHTC portfolio. Policy makers at all levels of federal, state and local governments must give greater thought to achieving long-term sustainability of the properties constructed and preserved through the Section 42 program. Nevertheless, the new rule is a good step in the right direction. NAHMA was pleased to help bring about these necessary changes.

[4] *Federal Register* pg. 43867.
[5] *Federal Register*, pg. 43865.
[6] *Federal Register*, pg. 43865.