

Chapter 9

Category 11e

Changes in the Applicable Percentage

Definition

This category is used to report violations associated with the Eligible Basis of a building (discussed in chapter 8) or any occurrence that result in a decrease in the Applicable Percentage of a building. This chapter addresses noncompliance affecting the Applicable Percentage of a building.

The low-income housing credit amount is based on certain costs associated with a building (*eligible basis*) and the portion of the building (*Applicable Fraction*) that low-income households occupy. The cost of acquiring and rehabilitating, or constructing a building constitutes the building's *Eligible Basis*. The portion of the Eligible Basis attributable to low-income units is the building's *Qualified Basis*. The Qualified Basis is multiplied by a factor (*Applicable Percentage*) so that the credit is limited to 70 percent or 30 percent of the Qualified Basis.¹ In summary, the annual credit is:

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

$$\text{Qualified Basis} \times \text{Applicable Percentage} = \text{Annual Credit}$$

Generally, under IRC §42(f)(1), the annual credit can be claimed for 10 taxable years, beginning with the taxable year in which the building is placed in service; or, at the election of the taxpayer, the succeeding year². Under IRC §42(f)(2)(A), there is a special rule for the first year of the credit period. Any reduction in the credit allowable for the first year of the credit period by reason of the rule is allowable for the first taxable year following the credit period. (See IRC §42(f)(2)(B).) In addition, under IRC §42(f)(3), if the qualified basis as of any taxable year in the 15-year compliance period (after the first year) exceeds the qualified basis as of the close of the first year of the credit period, then the applicable percentage applied to the excess Qualified Basis is two-thirds of the Applicable Percentage that would otherwise apply.

IRC §42(b)(1)(B) provides that a new building that is not federally subsidized is eligible for an Applicable Percentage equal to a 70 percent present value credit while a new building that is federally subsidized and an existing building are eligible for a 30 percent present value credit.

Monthly credit tables published in the Internal Revenue Bulletin provide the actual Applicable Percentages to be used in calculating the credit. These tables effectively adjust the rates on a monthly basis so that the present value over the ten-year credit period will continue to yield the 70 percent and 30 percent figures.

A special rule under IRC §42(b)(2)(B) for non-federally subsidized building placed in service after July 30, 2008, and before December 31, 2013, provides that the applicable percentage shall not be less than 9 percent.

¹ IRC §42(b)(2)(B).

² IRC §42(f)(1)(B).

Federal Subsidies for Buildings Placed in Service Before July 31, 2008

For buildings placed in service before July 31, 2008, former IRC §42(b)(2)(B)(ii) (now IRC §42(b)(1)(B)(ii)) provides that the Applicable Percentage for new buildings that are federally subsidized is the 30 percent present value. *Former* IRC §42(i)(2)(A) provides that a new building is federally subsidized for any tax year if, at any time during such tax year or any prior tax year, there is or was outstanding any obligation the interest on which is exempt from tax under §103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation. However, the building will become eligible for the 70 percent present value credit if (1) by the close of the first year of the credit period the taxpayer elects (on Part II of Form 8609) to reduce the Eligible Basis of the building by the principal amount of the loan or by the proceeds of the tax-exempt bond, or (2) before the building is placed in service, the taxpayer repays the loan or redeems the tax-exempt bond.

*IRC §1400N, Tax Benefits for Gulf Opportunity Zone

Under IRC §1400N(c)(6), loans from Community Development Block Grant³ funds are not considered a federal subsidy if the low-income buildings are located in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone and the low-income buildings were placed in service during the period beginning on January 1, 2006 and ending on December 31, 2010.*

Assistance Provided Under the HOME Investment Partnership Act

For buildings placed in service before July 31, 2008, former IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnership Act (HOME) *or the Native American Housing Assistance and Self-Determination Act of 1986 (NAHASDA)* with respect to any building will not be treated as a below market Federal loan if 40 percent or more of the residential units *in the building* are occupied by individuals whose income is 50 percent or less of the Area Median Gross Income (AMGI). *This Code section is commonly referred to as the 40-50 rule.*

Example 1⁴: Qualifying for the 70 Percent Present Value Credit Under IRC §42(b)

A new qualified low-income housing project consists of Building 1 and Building 2, each containing 100 residential rental units. Forty percent of the units in each building are low-income units. The owner elected the 40/60 minimum set-aside under IRC §42(g)(1)(B). Also, the owner elected, on Form 8609, Low-Income Housing Credit Allocation Certification, to treat the buildings as part of a multiple building project. The owner obtained a HOME loan at less than the AFR for the project.

The rule under IRC §42(i)(2)(E)(i) applies on a building-by-building basis. To qualify for the 70 percent present value credit, the taxpayer must rent at least 40 units in both Building 1 and Building 2 to tenants whose income is 50 percent or less of AMGI throughout the 15-year compliance period.

³ IRC 1400N(c)(6) reads. "...a loan shall not be treated as a below market Federal loan solely by reason of any assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 by reason of section 122 of such Act or any provision of the Department of Defense Appropriations Act, 2006, or the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006.

⁴ This example is based on Rev. Rul. 2004-82, Q&A #6.

In addition:

- a. The units used to satisfy the rules under IRC §42(i)(2)(E)(i) are also counted toward the project's minimum set-aside under IRC §42(g)(1).
- b. The rent restriction for all the low-income units, including the units used to satisfy the rules under IRC §42(i)(2)(E)(i), is based on the applicable income limitation under IRC §42(g). In this example, the imputed income limitation applicable to the units in the project is 60 percent of AMGI and the rent may not exceed 30 percent of that amount.

See reference #1 at the end of the chapter for IRC §42(i)(2) as applicable to buildings placed in service prior to July 31, 2008.

Federal Subsidies for Buildings Placed in Service After July 30, 2008

*For buildings placed in service after July 30, 2008, below market federal loans are no longer considered federal subsidies. Therefore, below market loans under HOME or NAHASDA are not federal subsidies. Under section 3002(b) of the Housing Assistance Tax Act of 2008, IRC §42(i)(2)(D) and (E) were removed.

See reference #2 at the end of the chapter for IRC §42(i)(2) as applicable to buildings placed in service prior to July 31, 2008.*

In Compliance

A new building receiving the 70 percent present value credit is in compliance if no federal subsidy is used (directly or indirectly) for the building or for its operation.

Buildings Placed in Service Before July 31, 2008

If a federal subsidy is used (directly or indirectly) for the building or for its operation, a building *receiving the 70 percent present value credit* is in compliance if (1) the taxpayer elected (on Part II, Form 8609) to reduce the Eligible Basis of the building *by the amount of the subsidy* and this reduction is properly reflected in the Eligible Basis determined at the close of the first year of the credit period, or (2) the federal subsidy is redeemed or paid before the building is placed in service. *A building using (directly or indirectly) the proceeds of a below market federal loan provided under the HOME or NAHASDA programs will not be considered a federally subsidized building as long as 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of AMGI.*

*Buildings Placed in Service after July 30, 2008

New buildings placed in service after July 30, 2008, may use the proceeds of a below market federal loan without being characterized as federally subsidized. However, the proceeds of tax-exempt bonds used (directly or indirectly) at any time for the building or its operation continue to characterize the building as federally subsidized.

If tax-exempt bonds are used (directly or indirectly) for the building or its operation, a building receiving the 70 percent present value credit is in compliance if the taxpayer elected (on Part II, Form 8609) to exclude from Eligible Basis of the building the

proceeds of the tax-exempt bond.*

Out of Compliance

A new building receiving a 70 percent present value credit is out of compliance if a federal subsidy is used (directly or indirectly) for the building or for its operation and:

1. The taxpayer fails to elect (on Part II, Form 8609) to reduce the Eligible Basis of the building,
2. The taxpayer elects (on Part II, Form 8609) to reduce the Eligible Basis of the building but the reduction is not properly reflected in the Eligible Basis of the building determined at the close of the first year of the credit period, or
3. The federal subsidy is not redeemed or paid before the building is placed in service and the taxpayer did not elect to reduce the Eligible Basis as described above.

A new building receiving the 70 percent present value credit is also out of compliance if it otherwise meets the “In Compliance” requirements above, but a federal subsidy is subsequently used with respect to the building or its operation during years 2 through 15 of the compliance period.

A building placed in service before July 31, 2008, receiving assistance under the HOME or NAHASDA programs and subject to the 40-50 rule, is out of compliance if the number of residential units in the building occupied by individuals whose income is 50 percent or less of area median gross income is less than 40 percent.

A building is out of compliance as of the date the federal subsidy *rule (or exception) is violated.*

*Example 1: Assistance under HOME

An owner received an allocation of 70 percent credit for a building constructed using HOME assistance and placed in service on January 1, 2007. The state identified, on line 6f of Form 8609, that the building was not federally subsidized by reason of the 40-50 rule under IRC §42(i)(2)(E).

The owner complied with the 40-50 rule, and therefore was able to claim the 70 percent credit, for tax years 2004, 2005 and 2006. In 2007, however, the number of units rented to households with income of 50% or less than AMGI fell below the minimum required 40%.

The taxpayer is out of compliance. Therefore, the Applicable Percentage for the year of noncompliance and all subsequent years is limited to the 30% present value credit.*

Back in Compliance

In general, a violation of the federal subsidy rules is a noncompliance event that cannot be corrected. For example, a federal subsidy used (directly or indirectly) with respect to a new building receiving the 70 percent present value credit during years 2 through 15 of the compliance period results in a decrease in the Applicable Percentage of the building from the 70 percent to the 30 percent present value credit, beginning with the year the subsidy is used and for all remaining years in the compliance period. Following the close of the first year of the credit period, a taxpayer cannot elect to reduce the Eligible Basis of the building in an attempt to qualify for the 70 percent present value credit.

If a state agency identifies the receipt of a federal subsidy during years 2 through 15 of the compliance period for the operation of a building or project where the Applicable Percentage is the 70 percent present value credit rate, noncompliance should be reported under category 11e. No attempt should be made to determine whether the taxpayer correctly lowered the Applicable Percentage.

Under unusual circumstance, it might be possible to correct a noncompliance event occurring during the first year of the credit period. For example, the owner receives a favorable private letter ruling from the IRS allowing the taxpayer to make a late election on Part II, Form 8609, to reduce Eligible Basis to the extent of a federal subsidy. The owner should not be considered back in compliance unless documented by a favorable determination by the IRS.

References

1. *IRC §42(i)(2), as applicable to buildings placed in service before July 31, 2008.
 - (2) Determination of whether building is federally subsidized.
 - (A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b)(1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.
 - (B) Election to reduce eligible basis by balance of loan or proceeds of obligations. A loan or tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d)--
 - (i) in the case of a loan, the principal amount of such loan, and
 - (ii) in the case of a tax-exempt obligation, the proceeds of such obligation.
 - (C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if--
 - (i) such obligation or loan (when issued or made) identified the building for which the proceeds of such obligation or loan would be used, and
 - (ii) such obligation is redeemed, and such loan is repaid, before such building is placed in service.

(D) Below market Federal loan. For purposes of this paragraph, the term "below market Federal loan" means any loan funded in whole or in part with Federal funds if the interest rate payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date on which the loan was made). Such term shall not include any loan which would be a below market Federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (as in effect on the date of the enactment of this sentence [enacted Dec. 19, 1989]).

(E) Buildings receiving home assistance or Native American housing assistance.

(i) In general. Assistance provided under the HOME Investment Partnerships Act (as in effect on the date of the enactment of this subparagraph [enacted Aug. 10, 1983]) or the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4101 et seq.) (as in effect on October 1, 1997) with respect to any building shall not be taken into account under subparagraph (D) if 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of area median gross income. Subsection (d)(5)(C) shall not apply to any building to which the preceding sentence applies.

(ii) Special rule for certain high-cost housing areas. In the case of a building located in a city described in section 142(d)(6), clause (i) shall be applied by substituting "25 percent" for "40 percent".*

2. *IRC §42(i)(2), as applicable to buildings placed in service after July 30, 2008.

(2) Determination of whether building is federally subsidized.

(A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b)(1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

(B) Election to reduce eligible basis by proceeds of obligations. A tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d) the proceeds of such obligation.

(C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation used to provide construction financing for any building if--

(i) such obligation (when issued) identified the building for which the proceeds of such obligation or loan would be used, and

(ii) such obligation is redeemed before such building is placed in service.*

3. Rev. Rul. 2004-82, 2004-35 I.R.B. 350.