TechNotes

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In Brief: **Often underestimated in the development of LIHTC properties is the significance and complexity of the placed-in-service date. Besides its obvious importance in determining when tax credits can be claimed, the placed-in-service date plays a major role in assuring compliance, particularly in the case of acquisition and rehabilitation projects. As early as the predevelopment phase of an acquisition and rehabilitation project, members of the development team need to work out a resident certification plan that will allow all parties to maximize credits.**

Placing a LIHTC Project in Service: The Importance of Timing and Compliance

Kelly Brown and Greg Mayo

The placed-in-service date is a significant milestone for low-income housing tax credit (LIHTC) development since it determines the start of the tax credit period. The elections that owners make with respect to this crucial deadline (see box, *right*) influence the amount of tax credits to be claimed and trigger the project's compliance requirements for the entire credit period.

While determining the date on which a project is placed in service would appear simple, this important event is not always easily identified. This issue of *TechNotes* looks at both the rules applicable to determining the placed-in-service date and the consequences of placement in service for acquisition and rehabilitation projects. Acquisition and rehabilitation projects pose a special challenge for both developers and management agents in coordinating the placed-in-service date and lease-up activities in conjunction with their state allocating agency's interpretations of Section 42 of the Internal Revenue Code (the "Code").

Acquisition/rehabilitation projects pose a special challenge for both developers and management agents.

Determining the Date

For new construction, the placed-in-service date is the "date on which the building is ready and available for its specifically assigned function, i.e., the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law."[1] To be placed in service, a unit is not required to be leased or occupied. Rather, receipt of a certificate of occupancy or other release issued by the local jurisdiction is generally accepted as the placed-in-service date.

Then there is the question of the *number* of placed-in-service dates. A project with one newly constructed building or a multiple-building project that is not identified as a multiple-building project will have a single placed-in-service date for the LIHTC program. We should point out that it does not matter if a project receives a building-based allocation or a project-based allocation because in either case, each separate building will have a separate placed-in-service date for practical and accounting purposes. The only difference between a project-based or building-based allocation is the timing of when specific amounts of credit are allocated to each building.

Under a project-based allocation, the amount of credit allocated to each building is determined at the time that the building is placed in service. Under a building-based allocation, the amount is determined at the time that the carryover allocation is issued. In this regard, for projects that may need to shift costs among buildings, particularly projects involving rehabilitation, the taxpayer should elect to receive allocations on a project basis. In almost all other circumstances, it is more advantageous to identify a multiple-

Significant LIHTC Events Tied to the Placed-in-Service Date

The start of the *Credit Compliance Period* unless the owner elects to defer the period for one year

The last opportunity to make the *Minimum Set Aside Election* for the project

The second and final opportunity to make the *Minimum Gross Rent Floor Election*

The final opportunity to lock the *Tax Credit Rate*

Community Affordable Housing Equity Corp. (CAHEC) was created in 1992. CAHEC's mission is "to raise and invest equity capital in low-income housing tax credit projects, to empower residents living in developments CAHEC helps finance, and to promote home ownership."

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building project as a multiple-building project.

Buildings that receive an allocation of rehabilitation credit may elect the date upon which the building is placed in service pursuant to Code Section 42(e)(4)(A). The placed-in-service date for projects receiving acquisition (4%) credits for the purchase of occupied existing buildings is the date the new owner acquires the property. If a vacant building is acquired, it is not placed in service until the date of the taxpayer's choice under Code Section 42(e)(4)(A).

The election to place a rehabilitation project in service is not completely unfettered; the date must occur after the aggregate rehabilitation expenditure in the 24-month period following the LIHTC allocation equals the greater of $3,000 per tax credit unit or 10% of the unadjusted basis of the building.

Also, for projects not financed by tax-exempt bonds, the project must be placed in service by the end of the second year after the year in which the allocation is received. Tax-exempt bond financed projects that are exempted from receipt of an allocation of credit under Code Section 42(h)(4) do not have a limit on the period of time that they may be placed in service.

Generally Accepted Placed-in-Service Dates by Project Type

New Construction with an Allocation by Building - The date when the first unit in the building is released for occupancy by local jurisdiction

New Construction with a Project Allocation - The date when a unit in the last building needed to meet the Minimum Set Aside is released for occupancy by local jurisdiction

Acquisition Project - The date when an accepted property is acquired by the new ownership entity

Rehabilitation Project - The date when the aggregate rehabilitation expenditures equal the greater of $3,000 per unit or 10% of the unadjusted basis of the building, which date may be deferred by election of the taxpayer

If a building is not entirely leased to qualified tenants at the end of the initial year of the credit period, credit attributable to additional units leased to qualified tenants in subsequent years are reduced to two-thirds the amount permitted for units qualified in the initial year. Accordingly, taxpayers generally elect to defer credit until the year after placement in service with respect to buildings that are not entirely or almost entirely qualified at the end of the placement-in-service year. Taxpayers are well advised to focus their leasing strategy to leasing all of the units in a building or group of buildings before opening additional buildings to occupancy.

Tax-exempt bond financed projects that are exempted from receipt of an allocation of credit under Code Section 42(h)(4) do not have a limit on the period of time that they may be placed in service.

Coordinating Completion and Placement in Service

Because placed-in-service dates are chosen as rehabilitation work and qualification of units under Section 42 progress, owners and management agents need to keep the lines of communication open so as to ensure compliance, maximize credit delivery, and preserve the quality of life of existing tenants.

In most instances, placing a building or project in service generates positive economic returns for the project (i.e., rental income) and the investor (i.e., depreciation and tax credits) and should be sought as early as possible. There are at least two occasions, however, where it may be prudent to delay placing a building or project in service.

The first occurs when the investor is not yet admitted to the deal, and the deal is expected to generate tax credits immediately. Tax credits generated prior to the admission of the investor will be lost to the investor, who will subsequently reduce the amount of equity available.

The second instance involves non-historic projects[2] that could be placed in service at the end of the year. Although the decision to place in service by year end may generate a small boost in the return for the investor, it significantly increases the risk associated with initially qualifying units.

This risk results from the stipulation in the Code allowing the owner to defer the start of the 10-year tax credit period until the year following the placed-in-service date. As an illustration, the owner of a project placed in service on or after December 1, 2002, would have one month—December—to qualify units and meet the minimum set aside test if the owner elects to begin the tax credit period in 2002. For this purpose, a project is not "qualified" and cannot claim credit unless either 20% of the tenants earn less than 50% of area median gross income adjusted for family size or 40% of the tenants earn less than 60% of area median gross income adjusted for family size.

If the owner defers until 2003, the time to qualify is extended to 13 months (one month in 2002 and 12 in 2003). However, if the owner does not place the project in service until January 1, 2003, and then elects 2004 as the start of the tax credit period, the owner gains an additional 12 months in which to qualify (11-12 months in 2003 plus all of 2004).

The question the development team must answer is, How much time will the management agent require to lease the LIHTC units to qualified tenants? The team needs to weigh the relatively small boost in return gained by placing the project in service in the current year against the potential loss of credits incurred from failing to be in compliance.

Compliance, the Code, and Acquisition/Rehabilitation

Certainly the development team in an acquisition/rehabilitation project recognizes the importance of compliance with respect to all occupied buildings, but compliance receives renewed attention once the placed-in-service date has been set. For the owner, construction issues are now coupled with concerns regarding qualifying units and stabilizing operations. Ultimately, a project's success or failure is linked to how well all members of the development team communicate during this critical time.

Since PLR 200044020 was published, many states have required LIHTC developments to execute only one round of tenant income certifications.

As we noted earlier, acquisition and rehabilitation projects receive a separate placed-in-service date for acquisition and for rehabilitation credit. Owners and property managers need to know how these dates affect compliance requirements and lease-up. Specifically, they need to know with respect to their state's allocating agency:

- When should property managers begin verifying the eligibility of existing tenants?
- What are the state and local laws regarding eviction for non-eligibility under LIHTC?
- When should tenants be certified?

Because of the multiple placed-in-service dates, everyone on the development team needs to know precisely how the state monitors compliance for this type of project.

Prior to 2000, developers and management agents generally assumed that they needed to certify tenant income at both the acquisition placed-in-service date and the rehabilitation placed-in-service date. This procedure applied whether the acquired building/project was vacant or occupied. If an existing resident met the income requirement at the time of the first certification but not at the second, the resident was expected to move out of the LIHTC unit.

This dual certification practice was clarified in Private Letter Ruling (PLR) 200044020 in November 2000. Responding to a taxpayer who questioned the necessity of recertifying residents when the rehabilitation credits were placed in service, the IRS wrote, "[W]e do not believe there is a statutory mandate in section 42 for the Taxpayer to engage in a second round of tenant income certifications after performing this task at the time of acquisition of the Project and throughout the rehabilitation process as new tenants are admitted."[3]

Although the IRS cautions that a PLR "is directed only to the taxpayer who requested it," most housing professionals see PLRs as industry guidelines. Accordingly, since PLR 200044020 was published, many states have required LIHTC developments to execute only one round of tenant income certifications. With no nationwide uniformity, however, it is essential for LIHTC practitioners to contact their state agency to learn how many rounds of certifications it requires.

Lease-up Process

Below we have laid out steps in the lease-up process that will have a direct impact on qualifying LIHTC units. Table 1 provides additional information for complying with the regulations as interpreted by specific allocating agencies.

1. Pre-Acquisition/Acquisition: All existing tenants should be screened to determine eligibility and certified as if they were new move-ins. Even if they have previously qualified for a housing program like Section 8, current residents do not automatically qualify to live in a LIHTC development; they must meet LIHTC guidelines as if moving in for the first time. For projects financed with tax-exempt bonds, tenants must generally be certified prior to the issuance of the bonds.

The application process can begin and verifications of tenant eligibility can be obtained as long as the verifications are not more than 90 days old at the time the tenant income certification is executed (some states allow an extension to 120 days with a verbal update from a third-party source—e.g., employer, bank). If the developer can estimate within a reasonable timeframe the acquisition placed-in-service date, the property manager can schedule the certification process to coincide with the state agency's deadline. This communication on timing issues is important; otherwise, property managers may have to redo the verification/certification process to maintain compliance with the state's interpretation of the Code.

Checklist for Acquisition/Rehabilitation Projects

1. **Acquire property and begin rehab**
2. **Screen all existing tenants to determine eligibility**
3. **Notify all ineligible tenants to vacate (remember to comply with in-place lease provisions and state laws)**
4. **Designate acquisition placed-in-service date (flexible)**
5. **Certify all existing eligible tenants per state interpretation**
6. **Begin marketing and renting vacant rehabilitated units**
7. **Relocate tenants as necessary per state interpretation**
8. **Complete rehabilitation**
9. **Designate rehabilitation placed-in-service date (flexible)**
10. **Finish lease-up of vacant units**
11. **Recertify tenants within 12 months after previous certification**

Before notifying non-eligible residents to vacate, management agents need to consider in-place lease provisions, state laws, and conflicts with other programs. For instance, properties initially layered with HUD project-based Section 8 or Rural Development Rental Assistance may only terminate a lease with "cause." However, a conflict with a new layer of financing, like the Low-Income Housing Tax Credit Program, is not considered cause. Rather than remove the unit from eligible basis because it is unable to earn LIHTCs, management can offer a series of incentives to any ineligible households as encouragement to move out. Marketing and leasing should begin immediately for the vacant or soon-to-be vacant units.

2. Qualification: With little guidance given in the Code, the state agencies have interpreted the timing of tenant income certification in a number of different ways. Some contend that all certifications must take place within 90 days of the acquisition placed-in-service date, while others dispute the connection between 90 days and the placed-in-service date, instead simply stating that credits cannot be earned until the units are qualified.[4]

Again, communication is the key to qualifying the units properly. If a communication breakdown occurs, another round of certifications may be necessary to comply with the applicable state requirement. (Note: Because some states chose not to adopt the language of the PLR, two rounds of certifications are required.)

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Certifying the units as close to the acquisition placed-in-service date as possible without violating the interpretation imposed by the state agency will result in the earliest delivery of credits.

When a property is newly constructed or acquired, the tenant income certification and lease are typically executed simultaneously. The Code requires that LIHTC units be used on a non-transient basis, which necessitates initial lease terms of at least 6 months for each tenant. With an acquisition/rehabilitation project involving existing tenants, however, many leases have already converted to month-to-month terms after years of occupancy. Rather than require new leases with terms of 6 months or longer, the IRS communicated in PLR 200044020 that documentation of a tenant's prior longstanding rental history in a development proves that the unit is not used on a transient basis. Because of this ruling, many state agencies no longer require a new lease for existing tenants with a longstanding rental history.

3. Relocation: With an occupied rehabilitation, issues also arise regarding the temporary relocation of residents. The Code does not specify the time period allowed for rehabilitation of occupied units; the Code only states that the relocation of tenants be "temporary." Consequently, state agencies have defined "temporary" in a variety of ways. While some states define temporary as 3 months or less, others simply require that the households return to the unit they qualified by the time of the recertification (no more than 12 months later).

4. Rehabilitation: Once the rehabilitation threshold is met, the second placed-in-service date is chosen, and the project is able to earn rehabilitation credits. However, just as in new construction projects, the qualification of units determines the amount of those credits. Again, some states require another round of certifications tied to the rehabilitation placed-in-service date. In PLR 200044020, the IRS ruled that a taxpayer may claim rehabilitation credit with respect to qualified units from the date that the acquisition credit is claimed, typically January 1 of the first year of the credit period.

5. Recertification: As always, tenants are recertified no later than 12 months after the initial LIHTC certification. In the case where double certifications are required by the state, the 12-month period will begin again when another certification is completed at the second placed-in-service date. Multiple certifications may be necessary in the early life of the property to comply with the applicable state interpretation.

The complexity involved in placing many LIHTC projects in service cannot be underestimated. The "Checklist for Acquisition/Rehabilitation Projects" (see page 3) sums up the process, but it is important to remember that many of the steps overlap in execution and also must correspond with state regulations. With so much at stake, developers, property managers, and investors must work together to ensure that all requirements associated with the placed-in-service date are met and that a date that is most advantageous to the project is used.

Notes

[1]Internal Revenue Service's Advance Notice 88-116 on the Low-Income Housing Tax Credit, issued October 12, 1988.

[2]Since historic credit is earned at the placed-in-service date, projects with historic tax credits deliver substantial benefits immediately upon being placed in service, and the economic incentive to deliver these benefits before year end may justify accepting a short lease-up period. The developer should always consult with the investor prior to taking action that will alter the projected delivery of tax credits.

[3]PLR 200044020; htt://apps.irs.gov/pubs/irs-wd/0044020.pdf.

[4]This 90-day rule, if in place, is not to be confused with the 90-day rule mentioned under "Pre-Acquisition/Acquisition." The first refers to verifications in relation to the tenant income certification, while the second refers to the tenant income certification in relation to the placed-in-service date.