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First-Year Compliance Issues: Back to Basics, Part II

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Have you ever wondered why, during the lease-up of a property, it's important to fully occupy a building before moving to occupy the next building? Or why it's crucial to move in low-income households before the end of a month?

The answer to both of these questions lies in the calculation of the first year's applicable fraction. Part II of the "Back to Basics" column unfolds the mystery behind first-year credit calculations.

Part I of this column appeared in the May issue of the Novogradac Journal of Tax Credits and discussed how Internal Revenue Service (IRS) Form 8609 is issued on a building-by-building basis., which means that credits are calculated on a building-by-building basis.

General Credit Calculations:

Q: Often owners elect to restrict more than the minimum required as low-income. Why would an owner elect to do so?

EXAMPLE 1-BUILDING A		
Eligible Basis	=	$10,000,000
Applicable Fraction	=	100%
Credit Percentage	=	9%
To calculate the total credit this building could generate:		
	$10,000,000	
	x 100%	
	$10,000,000	
	x 9%	
	$900,000	
	x 10 years	
	$9,000,000	

Source: Novogradac & Company LLP

EXAMPLE 2-BUILDING B		
Eligible Basis	=	$10,000,000
Applicable Fraction	=	80%
Credit Percentage	=	9%
To calculate the total credit this building could generate:		
	$10,000,000	
	x 80%	
	$8,000,000	
	x 9%	
	$720,000	
	x 10 years	
	$7,200,000	

Source: Novogradac & Company LLP

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A: The amount of credit that a building will generate is directly related to the following factors:

1. Eligible basis: the cost to construct, acquire or rehabilitate;
2. Applicable fraction: the lesser of the low-income unit fraction or the low-income square footage fraction; and,
3. Applicable credit percentage: the program allows for a 9 percent or a 4 percent credit.

First, you determine qualified basis by multiplying eligible basis by the applicable fraction. Then, qualified basis is multiplied by the applicable credit percentage to determine the annual credit. Finally, total credits for each buildings are calculated by multiplying the annual credit by the 10 years of the 10-year credit period.

In other words, the higher percentage of low-income units (applicable fraction), the more credits the building will generate.

First Year Credit Calculations:

Q: Are the first year's credits calculated any differently?

A: Yes. In the first year, the applicable fraction is referred to as the "Year 1 monthly weighted average applicable fraction." It is still a calculation of the lesser of the low-income unit fraction or the low-income square footage fraction. However, in Year 1, the calculation is done at the end of each month, for a weighted average applicable fraction for the year.

There are two factors in calculating the weighted average applicable fraction. First, the building must be placed in service for a full month to count that month in the weighted average. Second, each month's qualified units is counted at the end of each month. Qualified units are units that are occupied by a qualified low-income household that is rent restricted. Remember, it does not matter when you place in service; Year 1 generally starts Jan. 1.

Using the earlier example, Building A was placed in service June 15, 2017, and the owner elected to start the credit period in 2017. Building A was expected to be 100 percent low-income:

Calendar Year 2017			
January	0%	July	50%
February	0%	August	75%
March	0%	September	100%
April	0%	October	100%
May	0%	November	100%
June	25%	December	100%

Source: Novogradac & Company LLP

To calculate the Year 1 monthly weighted average applicable fraction for Building A, we would add the low-income occupancy percentage for each includable month and divide by 12 months. July is the first month we can include in the credit calculation, because the building was placed in service June 15, 2017, and the building was not placed in service for a full month. Therefore, we couldn't include June, even though there was occupancy during the month. Starting with July, we would calculate (50% + 75% + 100% + 100% +100% + 100%) / 12 = 43.75%.

Q: How does the Year 1 monthly weighted average applicable fraction affect the amount of credits for Year 1?

A: In the above example for Building A, the Year 1 monthly weighted average applicable fraction is 43.75 percent. Since our target applicable fraction is 100 percent, we can use the Year 1 monthly weighted average applicable fraction in the earlier example to see the effect on first-year credit delivery.

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EXAMPLE 1 (BUILDING A)-GENERAL CREDIT CALCULATIONS		
Eligible Basis	=	$10,000,000
Applicable Fraction	=	100%
Credit Percentage	=	9%
To calculate the total credit this building could generate in Years 2-10:		
	$10,000,000	
	x 100%	
	$10,000,000	
	x 9%	
	$900,000	

Source: Novogradac & Company LLP

EXAMPLE 1 (BUILDING A)- YEAR 1 CREDIT CALCULATIONS		
Eligible Basis	=	$10,000,000
Applicable Fraction	=	100%
Credit Percentage	=	9%
To calculate the total credit this building could generate in Year 1:		
	$10,000,000	
	x 43.75%	
	$4,375,000	
	x 9%	
	$393,750	

Source: Novogradac & Company LLP

This example assumes that the target applicable fraction of 100 percent was met by the end of the first year. If the target applicable fraction of 100 percent was not met in the first year, then the owner is subject to the credits being delivered over the 15-year compliance period instead of the 10-year credit period.

Q: Wait! If the building is expected to generate $900,000 annually in credits, but because of the Year 1 monthly weighted average applicable fraction, only $393,750 will be expected in the first year, is the difference of $506,250 ($900,000 - $393,750) lost forever?

A: No. The $506,250 can be taken in Year 11.

Conclusion:

As you develop your strategy for lease-up, it is recommended that you discuss best practices with a compliance specialist who understands the weighted average of the first year's applicable fraction so that you can maximize claimed credits in the first year of the credit period. ❖

This article first appeared in the June 2018 issue of the Novogradac Journal of Tax Credits.

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