EXCERPT

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The Low-Income Housing Tax Credits *Issue*

The Many Meanings of 'Mixed-Income' and How they Affect Policymakers
The term "mixed-income" can describe six different circumstances in the LIHTC context, each with important implications.
Page 10

Stop Locking the LIHTC Rate
Filling out an election to lock the LIHTC rate is currently not necessary and has the theoretical potential to hurt a LIHTC development.
Page 12

Reauthorizing, Increasing Funding for NAHASDA Could Help Provide Crucial Funding for Native Housing
Reauthorizing and properly funding Native American Housing Assistance and Self Determination Act could help tribally designated housing entities better access LIHTC.
Page 16

Underwriting for Impact: A New Tool from Urban Institute
The Capital for Communities Scorecard assesses various impacts of a proposed real estate development or operating business investment.
Page 18

Insights on Affordable Housing, Community Development, Historic Preservation and Renewable Energy

Challenges and Benefits of Using–but Not Combining–NMTCs and LIHTCs in a Development

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The development of a building in a low-income community with both commercial and residential rental uses presents several issues when considering the use of the federal low-income housing tax credit (LIHTC) and/or new markets tax credit (NMTC) incentives. Navigating the complexities of the LIHTC and NMTC programs requires careful consideration of the composition and intended use(s) of the building, as well as adherence to the specific requirements outlined by the LIHTC and NMTC incentives.

First, either incentive may be used as a subsidy for the development of a mixed-used building that includes commercial and residential components. If a sponsor receives an allocation of LIHTCs from the state housing agency, which may be very competitive, and the economics of the building will be supported with tenants whose income and rent satisfy the LIHTC income and rent limitation for at least 30 years, then the building can be developed with LIHTC equity. However, it is important to note that the commercial space within the building is generally not eligible for tax credit basis when calculating the amount of LIHTC eligible basis.

Conversely, if the building is predominantly commercial with a limited residential rental component, NMTCs may be a viable option. However, to be eligible for NMTC allocation, certain conditions (NMTC residential affordability requirements) must be met:

1. the building is not "residential rental property" as defined under Internal Revenue Code (IRC) Section 168(e)(2)(A); and
2. at least 20% of the residential rental units in the building must be designated as "affordable" (as defined in the NMTC program) during the seven-year NMTC compliance period.

IRC Section 168(e)(2)(A) defines residential rental property as: "a building or structure shall be considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income from such building or structure for such year is rental income from dwelling units."

With respect to the NMTC residential affordability requirements, which are contained in an NMTC allocation agreement, the CDFI Fund's Frequently Asked Questions Compliance Monitoring and Evaluation from November 2023 defines the affordability requirement as:

> "Rent Restricted (the maximum monthly rent should not exceed 30% of the adjusted income of a family whose annual income equals 80% of the median income for the area, as determined by HUD, with adjustments for the number

of bedrooms in the unit) and (ii) occupied by individuals whose family income calculated in accordance with the U.S. Department of Housing and Urban Development (HUD) Handbook 4350.3 REV-1 (or subsequent versions), is less than or equal to 80% of the area median family income as determined and adjusted annually by HUD."

In addition, the NMTC residential affordability requirements impose an additional monitoring and compliance responsibility for the community development entity providing NMTC allocation under its NMTC allocation agreement.

When determining whether to use the LIHTC or NMTC incentive for the development of a mixed-use building, the initial consideration revolves around whether the economics of the development support the exclusive use of one program. If the economics of the development of the building support the use of either the NMTC or LIHTC programs, the option exists to use, but not combine, NMTCs and LIHTCs. While it is clear under Treasury regulations that the NMTC program cannot be combined with the LIHTC program, it is feasible to legally segregate mixed-use buildings to use each incentive for different portions of the development. There are benefits and challenges to using both in the development of a mixed-use building.

Once it is determined that both should and can be used, the next question is how to separate the commercial and residential rental uses in a mixed-use building so that the NMTC and LIHTC tax incentives are not combined. The most common structure is to establish a condominium regime to create two distinct units: one comprising the commercial space and the other containing the residential rental units. The advantage of this separation lies in optimizing tax credit equity, as the commercial portion can benefit from the NMTC equity while the residential section can leverage LIHTC equity, with more equity than if only one program was used for the development of the building.

However, several challenges accompany this separation process. First, preparation of the separation documentation–such as condominium declarations or master deeds, which need detailed architectural plans delineating the commercial and residential units, as well as general and limited common elements–will be expensive and time consuming. Additionally, the NMTC side requires scrutiny to ensure that no residential unit inadvertently benefits from NMTC allocation, potentially jeopardizing tax credits for NMTC investors. Furthermore, the 20% affordability requirement under the NMTC incentive would be replaced with the requirement that all the residential rental units satisfy the income and rental restrictions of the LIHTC program for at least 30 years.

Another issue when dealing with mixed-used buildings within the development–regardless of the separation of the commercial space and residential rental units by a condominium declaration–is if the development consists of multiple buildings, none of the individual buildings can constitute residential rental property. This may raise the issue of whether multiple buildings are integrated as one building for federal income tax purposes. In this vein, there are several private letter rulings by the Internal Revenue Service that discuss that where two or more buildings or structures on a single tract or parcel of land (or contiguous tracts or parcels) operate as an integrated unit (as evidenced by their actual operation, management, financing and accounting), they may be treated as a single building for purposes of determining whether the building or structure is residential rental property. As such, if multiple buildings are being developed and one of the buildings could constitute residential rental property, an analysis of the facts should be performed to determine whether the buildings are, for federal income tax purposes, one integrated building.

While the use of both NMTC and LIHTC incentives offer potential benefits in optimizing tax credit equity, challenges persist. Balancing these considerations is crucial in navigating the complexities of developing mixed-use buildings in low-income communities. ❖

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