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Building the 4% Floor: IRS Issues Low-Income Housing Tax Credit Guidance

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In December 2021, affordable housing development projects received new guidance from the Internal Revenue Service (IRS) related to stimulating the development of affordable housing by increasing the Low-Income Housing Tax Credit (LIHTC) available to certain project developers.

Congress created the LIHTC as part of the 1986 Tax Reform Act to encourage developers to construct and rehabilitate low-income housing. There are two main credit types: the 4% credit and the 9% credit, which are calculated as 4% or 9% of the project's qualified basis, an amount based on the construction costs of the project's affordable units. Both credits are redeemable each year for 10 years. The 9% credit is for projects that construct new housing or substantially rehabilitate old housing without federal subsidies. The 4% credit is for projects that involve the acquisition and rehabilitation of existing housing, or construction of new housing, with tax-exempt bonds.

Though they are referred to as the 4% credit and the 9% credit, the actual value of the credits is set by the IRS and fluctuates based on the applicable federal interest rates each year. These fluctuations meant that when rates fell, the tax credit percentage decreased, diminishing the incentive for developers to invest in affordable housing. To increase program stability and encourage continued development of affordable housing, Congress in 2008 set a floor for the 9% credit, providing that the credit would be worth a minimum of 9% each year, regardless of current interest rates. But because the 9% floor only applied to the 9% credit, the value of the 4% credit continued to vary depending on interest rates.

Congress addressed this discrepancy by adopting a 4% floor for projects that qualify for the 4% credit in the 2021 Consolidated Appropriations Act (the Act). New Section 42(b)(3) of the Internal Revenue Code (IRC) sets a 4% minimum tax credit for buildings placed into service after December 31, 2020 (see IRC § 42(b)(3), 26 U.S.C. § 42(b)(3)). To qualify for the 4% minimum credit, the building must also be financed by specific types of obligations issued after December 31, 2020. P.L. 116-260, Title II, § 201(b)(2). However, the Act was unclear whether certain issuances that are connected to preexisting financing structures satisfy this new requirement.

To address this uncertainty, the IRS issued Revenue Ruling 2021-20 and Revenue Procedure 2021-43 to analyze the application of the 4% floor to building projects that had financing structures in place prior to December 31, 2020. The IRS reasoned that the intention of the new requirement was to prevent developers from claiming the 4% minimum credit if they had substantially finalized the financing structure for the project before December 31, 2020. The IRS was particularly concerned that allowing these projects to benefit from the 4% floor would result in a windfall to the developer. Specifically, the Revenue Ruling concludes that:

1. The 4% minimum credit does **not** apply to a building which is financed in part with a draw-down exempt facility bond that was issued in 2020 and on which one or more draws are taken after December 31, 2020, since the financing structure for this project would have been finalized when the loan was first issued in 2020, prior to the enactment of the 4% minimum credit;
2. The 4% minimum credit does **not** apply to a building which is financed from two issuances of exempt facility bonds—one issued in 2020 and the other issued in a de minimis amount after December 31, 2020, since this would result in a project receiving substantially more credit than an equivalent project with all pre-2021 financing, not to mention an increase in credits disproportionate to the amount of de minimis financing issued; and
3. The 4% minimum credit does **not** apply to a building which receives an allocation of housing credit dollar amount in 2020 and a de minimis additional allocation after December 31, 2020, for similar reasons as discussed in (2) above. The IRS noted that the same principles and legislative intent governing its treatment of de minimis bond amounts also applied to de minimis allocations of credit.

Additionally, the Revenue Procedure provides safe harbors for determining whether an exempt facility bond or housing credit issued after December 31, 2020 is more than de minimis for purposes of Holdings 2 and 3 (noted above) of the Revenue Ruling.

LIHTCs are complex as they are dependent on the presence of fact-specific circumstances. Thus, any CAA seeking to determine the applicability of the new 4% LIHTC to their affordable housing projects should consult with an attorney with tax expertise and knowledge of this new guidance.

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