Update on Section 42 Utility Allowance Requirements

The IRS published both final and temporary regulations relating to utility allowances for LIHTC properties in the March 3, 2016 Federal Register. Many Section 42 practitioners remain confused about how the changes to this IRS Regulation 1.42-10 may be applied to tax credit properties.

The final regulations clarify the circumstances in which utility costs paid by a tenant based on actual consumption in a submetered rent-restricted unit are treated as paid by the tenant directly to the utility company. The regulation extends the principles of the submetering rules to situations in which a building owner sells to tenant's energy that is produced from a renewable source and that is not delivered by a local utility company.

Background

In 2012, the IRS published a Federal Register notice of proposed rulemaking that provided that utility costs paid by a tenant based on actual consumption in a submetered rent-restricted unit are treated as paid by the tenant directly to the utility company, and thus do not count against the maximum rent that the building owner can charge. In these cases, the owner may establish a utility allowance in accordance with the IRS utility allowance regulation 1.42-10 for submetered utilities.

The final regulation adopts the 2012 proposed regulation, and extends those rules to the provision of energy that the building owner acquires directly from renewable sources and then provides to low-income tenants (e.g., solar energy sources).

Submetering

1. *Actual-Consumption Submetering Arrangements and Ratio Utility Billing Systems (RUBS)*
    a. The 2012 proposed regulations defined an actual-consumption submetering arrangement for utility allowance purposes as one that does *not* include a ratio utility billing system (RUBS). The regulations precluded an arrangement such as RUBS from qualifying as an actual consumption submetering arrangement. The regulation did not prohibit the use of RUBS for low-income housing tax credit projects. However, any amount paid by a tenant for utilities using RUBS must be included in gross rent, and may not be part of the utility allowance.

    The final regulations follow this approach and continue to define an actual-consumption metering arrangement as not including RUBS.

2. *Administrative Cost of Submetering*
    a. The final regulations do not include a requirement to determine actual monthly cost of administering the submetering program. They generally permit owners to charge tenants an administrative fee in accordance with a state or local law that specifically prescribes a dollar amount. The regulation authorizes the Treasury Department and IRS to provide for administrative fees in excess of five dollars per month, even in the absence of state or local law doing so, and to put

an upper limit on administrative fees even if state or local law allows higher fees.

    i. The proposed regulation limited the fee charged per unit to the lesser of (A) $5 per month; or (B) the owner's actual monthly cost paid or incurred for administering the arrangement.

b. If a building owner or its agent charges a unit's tenants a fee for administering an actual-consumption submetering arrangement, the gross rent includes any amount by which the aggregate amount of monthly fees for all of the unit's utilities under one or more actual-consumption submetering arrangements exceed the greater of (i) five dollars per month; (ii) an amount (if any) designated by publication in the Internal Revenue Bulletin; or (iii) the lesser of a dollar amount (if any) specifically prescribed under a state or local law or a maximum amount (if any) designated by publication in the Internal Revenue Bulletin.

This essentially permits owners to charge more for administrative fees than permitted under this regulation, but any charges in excess of those permitted must be included in gross rent.

3. *Energy Acquired Directly from a Renewable Source*
    a. The proposed regulation appeared to preclude applying submetering principles to electricity generated from renewable sources by the building owner or by some other person from whom the building owner purchases it directly.
    b. This regulation contains temporary regulations that apply those principles to energy that the building owner provides to tenants after having acquired it directly from renewable sources.
        i. However, in such cases, charges to the tenants for this energy must be comparable to local utility rates. Charges by the building owner must not exceed the rates that the local utility company would have charged the tenants if they had instead acquired the energy from that company. [e.g., if an owner charges residents for electricity generated by solar power, the amount charged may not exceed the amount the residents would pay for electricity provided by the local utility company].

Issues Relating to Utility Allowances Generally

1. *Role of Agencies Regarding the Utility Allowance Methods*
    a. A significant change in the final regulations is that agency approval will be required only for qualified professionals who are not properly licensed engineers. The prior requirement was that the agencies had to approve both qualified professionals and licensed engineers.
    An agency continues to have the option to review, and take appropriate action regarding, utility estimates based on the energy consumption model or the other optional methods.

    b. The regulation continues to allow an agency to approve or disapprove a method or to require certain information before permitting use of an energy consumption model. Also, an agency has the ability to review the energy

consumption model even when a properly licensed engineer, who is not subject to agency approval, uses the model. The final regulations specifically authorize an agency to approve or disapprove use of the energy consumption model or require information about the model before permitting its use, regardless of the type of professional that calculates the utility estimates.

2. *Use of Consumption Data for the Energy Consumption Model*
    a. The final regulations remove the requirement that an energy consumption model use the building's consumption data for a particular 12-month period. Instead, the final regulations revise the specific factors used in determining estimates under the energy consumption model to include available historical data.

    This is due to the fact that the most recent 12 months of utility data (required under the current regulation) may not be representative of actual consumption.

3. *Areas With No Public Housing Authorities*
    a. The existing regulations provide that if a building is neither a Rural Housing Service (RHS)-assisted building nor a HUD-regulated building, and no tenant in the building receives RHS tenant assistance, then the appropriate utility allowance for the units in the building is the applicable PHA utility allowance. This creates problems in areas where there is no local PHA.

    The IRS is requesting comments on how the rules might best address situations in which no PHA exists, and IRS may address this issue in the future. In the meantime, in areas where there is no PHA, the agency that administers the local voucher program is normally considered the local PHA – even if it is not an actual public housing agency. However, in these cases, owners and managers should seek guidance from the appropriate housing finance agency.

4. *Changes in Public Housing Authority Utility Allowances*
    a. The final regulation retains the requirement that if a PHA utility allowance changes, the building owner must use the new utility allowance to compute gross rents of the units due 90 days after the change.
    In other words, the 90-day period ends 90 days after the effective date of the revised PHA allowance. IRS regulations state that "A building owner that checks the PHA utility allowance every 60 days would have at least 30 days in which to adjust rents."

5. *HUD-Regulated Building*
    a. Prior regulations defined a HUD-regulated building as one for which HUD reviews the rents and utility allowances on an annual basis. Since HUD does not review rents and utility allowances on an annual basis for all programs, the final regulations define a HUD-regulated building to mean one in which the rents and utility allowances of the building are regulated by HUD (with no requirement for an "annual" review).

Effective Dates

Beginning on or after March 3, 2016, building owners were able to use the revised regulations. A building owner *could* have applied the regulations to taxable years earlier, but were not required to do so. They could have continued to use the prior regulations contained in IRS Regulation 1.42-10 for taxable years beginning prior to March 3, 2016. In effect, if an owner's taxable year began Jan. 1, 2016, they were able to use either the IRS utility allowance regulation published on March 3, 2016, or the regulations in effect prior to March 3, 2016.

Summary of Major Changes

1. Owners may submeter units for utilities that owners obtain directly from renewable sources instead of from utility providers.

2. The maximum administrative fee that may be charged for submetering is changed from the lesser of (1) $5 per month, or (2) the owner's actual monthly costs paid or incurred for administering the arrangement, to the greater of (1) $5 per month; (2) an amount designated by the IRS; or (3) the lesser of a dollar amount specifically prescribed under State or local law or a maximum amount designated by the IRS. If a fee in excess of the permitted amount is charged, it must be included in gross rent.

3. Owners are no longer required to have HFA approval when using a licensed engineer in the preparation of a utility allowance (HFA approval for other qualified professionals is still required). Agencies still have the ability to review and take appropriate actions relative to utility allowance estimates prepared by licensed engineers.

4. The requirement when using a consumption model to use data from a particular 12-month period, and instead requires use of available historical data has been removed.

5. The rule eliminates requirement that HUD-regulated buildings be those for which HUD reviews the rents and utility allowances on an annual basis. The requirement now is only that the building be HUD-regulated.