After-School Programs at LIHTC Properties: Avoiding Common Area Mistakes

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It is not uncommon for owners of Low-Income Housing Tax Credit (LIHTC) properties to establish after-school or similar programs at their properties. Such resident services are often offered based on a requirement in an Extended Use Agreement or simply as an additional benefit for residents. While these programs are generally recommended and provide significant advantages for residents, care should be taken when setting them up to ensure that the rules of the LIHTC program are not violated, especially those relating to the use of common areas.

Common areas are those areas outside the apartments themselves that are considered facilities "reasonably required" for property operations, and are functionally subordinate to the operation of the residential rental units. Examples of common areas are community rooms, swimming pools, fitness centers, laundry rooms, and parking lots.

Common Area Basics

One of the most frequently used techniques for generating additional income at apartment communities is the charging of fees for use of certain facilities. For example, residents at conventional properties may be charged a rental fee for using a swimming pool or community room for a private party. Or, a community may charge an annual membership fee for using an onsite fitness center. While such charges may be standard for conventional apartment properties, they are generally not permitted at LIHTC sites.

Section 42(d)(4)(B) of the Internal Revenue Code indicates that common areas may be included in eligible basis (i.e., credits may be claimed on the cost of the common areas) as long as such common area is provided as *"comparable amenities to all residential rental units…." "Amenities" are typically recognized as being a convenience that is included as part of the rent. The IRS codified this interpretation in Regulation 1.42-5(c)(VII) which requires that owners certify annually that "there was no change in the eligible basis (as defined in Section 42(d)) of any building in the project, or if there was a change (e.g., a common area has become commercial space or a fee is charged for a tenant facility formerly provided without charge)."*

This prohibition against such fees is given further weight by the discussion of eligible basis in the *General Explanation of the Tax Reform Act of 1986*. This document, which outlines Congressional intent with regard to the LIHTC program, states that common areas may be included in eligible basis *"provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project."* This language in clear in its prohibition against the charging of any fees for the use of LIHTC common area that was included in eligible basis. It should also be noted that the charging of fees does not relate only to residents. Based on the language in all IRS guidance, *no one* may be charged a fee for use of common area included in eligible basis, including market-rate tenants and people who are not residents of the property.

It may be acceptable to charge additional fees for use of project facilities if the facilities are common area (i.e., not part of the apartments themselves) and the cost of the common area was not included in eligible basis. For example, in New York City it is not unusual to see annual membership fees of $350 or more for fitness centers located in apartment buildings with tax credits. These fees are permitted because the owner did not include the cost of the fitness centers in the project's eligible basis.

In addition to not charging fees for common areas included in eligible basis, the space must be available to all residents on a "comparable" basis. Basically, this means that all residents must have approximately equivalent access to and use of a common facility. When this space is not available to all residents on a comparable basis, it may not be included in eligible basis. For example, assume a 100-unit property with 50 common area storage units (i.e., the storage units are not part of individual apartments). Many owners would include the cost of these storage spaces in basis and make the storage available at no charge to residents, on a first-come/first-served basis. The error in this case is that since there are not enough storage spaces for all residents, *none* of the cost of the spaces may be included in eligible basis. If a State Agency discovers that such space was included in basis, the violation would be reported to the IRS as a reduction in eligible basis, resulting in a potentially significant credit reduction and possible recapture. However, if the storage units were not included in eligible basis, the owner would be able to charge a fee for their use.

Commercial Activity

A "commercial use" is one that is making or is intended to make a profit.

Owners of LIHTC properties often believe that commercial activities may not be undertaken at a Section 42 property. This is not the case.

While commercial activities are allowed on a tax credit property, the costs of the property must be reasonably allocated between the commercial and residential users [General Explanation of the TRA 1986, page 158, which refers to Prop. Reg. 1.103-8(b)(4)(v)]. The General Explanation also states that the adjusted basis of a building must be reduced by the cost of any property that is not residential rental property.

As stated in the General Explanation, Congress intended that the costs of common elements be allocated between residential and non-residential uses according to any *"reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly by the units…and the non-qualifying property."*

Instructions to the State Agencies in the most recent IRS 8823 Guide indicate that if common area is converted to commercial use, the HFA *must* report it as non-corrected, even if put back to residential use. The IRS will decide when or if the issue is corrected. This clearly indicates that a report by a state agency of commercial use increases the risk of IRS scrutiny of a property.

Examples of Commercial Use

As noted, a commercial use is one that is making or is intended to make a profit. Examples of activities that could be construed as owner conversion to commercial use include:

- Charging rent for a beauty salon operator in part of a community building;
- Renting excess parking space to users not associated with the property; and
- Charging residents' guests a fee to use the swimming pool.

The Effect of a Commercial Activity on the LIHTC

Since the cost of commercial space may not be included in eligible basis for Section 42 purposes, any commercial activity initiated in a common area of a tax credit project will result in a basis reduction. Since the cost of common area is generally pro-rated throughout the residential buildings in a tax credit project, this reduction could result in a loss of eligible basis in each residential building.

For example, if a swimming pool costs $500,000 to build (all of which was included in basis,) and an owner was discovered to be charging outside groups a rental fee to use the pool, the entire $500,000 could be removed from basis. If there were five residential buildings in the project, this would result in a $100,000 basis reduction for each of the buildings. Also, if discovered by the HFA, each building would also receive an 8823, which would likely generate very close scrutiny by the IRS, not only because of the commercial use, but because the entire project would be out of compliance.

Owners should remain aware that while commercial activity is not prohibited at a Section 42 property, careful structuring of the deal is required in order to ensure against a possible reduction in tax credits. Sound professional advice should always be sought prior to converting any part of a tax credit property to commercial use.

After-School Programs

The benefits of after-school activities for children are well known, ranging from physical benefits to psychological and social advantages. These programs, if structured correctly, can boost academic performance, improve life and social skills, create safer, happier children and promote healthy hobbies. After-school programs at family apartment communities are highly recommended, and are sometimes required by the extended use agreements entered into between HFAs and property owners.

While the advantages of after-school programs are well known, care must be taken when establishing such programs in the common area of a LIHTC property.

As noted above, IRS regulations prohibit the charging of fees for use of a common area. However, the Code also provides an exception to this rule in the case of "community service facilities" located in tax credit properties that are in a "qualified census tract." A Qualified Census Tract is an area designated by the Department of Housing and Urban Development (HUD) as a difficult-development or high-cost area. Developers who place tax credit properties

in these areas are entitled to certain benefits not available to other tax credit developments.

Among these is the ability to provide a community service facility which serves not just the residents of the property, but the community at large.

In order for a property to contain such a facility and claim credits on the space occupied by that facility, the following requirements must be met:

- Individuals served by the facility must have income at or below 60% of the area median income;
- The project must be located in a Qualified Census Tract;
- A comprehensive market study of the housing needs of low-income residents in the area must have been conducted prior to the awarding of the credits, and the need for the services should have been noted in the market study;
- The facility must be used to provide services that will improve the quality of life for community residents;
- The facility must be located in the tax credit development;
- Any fees charged for services must be affordable to individuals at or below the 60% income level; and
- No more than 25% of project space for the first $15 million of eligible basis and no more than 10% of space for any eligible basis in excess of $15 million may be used for the facility.

If all these conditions apply, tax credit properties may include community service operations that will not reduce the amount of credit that may be claimed for the property. If any of these conditions are not present, such a facility could result in a reduction in credits to a property.

If the common area of a property does not constitute an approved 'community service facility,' it is still possible to charge a fee for a "service" offered in a common area, as long as there is no fee for the actual use of the area. For example, computer training, painting classes, exercise classes, swim lessons, etc., could require a participation fee – even if located in common area that is included in eligible basis. In all such cases, one of the characteristics of these charges is that they would be for optional tenant activities that occur over a very limited period of time (e.g., an hour or two per week), leaving the space available to residents at no cost for most of the time.

An after-school program is clearly different. Presumably, the facility would be used at least five days a week, for two to four hours per day for the after-school activities. In such cases, charging a fee for participation in the program is strongly discouraged, although it may be possible to charge fees for certain activities that take place as part of the after-school program.

Care should also be taken with regard to permitting people from outside the apartment community to participate in the after-school program. Unless the common area is a 'community service facility' as defined above, the facility should be for the *exclusive* use of property residents. If an HFA were to discover that outsiders were using the facility for after-school care, the Agency could question whether or not the amount of space that was included in eligible basis actually exceeded the amount needed for project residents, thus posing a challenge to eligible basis.

Summary

While after-school programs are beneficial and recommended, owners of LIHTC properties must take care in how such programs are set up. The following should be kept in mind:

- Was the space included in eligible basis? If so, and the space is not part of a Community Service Facility, no fee for the use of the space should be charged;
- Ensure that the HFA has approved the use of the facility as an after-school program;
- Limit the after-school services to residents of the apartment community; and
- Make sure not to engage in any commercial activities (e.g., if an outside operator of the after-school program pays rent to the owner of the property).

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