

**SUBSIDIZING RESIDENTIAL CARE APARTMENT COMPLEXES
WITH
LOW-INCOME HOUSING TAX CREDITS**

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Residential care apartment complexes (RCACs), formerly known as assisted living facilities, are designed to give the elderly the ability to live independently in a traditional apartment setting while having ready on-site access to a broad array of personal, supportive and nursing services. The 1998 regulations governing RCACs are set forth in Chapter 89 of the Wisconsin Administrative Code, Department of Health & Family Services (HFS Regulations). RCACs in Wisconsin have typically been operated as market rate housing, due primarily to high operating costs and the inadequacy of available rental and supportive service subsidies. It can be financially feasible to operate an RCAC at “affordable” rents if a portion of the construction costs are financed with investor equity raised through the sale of federal low-income housing tax credits (Tax Credits). Although RCACs have been subsidized with Tax Credits in the past, there are a number of potential roadblocks and unresolved issues that arise in combining the two programs. The purposes of this article are to highlight the issues inherent in combining Tax Credits with RCACs and to suggest ways in which the two programs can be successfully used together.

Tax Credit Program Basics. The summary of the Tax Credit program set forth below is intended only to provide a basic background for the detailed discussion of the RCAC/Tax Credit issues facing the project developer that follows. All of the key concepts touched upon below are complex and must be separately analyzed for each Tax Credit project.

The Tax Credit is a dollar for dollar offset to federal income tax liability allowed by Section 42 of the Internal Revenue Code (the Code). The Tax Credit is allowed over a ten-year period as a percentage of the qualified costs incurred to construct, acquire or rehabilitate a “qualified low-income building.” The discounted present value of the Tax Credit for new buildings or substantial rehabilitations is 70% of the qualified costs for buildings that are not “federally subsidized”, and 30% of qualified costs for acquisitions and new buildings or substantial rehabilitations that are federally subsidized. Qualified costs include only capitalized costs eligible for depreciation, and do not include certain “soft” costs such as permanent financing fees, organization and syndication costs, and expenditures incurred to lease units in the building. The percentage of qualified costs eligible for Tax Credits is the same as the percentage of the building occupied by low-income tenants at the restricted rent levels imposed by Section 42. Most building owners seeking Tax Credits structure their projects at or close to 100% qualified occupancy.

The Wisconsin Housing and Economic Development Authority (WHEDA) is responsible for determining which buildings otherwise qualified under the Code will be entitled to receive an allocation of Tax Credits and the amount of the allocation. WHEDA issues a qualified allocation plan each year explaining how buildings are ranked in the Tax Credit allocation process. The Tax Credit application and allocation process is very competitive due to the limited supply of Tax Credits. However, an RCAC with 100% affordable units should qualify for an allocation of Tax Credits under WHEDA's criteria in most circumstances. Buildings over 50% financed with federally tax-exempt bonds do not need to go through the competitive allocation process, but are eligible only for the 30% present value credit. WHEDA is also responsible for monitoring compliance with Tax Credit program income and rent requirements.

Individual and closely held corporations are subject to significant restrictions on their ability to use Tax Credits to offset federal income tax liability. As a result, most Tax Credits are "purchased" by large, widely held corporations which, rather than purchasing a building directly, acquire 99.9% interests in so-called "pass through" entities (typically limited partnerships or limited liability companies) that in turn own and operate the Tax Credit building. The Tax Credits allowed with respect to the building are passed through to the partners of the partnership or members of the limited liability company based on their percentage interests.

These basic rules may be illustrated by a simple example. Developer obtains control over a parcel of land for construction of a 50-unit RCAC. Developer's market study indicates that there are a sufficient number of prospective tenants with an annual income less than 60% of area median income to fill the project. Developer estimates that the total capitalized construction cost of the RCAC will be \$5 million, with an additional \$500,000 of Tax Credit ineligible soft costs. Developer applies to WHEDA for an allocation of Tax Credits. WHEDA allocates Tax Credits in the aggregate amount of \$4,250,000 over a 10-year period. Current market prices for Tax Credits are about 78 cents per dollar for allowable Tax Credit. Developer transfers the property to a limited partnership and sells a 99.9% interest in the limited partnership to a Tax Credit investor for \$3,315,000. As a result, Developer requires only \$1,985,000 of debt financing to complete the \$5.3 million project¹. By so reducing the amount of permanent financing, the project becomes financially feasible at the restricted Tax Credit rent levels.

In order to raise the Tax Credit equity, Developer will have to convince tax counsel for the Tax Credit investor that neither the service plan for project tenants nor RCAC program requirements will jeopardize the availability of the Tax Credits allocated by WHEDA². There are three basic issues that must be addressed in order to construct and operate an RCAC as a Tax Credit project: (1) the RCAC must be classified as a "residential rental property" with units that are available for rental by the "general public"; (2) the charges for services provided to tenants must not be includable in gross rent for Tax Credit purposes; and (3) the Medicaid or

¹ There are several issues that arise in obtaining permanent debt for an RCAC; for example, lenders are reluctant to count projected net income from service charges in sizing the loan. These and other financing related issues are beyond the scope of this article.

² As a result, it is important to address these issues early on in the Tax Credit syndication process.

other assistance received as reimbursement for service charges must not be treated as “federal grants” that reduce the amount of qualified costs eligible for Tax Credits.

Residential Rental Property Available for use by General Public. An RCAC will qualify as residential rental property available for use by the general public if (1) the units contain complete facilities for living, sleeping, eating, cooking and sanitation; and (2) the level of services provided to project tenants is not so great as to cause the RCAC to be classified as a nursing home, sanitarium, life-care facility or retirement home for Tax Credit purposes.

RCAC units are required by the HFS Regulations to have individual exits, a kitchen, a bathroom, a bedroom and living area. Accordingly, RCACs designed and constructed in accordance with state law requirements will satisfy the parallel Tax Credit design and construction requirements. Notably, the design and construction requirements for Tax Credit units are essentially the same as the requirements for projects financed with federally tax exempt bonds. As a result, RCAC units designed and constructed in accordance with the HFS regulations will be treated as residential rental units for tax-exempt bond purposes as well³.

The Internal Revenue Code, Treasury Regulations and IRS rulings do not specify precisely how much and/or what types of assisted living services will cause an RCAC to cross the line from a “residential rental property” that qualifies for Tax Credits to a “nursing home, sanitarium, life-care facility or retirement home” that does not qualify for Tax Credits. However, as discussed below, it is this writer’s view that an RCAC can be operated in accordance with the HFS Regulations without providing a level of services that exceeds the amount permitted under existing IRS interpretations of applicable law.

While there have been a number of private letter rulings discussing what types and amount of services are excessive, these private letter rulings cannot be relied upon as precedent and thus are not discussed in this article. In any event, most of these private letter rulings were superseded by the issuance of Revenue Ruling 98-47, a tax-exempt bond ruling which provides specific examples of service levels that do and do not violate the general rule set forth in the Treasury Regulations. The general rule, as set forth in Treasury Regulation 1.42-11, is that a project which provides “continual or frequent nursing, medical or psychiatric services” will not qualify for Tax Credits. Revenue Ruling 98-47 applied the general rule to three separate buildings to be financed by tax-exempt bonds, as follows:

Each of the three buildings provided a basic package of services, including laundry, housekeeping, meals, 24 hour emergency call buttons, recreation activities and transportation services. Building X provided only these services, none of which were “nursing, medical or psychiatric services”, and thus clearly qualified as residential rental property. Building Y also provided medication assistance, nurse consultation as needed, personal care assistance and staff monitoring. The IRS concluded that Building Y also qualified as residential rental property. Building Z provided each of the services provided by Building X and Y, but was also staffed with a registered nurse for 12 hours a day and licensed practical nurses and nurses

³ As a corollary, IRS pronouncements involving the classification of residential rental property for tax-exempt bond purposes can generally be relied upon for Tax Credit purposes.

aids around the clock. The IRS felt that this level of nursing services was “continual and frequent”, and therefore concluded that Building Z did not qualify as residential rental property.

The critical points in Revenue Ruling 98-47 are as follows: (1) it appears that any amount of non-medical/nursing services (e.g., laundry, housekeeping, meals, personal care, transport) is permitted because they are not medical, psychiatric or nursing services; (2) the provision of some medical or nursing services on an “as needed” basis by doctors or nurses not located on the project site but available at the request of the building operator is acceptable; (3) having “staff” doctors or nurses available at all times to provide nursing or medical services is not acceptable; and (4) it would appear that “assisting” tenants with medication is not considered a “medical” service. Even with the guidance provided by Revenue Ruling 98-47, RCAC developers seeking the Tax Credit subsidy should carefully and conservatively structure their service plans in consultation with their tax advisors because the ruling leaves many “gray areas”. For example: (a) the ruling assumes that if registered nurses are available around the clock there will be excessive nursing services provided, an assumption which might not prove true in practice; and (b) the ruling does not describe when or how medication assistance (good) becomes medical or nursing services (bad). Fortunately, the HFS Regulations give RCAC operators sufficient leeway to devise service plans that satisfy the admittedly ambiguous Tax Credit prohibition against “continual or frequent nursing, medical or psychiatric services.”

The HFS Regulations governing RCACs strongly support characterization of RCACs as residential rental property for Tax Credit purposes. It is generally helpful that RCACs are expressly distinguished from skilled nursing facilities (nursing homes) and community based residential facilities (CBRFs) under Wisconsin law, and are intended to be an independent living alternative to nursing homes or CBRFs. More importantly, the HFS Regulations limit the total amount of supportive services (meals, housekeeping, laundry, transportation and arranging for medical services), personal care services and nursing services to a total of 28 hours per week. Given the 28 hour limitation per week, it is likely that, after taking into account the hours of non-nursing service provided per week, a tenant could be ineligible to receive enough hours of nursing service to disqualify their unit as residential rental property. Several points bear special mention. First, tenants are not required to contract for 28 service hours per week. Thus, for Tax Credit purposes, it would be conservative to adopt a leasing policy which favors applicants who require less than 28 service hours per week. Second, the HFS Regulations ambiguously provide that only “staff” time that is directly attributable to providing or arranging supportive, personal or nursing services to a tenant count towards the 28-hour limit. Depending on who is included as “staff”, a tenant could in practice receive far more than 28 hours of service per week from “outside” providers whose services are only “arranged” by RCAC staff members. Third, a tenant is permitted to receive far more than 28 hours per week of services if (1) the tenant needs special recuperative care – this exception is limited to 90 days; or (2) the tenant individually arranges for additional services from outside providers. It is unclear how the IRS would view these two exceptions to the 28-hour limitations. However, an RCAC is permitted to adopt a policy requiring the relocation of any tenant who needs more than 28 services hours per week, including for this purpose tenant arranged services provided from outside sources. From a Tax Credit standpoint, such a policy should be included in the lease and service agreement for any RCAC utilizing Tax Credits.

The HFS Regulations require each tenant to enter into a separate service agreement with the RCAC specifying the type and amount of service that will be furnished by the RCAC or other contract provider. The service agreement must specify the charge for each requested service. Properly drafted service agreements should serve the purpose of establishing to the IRS, if necessary, that the level of nursing services provided to a tenant are not excessive for Tax Credit purposes. In addition, RCACs utilizing Tax Credits should keep careful records of actual service hours as a defense in the event of an IRS audit.

Finally, it is important to note that the “residential rental property” test is, at least to a point, applied on a unit by unit basis. Thus, in the 50-unit RCAC assumed above, if the tenants in 5 units received excessive services the RCAC would still generate 90% (45/50) of the Tax Credits allocated to the project. However, if less than 40% of the units in the RCAC satisfied the services test, no Tax Credits would be allowed with respect to the project⁴.

In summary, it is clear that the IRS could not disqualify an RCAC for Tax Credits solely on the basis of the Wisconsin statutory and regulatory provisions governing RCACs. It is also clear that an RCAC can be operated in a manner that satisfies the residential rental property “services” test for Tax Credits. Conversely, it would also be possible to operate an RCAC in a manner that disqualified some or all of the units for Tax Credits. Thus, any RCAC developer who wants to access Tax Credit equity is strongly advised to consult closely with knowledgeable tax counsel from the outset to develop service agreements and leasing policies consistent with Tax Credit requirements and acceptable to the Tax Credit equity investor⁵.

Inclusion of Service Charges as Gross Rent. No Tax Credits may be claimed for any unit that is not appropriately rent restricted. Generally, the maximum rent that can be charged (including an allowance for tenant paid utilities) on an annual basis is 30% of the applicable tenant annual income limit, which typically is 60% of area median income as published by HUD⁶. If the amounts paid by RCAC tenants for services are treated as “rent” for Tax Credit purposes, the rent restriction requirement would be violated in almost all cases.

The Treasury Regulations provide that payments for services which are “optional” are not included in gross rent. The IRS has adopted a two part test for determining whether a service is “optional”. The first prong of the test asks whether the service is “required as a condition of occupancy.” Under the HFS Regulations, no tenant is required to accept any particular service as a condition of occupancy; rather, the intention of the HFS Regulations is to allow each prospective tenant to select from a menu of services that must be made available by the RCAC if requested, but are not mandatory. RCAC owners must be careful not to adopt leasing policies or practices which neither require applicants to sign-up for a particular service or create the appearance that applicants not needing certain services will be summarily rejected. If

⁴ For most Tax Credit projects, 40% is the minimum number of units that must be occupied by qualified tenants and rent restricted in order to qualify the project for any Tax Credits at all.

⁵ Because the IRS has been inclined to issue favorable private letter rulings on the excessive service issue, in some cases the most prudent approach would be to apply for a private letter ruling blessing a specifically described service and leasing plan.

⁶ For a few Tax Credit projects, the maximum annual income limit is 50% of area median income.

the leasing policy and practice of the RCAC is consistent with the spirit of the HFS Regulations, charges for services voluntarily selected by the tenant should not be treated as gross rent paid by the tenant on the ground that they are required as a condition of occupancy. Further, because the HFS Regulations permit a tenant to modify the service agreement as the tenant's needs change, it would be difficult for the IRS to argue that the existence of a service agreement makes the services contracted for a "condition of occupancy."

The second prong of the test for determining whether a service is "optional" is as follows: To be an optional service, the tenant must have a "practical alternative" for obtaining the service from other sources. This practical alternative test is applied to each service provided to each tenant by considering all relevant facts and circumstances, and as a consequence raises more issues than it answers. For example, take something as simple as meal service. If a project is located 20-miles from the nearest grocery store and there is no local food service caterer, is there a practical alternative to paying the RCAC for meals? Does the answer change if the tenant has a car or if the RCAC offers transportation service to the grocery store? Similarly, is there a "practical alternative" to the transportation services offered by an RCAC if a tenant has no car? Does it matter if the tenant has family in the vicinity to assist with his transportation needs? More fundamentally, what if the home health agency serving RCAC tenants is the only home health agency in the vicinity providing nursing services? Does this mean the RCAC is not providing a practical alternative for obtaining nursing services elsewhere? There is little or no guidance on the practical alternative issue. It is apparent that RCACs located in remote rural areas will have the most difficult meeting the practical alternative test, while RCACs located in major cities or their suburbs will in most cases be able to point to practical alternative means for the tenants to obtain the services offered by the RCAC. RCAC owners can strengthen their position on this issue by documenting the availability of the service options and disclosing these options to the tenants in writing from time to time.

Section 42 contains a specific statutory exclusion from gross for certain services charges, whether or not the services are optional. Under this exception, service charges paid to the RCAC by tenant assistance programs will not be included in gross rent if the following five requirements are satisfied: (1) the assistance is provided based on the tenant's low-income status; (2) the provider is a 501(c)(3) organization or a government program; (3) the assistance must include rental assistance; (4) the portion of the financial assistance that is for services and the portion for rents must not be "separable", *i.e.*, there should be no way to figure out how much of the assistance is being paid as reimbursement for service charges and how much for rental assistance; and (5) the assistance must be provided so that the residents can avoid placement in a hospital, nursing home or intermediate care facility for the mentally or physically handicapped.

This statutory exception will be difficult, though not impossible, for an RCAC to utilize because the HFS Regulations require separate lease and service agreements, and separately stated charges for rent and each category of service provided. Nonetheless, there is nothing to prevent the 501(c)(3) or other assistance program from paying the RCAC an unallocated dollar amount for services and rent. In part because of the uncertainty of the practical alternative test, RCAC owners should seek to work creatively with local home health agencies or other 501(c)(3) organizations to create assistance programs that satisfy the five requirements listed above.

Treatment of Service Expense Reimbursements as Federal Grants or as Gross Income to the Tenant. Section 42 requires the qualifying costs taken into account in computing the annual Tax Credit amount to be reduced by the amount of any “federal grant with respect to a building or the operation thereof.” The Treasury Regulations promulgated under Section 42 expressly provide that certain federal rent subsidies can be received by a project owner without reducing the Tax Credit amount, e.g., HUD Section 8 payments. The regulations do not address the treatment of federal funds paid to an assisted living facility for providing needed supportive, nursing or medical services to tenants, the most prevalent example being Medicaid card payment for personal care or nursing services. (State reimbursements do not present an issue.) For several reasons, Medicaid card or similar payments should not be treated as federal grants that reduce the allocable Tax Credits. First, if the RCAC does not itself provide the services, the federal reimbursement will not even be paid to the building owner. Second, the services for which Medicaid reimbursement is paid are separately contracted for by each tenant, as is the Medicaid assistance for which the tenant is eligible. Use of the building by the tenant is irrelevant to the amount or availability of the reimbursement. As such, it seems unlikely that the IRS would seek to characterize Medicaid reimbursements as grants received “with respect to the building or the operation thereof.” However, if a federal subsidy is for rent and services, the RCAC owner should consult a tax advisor to determine what, if any, impact receipt of the subsidy will have on the Tax Credit amount.

Although it is clear that amounts received by a tenant as reimbursement for medical expenses are not included as gross income in determining whether the tenant’s income exceeds the Section 42 maximum, it is not entirely clear that reimbursements received by a tenant for non-medical supportive services are similarly excluded in computing the tenant’s annual income. The IRS has indicated informally that such reimbursements should not be included in tenant income for Section 42 purposes; however, it is conceivable in certain circumstances that reimbursement for some types of clearly non-medical services (e.g., laundry) could be counted as income.

Ancillary Eligible Basis Issues. As noted above, the allowable Tax Credit amount is based in part on the qualified costs, or “eligible basis”, incurred by the building owner. RCAC developments have several characteristics that can raise eligible basis issues. First, RCAC’s may contain beauty parlors or similar conveniences for which tenants must pay a fee. Technically, the costs associated with commercial or retail space are not properly includable in eligible basis, and a beauty parlor or salon appears to be a commercial operation. However, if use of the facility is limited to project tenants and the rent charged the operators is designed only to reimburse the RCAC for expenses associated with the space, there is a good argument for including construction costs allocable to the space in Tax Credit eligible basis. Second, RCACs often include community rooms and other large common areas, which in some cases are available for use by area seniors who do not reside in the project. While ideally use of these areas should be restricted to project tenants, it may be permissible in certain circumstances to permit nonresident senior use as long as any charge for such use is limited to clean-up or similar out of pocket expenses. Finally, in many cases RCACs are included in a campus type setting with townhomes and/or market rate independent living apartments. In such cases, there are often shared parking or other facilities. Such sharing arrangements require an allocation of construction costs between the RCAC and the other non-Tax Credit buildings benefiting from the facility.

Conclusion. RCACs can and should in many cases be operated as Tax Credit projects in markets where there are a sufficient number of qualified low-income tenants with access to medical benefits sufficient to pay for the services offered. However, developers must be careful to formulate and implement leasing and service plans that take into account the Tax Credit issues discussed above, and should select a tax credit equity source that is familiar with these issues and the attendant risks.