TEXAS AFFILIATION OF AFFORDABLE HOUSING PROVIDERS
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October 10, 2023

Mr. Cody Campbell, Director of Multifamily Finance
Texas Department of Housing and Community Affairs
221 E 11th Street
Austin, Texas 78701
cody.campbell@tdhca.state.tx.us

Re: Texas Affiliation of Affordable Housing Providers comments to the 2024 Draft Qualified Allocation Plan and Multifamily Rules

Dear Mr. Campbell:

The Texas Affiliation of Affordable Housing Providers ("TAAHP") greatly appreciates the time that TDHCA staff and the Board dedicated to the 2024 Draft Qualified Allocation Plan ("QAP") and Multifamily Rules. Our membership represents a variety of disciplines and works diligently to provide affordable housing to low- and moderate-income families in the State of Texas. It is TAAHP's policy to submit only those recommendations that represent consensus among our membership.

On behalf of TAAHP, we respectfully offer the following recommendations for staff consideration and implementation in the final 2024 QAP.

Proposed Fix for School Scores

As you are aware, pending litigation against the Texas Education Agency ("TEA") has delayed the release of the 2022-2023 Accountability Ratings. This litigation is the result of changes in the way TEA determines school scores, and could result in many more sites being ineligible at a time when the Department is trying to increase production of affordable housing. These rating are a key factor in siting new Developments and the uncertainty surrounding the lawsuit makes it quite difficult for our members to make business decisions going into the 2024 Tax Credit Cycle.

The QAP already has a provision that ties certain data sets to those available as of "August 1 of the year prior to Application." This date was chosen so that Applicants can make timely decisions related to site selection, and to prevent late changes in data sets from derailing the viability of those sites.

TAAHP therefore recommends that the data available as of August 1, 2023, be used for purposes of determining applicable school scores. To accomplish this change, we offer the following recommended language:

> §11.1(e) Data. Where this chapter requires the use of American Community Survey, Texas Education Agency, or Housing & Urban Development data, the Department shall use the most current data available as of August 1 of the year prior to Application, unless specifically otherwise provided in federal or state law or in the rules, with the exception of census tract boundaries for which 2020 Census boundaries will be used, unless otherwise noted…

Furthermore, for purposes of determining site ineligibility, it does not make sense to look back at school scores from 2019 because the children who were being tested at that time are no longer students at the subject school. Accordingly, TAAHP recommends the following two changes:

> §11.101(a)(3)(D)(iii) The Development Site is located within the attendance zone of an elementary school, a middle school or a high school that had a TEA Accountability Rating of "Not Rated: Senate Bill 1365" for 2022 ~~and a rating of D for 2023.~~, unless acceptable mitigation as determined by staff or the Board is submitted with the Pre-Application.
>
> §11.101(b)(1)(C) ~~Ineligibility of Developments within Certain School Attendance Zones. Any Development that falls within the attendance zone of a school that has a TEA Accountability Rating of F for 2023 and a rating of "Not Rated: Senate Bill 1365" for 2022 is ineligible with no opportunity for mitigation.~~

Postponement of new Quantity of LIHTC Units Scoring Item

As an organization, TAAHP shares the Department's objective to increase the production of affordable housing units. However, the new Quantity of LIHTC Units scoring item, will likely result in unintended consequences that run counter to the Department's intentions.

First, the current economic climate makes producing additional affordable units nearly impossible. Rising interest rates have limited debt capacity and increased investor yield requirements, which has resulted in declining equity pricing. The majority of LIHTC developments are funded solely with these two capital sources. When debt and equity are constrained, the number of units that can be built decreases. This is no different than purchasing a single-family home; when interest rates rise, the maximum home price that a buyer can afford decreases.

Second, it is clear via other provisions in the QAP, that the Department has a stated goal of creating housing for families. If an Applicant has any chance at all of producing 20% more affordable units than the 2-year average, it will be through the development of Elderly transactions (which are largely one-bedroom/one-bath units) that have bare minimum square footage, and drastically reduced quality.

In order to be competitive, Applicants must take every available point. This means that in order prioritize the number of units, Applicants will be forced to sacrifice quality, size and amenities. We do not believe this is the outcome the Department wants.

It is worth noting that Tex. Gov' Code §2306.6711(h), related to the limitation on Elderly developments in regions containing a county with a population that exceeds one million, is only applicable to the extent that there are general population Applications available to fund. In Regions subject to the limitation on Elderly developments, this scoring incentive will lead to one of two scenarios: 1.) the application log will consist of only Elderly deals, or 2.) the few general population deals that are submitted will be extremely low scoring, meaning the Applicants are not take the points for the Department's stated priorities.

For these reasons, TAAHP respectfully requests that §11.9(b)(3), related to Quantity of LIHTC Units, be removed in its entirety, and this policy discussion be postponed until the 2025 QAP Roundtables, where workable solutions can be fully vetted.

Removal of HOME Match Requirement

We would first like to commend the Department for how smoothly the Competitive Housing Tax Credit program has operated over the last two cycles, despite significant disruptions in the economy. TAAHP truly appreciates all the hard work that has gone into keeping this train on the tracks.

We understand that the Department has Federal HOME Match obligations that have been historically difficult to meet. However, we fear that applying Match requirements to non-HOME assisted Developments will create significant disruptions to the Tax Credit program.

A major area of concern is that the new Match Requirement would create a bottle neck for closings. Unlike tax credit LURAs, which are originated after construction completion, HOME Contracts and LURAs are executed at Debt and Equity closing. The existing MFDL closings have been significantly delayed in the last few years, so adding another 60+[1] developments to that already stressed pipeline has the potential to derail the Federal Tax Credit timeline, for which there is no cure.

Another serious issue relates to vertically integrated organizations. Vertically integrated groups cannot themselves make matching contributions to a Development because those contributions would be considered "owner equity or investment in a project", an ineligible form of Match (24 CFR Part 92.220(b)(3)). TDHCA's Board has made clear, through the removal of the Experience Requirement, its desire

[1] Approximate number of 2023 4% and 9% HTC transactions with recommended allocations of $1.5MM or more.

to open the program up to out-of-state developers, presumably to increase competition. However, the very groups being sought would likely be vertically integrated and would have significant difficulty meeting this new Match Requirement. Moreover, there are many vertically integrated groups that already participate in the Texas LIHTC programs who have been unable to participate in MFDL funding because of Match.

There are also concerns with the apparent differences between how HOME Match is approved at the staff level. Our membership has reported wide variability between Developments as to what types of Match were ultimately approved. Even with the best planning, there are times where MFDL Developments get stuck – Match submitted at close-out is disapproved by Department staff. The project is complete at this point, and there are no additional costs to be added.

There are also many unanswered questions with how placing HOME Match Units in a Development that is not HOME-assisted will work. What guidance has the Department received on things like Davis Bacon, Choice Limiting Action and Environmental Clearance?

With so many uncertainties looming, we respectfully request that this requirement be removed in its entirety. Our membership would be happy to participate in a Roundtable discussion on this topic to figure out ways to help the Department meet its Federal Match obligation.

Interest on Related Party Loans

The new interest rate cap of 1% on Related Party Loans (§11.302(d)(4)(A)), directly conflicts with IRC §7872, which requires a minimum an interest rate of not less than the Applicable Federal Rate ("AFR"). For detailed information on the tax implications of using a rate less than AFR, please see the attached articles.

AFR is a floor, not a ceiling, and there are many business reasons why an interest rate would be set higher than AFR. Therefore, we offer the following suggested language.

> Interest on Related Party or Affiliate loans will be underwritten at ~~1% or lower~~ AFR as of the month prior to Application submission for initial underwriting, or the actual interest rate indicated in the loan agreement at cost certification. ~~The underwriter will not amortize Related Party or Affiliate cash flow loans in order to meet feasibility requirements.~~

Cap on Efficiency and One-Bedroom Units

TAAHP appreciates and support the Department's desire to build housing for families, which means building more two- and three-bedroom units. However, we believe that the 30% limit enacted in the 2023 QAP is too low. We respectfully request that the limit be increased to 50% to account for the market needs of individual communities (§11.101(b)(1)(A)(vii)).

On behalf of our membership, we again thank you for all your efforts on the QAP, and for your consideration and implementation of these recommendations.

If you have any questions of would like to discuss either of these items further, please do not hesitate to contact Kathryn Saar at (512) 828-6413 or via email at kathryn@tbsg.com any time.

Sincerely,

Kathryn Saar
TAAHP QAP Committee Co-Chair

Deborah Welchel
TAAHP QAP Committee Co-Chair

CC: Valerie Williams, President
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Applicable Federal Rate (AFR): What It Is and How To Use It

Full Bio

5–6 minutes

What Is the Applicable Federal Rate (AFR)?

The applicable federal rate (AFR) is the minimum interest rate that the Internal Revenue Service (IRS) allows for private loans. Each month the IRS publishes a set of interest rates that the agency considers the minimum market rate for loans.1 Any interest rate that is less than the AFR would have tax implications. The IRS publishes these rates in accordance with Section 1274(d) of the Internal Revenue Code.2

Key Takeaways

- If the interest on a loan is lower than the applicable AFR, it may result in a taxable event for the parties involved.
- AFRs are used to determine the original issue discount, unstated interest, gift tax, and income tax consequences of below-market loans.
- Parties must use the AFR that is published by the IRS at the time when the lender initially makes the loan.

Understanding the Applicable Federal Rate (AFR)

The AFR is used by the IRS as a point of comparison versus the interest on loans between related parties, such as family members.3 If you were giving a loan to a family member, you would need to be sure that the interest rate charged is equal to or higher than the minimum applicable federal rate.

The IRS publishes three AFRs: short-term, mid-term, and long-term. Short-term AFR rates are determined from the one-month

average of the market yields from marketable obligations, such as U.S. government T-bills with maturities of three years or less. Mid-term AFR rates are from obligations of maturities of more than three and up to nine years. Long-term AFR rates are from bonds with maturities of more than nine years.4

In addition to the three basic rates, the rulings in which the AFRs are published contain several other rates that vary according to compounding period (annually, semi-annually, quarterly, monthly) and various other criteria and situations.

Example of How to Use the AFR

As of May 2023, the IRS stated that the annual short-term AFR was 4.30%, the mid-term AFR was 3.57%, and the long-term AFR was 3.72%. Please bear in mind that these AFR rates are subject to change by the IRS.5

Which AFR rate to use for a family loan would depend on the length of time designated for payback.6 Let's say you were giving a loan to a family member for $10,000 to be paid back in one year. You would need to charge the borrower a minimum interest rate of 4.30% for the loan. In other words, you should receive $430 in interest from the loan.

In our example above, any rate below 4.30% could trigger a taxable event. For example, let's say you gave the same loan, but you didn't charge any interest. By not charging any interest, you would have "foregone" $430 in interest income, and according to the IRS, it would be considered a taxable gift. Any interest rate charged below the stated AFR for the particular term of the loan would be considered foregone interest and, as a result, be taxable.

Special Considerations

When preparing to make a loan between related parties, taxpayers should consider two factors to select the correct AFR. The length of the loan should correspond to the AFRs: short-term (three years or less), mid-term (up to nine years), and long-term (more than nine years).4

If the lender charges interest at a lower rate than the proper AFR, the IRS may reassess the lender and add imputed interest to the

income to reflect the AFR rather than the actual amount paid by the borrower. Also, if the loan is more than the annual gift tax exclusion, it may trigger a taxable event, and income taxes may be owed. Depending on the circumstances, the IRS may also assess penalties.7

Am I Required to Charge Interest When Loaning Money to Family?

No, you're not required to charge interest. However, by not doing so, the IRS may consider your loan a gift and levy taxes accordingly.

How Often Is the AFR Determined?

The AFR is released monthly with updated interest rates based on the market interest rates.

Does My Loan Agreement With a Family Member Have to Be Notarized?

No. While notarization may take it the next step, your written and signed agreement is legally binding on its own.8

The Bottom Line

The applicable federal rate exists to set a standard for what differentiates a gift from a loan. Check this rate before loaning money to anyone—if you charge an interest rate less than this benchmark, you may be subject to gift taxes.

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The rules on interest for loans between related parties

8–10 minutes

One of the more confusing aspects of taxation is the federal mandate for a business to charge interest on loans to or from its owners. This is primarily targeted at corporation/shareholder loans but can affect other business entities as well. Given current interest rates this requirement seems both senseless and immaterial. However, understanding these self-charged interest requirements requires a trip back in time to their enactment.

Background

In 1984 the prime rate was over 10%. Congress foresaw potential abuses with owners taking loans from their businesses at no interest and vice versa. Congress saw these loans creating unjust enrichment, enabling loans between related parties without any cost to borrow. In an effort to curb these perceived abuses, Sec. 7872 was enacted as part of the 1984 tax overhaul (Deficit Reduction Act of 1984, P.L. 98-369). This Code section required loans between certain related parties, usually in excess of $10,000, to bear a minimum amount of interest based on the applicable federal rates (AFRs).

This new Code section immediately ran into a complication from a much older law, Sec. 267, which governs transactions between related parties. While the vast majority of individuals are cash-method taxpayers, many businesses operate on the accrual method. Accrual-method businesses can deduct expenses as they are incurred, but cash-method individuals do not recognize income until actually received. As such, an interest payment from an accrual-method business to its individual owner that is not paid, merely accrued, would be deducted by the business, but would not be income to the owner until it is paid. Sec. 267 steps in and forbids the deduction when a related party would not recognize the

corresponding income.

At first it would appear the old law, Sec. 267, would defang the new law, Sec. 7872. However, since Sec.7872 was enacted after Sec. 267, it is read as a modification of Sec. 267. Because Sec. 7872 mandates a minimum amount of interest income, regardless of payment, to be recognized by the related party lender, a cash-method related-party lender is forced to recognize some interest income. It effects this result by deeming the interest to be original issue discount. In turn, some relief is provided to the accrual-method borrower, who may now claim a deduction to the extent the related cash-method lender is required to recognize the income.

Unfortunately, when both the owner and the business are cash-method taxpayers, and Sec. 267 is not the limiting factor, the results are a bit different. If no interest is actually paid, Sec. 7872 still mandates the recognition of a minimum amount of interest income by a related-party lender. However, since the borrower in this case is cash method, it cannot deduct the related interest expense until paid.

The resulting dichotomy of treatment can cause basis differences for book and tax purposes, as well as between the lender and borrower. For example, an accrual-method business might accrue the face amount 5% rate on a loan from its cash-method owner for book purposes, but not actually pay anything. If the relevant AFR rate for calculating the prescribed Sec. 7872 minimum interest is only 1%, the business's book basis of the debt would increase by the 5%, but the tax basis in the debt would only increase by the 1% AFR. So, for tax and book purposes the business's debt has different basis that needs to be considered when payments are finally made.

Likewise, if both shareholder and corporation are cash-method taxpayers and payments are not made, the debtor and lender will have different tax basis in the debt. In this situation the lender, required to recognize income not yet received, would have a higher basis than the borrower of the debt. These differences need to be carefully tracked by each party for recognizing income and expenses when payments are made at a later date.

Catchall provision

While corporation/shareholder loans are the primary focus of Sec.

7872 (along with gift and compensation-related loans, which are outside the scope of this discussion), partnership/partner loans can also be pulled into this arena. Sec. 7872(c)(1)(D) includes a catchall provision for tax avoidance loans, defined as "any below-market loan 1 of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax."

This is less clearly defined than the automatic applicability of a corporation/shareholder loan, specified under Sec. 7872(c)(1)(C), but if the purpose of the partner/partnership loan is to reclassify a distribution in excess of basis, it would presumably apply, requiring self-charged interest on the debt. A similar argument could be made for a partner/partnership loan that increased the partner's at-risk basis, allowing a loss to be recognized.

Net investment income tax

Another complication for self-charged interest involves the net investment income tax under Sec. 1411. As interest income, even though not actually received, the mandated income recognition under Sec. 7872 would inherently be subject to the additional tax. Fortunately, Regs. Sec. 1.1411-4(g)(5) has additional rules for self-charged interest, borrowing from Regs. Sec. 1.469-7, to alleviate some of this issue.

Under this provision, only self-charged interest income from a passthrough that results in a reduction of income subject to self-employment tax is subject to the additional tax. Unfortunately, this rule applies only to passthrough entities, not C corporations. That means self-charged interest income to S corporation shareholders and limited partners is not subject to the additional tax. Only general partners, those LLC members treated as such, and shareholders in C corporations are subject to the net investment income tax on self-charged interest.

Administrative scrutiny

More concerning is what can happen if the required interest is not calculated and subjected to administrative scrutiny. One path mandates having the parties adjust their interest income and expense accordingly. This has been the result in most court cases involving Sec. 7872. If the amounts are sufficient, this can result in not only tax and interest, but penalties as well.

There is another, less fortunate path this can take. Failure to charge adequate interest can be viewed as indicia of a sham transaction disguising a dividend. Under this regime, the loan would be reclassified as a constructive dividend. For a shareholder of a C corporation this could create a taxable dividend.

The shareholder of an S corporation could have a distribution in excess of basis or a taxable distribution of accumulated earnings and profits. It could also create a disproportionate distribution, bringing an effective preferred stock into existence and disqualifying the S election. Any flowthrough owner could have a loss disallowed under the ordering rules for lack of basis under this scenario. Though the courts do not appear to go down this route often, it would result in much greater taxes, interest, and penalties, as well as potential complications in the case of an S corporation saddled with disproportionate distributions, than simply recognizing the statutory interest income.

Pay attention to the rules

With short-term rates well under 1%, and calculation thresholds as low as $10,000, the resulting amounts of self-charged interest can seem a waste of effort. This can be particularly true given the Byzantine interactions of Secs. 7872 and 267, and their tangential effects on the tax imposed under Sec. 1411.

However, if disregarded and challenged, there is not only the potential for interest and penalties, but also reclassification resulting in substantial potential income, loss denial, and/or disproportionate distributions. In summary, what may seem immaterial could have much larger effects, and the rules for mandated interest should not be disregarded in the name of efficiency.

*— **Damien Falato**, CPA, CGMA, MST, is a tax director at Paresky Flitt & Company LLP, Wayland, Mass. For comments on this article or suggestions of other topics, contact Sally Schreiber, senior editor, at Sally.Schreiber@aicpa-cima.com.*