Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 1 ***October, 2000***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Participation of Nonprofits

Projects receiving credits from state housing authorities which have been allocated under the 10% set aside (IRC §42(h)(5)) must meet specific requirements to be eligible to claim the credit.

The first requirement is the involvement of an organization which qualifies as a nonprofit under §501(c)(3) or §501(c)(4) of the code. This entity cannot be affiliated with, or controlled by, a for-profit organization. It must also have an ownership interest in the project and be a material participant in the development of the project and its operation throughout the 15-year compliance period.

Material participation is defined in IRC §469(h) and Treasury Regulation 1.469-5T. The Office of Chief Counsel has confirmed that the definition of material participation generally applied to individuals can be applied to nonprofit organization. By inference, the applicability of the seven tests found in the regulations can be applied to nonprofits as well.

References:

- Memorandum for Regional Chief Compliance Officers from Raymond J. Smith, dated 3/14/2000.
- *Housing Pioneers, Inc. v. Commissioner*, 49 F.3d 1395 (9th Cir. 1995).

How a MOU can Benefit the State Housing Authorities

The Georgia Department of Community Affairs (administrator of the LIHC program for the state) required developers to submit Forms 8821, Tax Information Authorization, for all of their existing projects when applying for Georgia credits in 2000.

When properly completed, Form 8821, in conjunction with a MOU, allows the Internal Revenue Service to notify the state of any compliance problems reported on Forms 8823 in other states, as well as audit results for LIHC issues related to the specified project.

There are certain pitfalls in this process to be avoided. First, specifying only Form 1065 in Box 3 (b) of the 8821 is insufficient. It must include Form 8823 (and anything else the state might want researched) that is not part of the 1065. The second potential pitfall concerns the taxpayer's signature. It is important to ascertain that the person signing the 8821 is authorized to do so.

If you wish to assist your state during their next round of applications, it is suggested that you discuss it with your contact at the Philadelphia Service Center in advance so that you don't encounter delays in implementing the practice.

Revenue Procedure 99-11: Alternative to Posting Bonds

Under Section 42(j), if a taxpayer disposes of a low income housing property during the 15-year compliance period, then the accelerated portions of the credit must be recaptured. Taxpayers can avoid credit recapture if the property is maintained as low income housing property by the new owner and the taxpayer posts bonds equivalent to the amount of credits that would otherwise be recaptured.

Revenue Procedure 99-11 provides an alternative to the requirement that a surety bond be posted. The taxpayer now has the option of pledging certain U.S. Treasury securities in lieu of the surety bond. The Rev. Proc. was created in response to the difficulty taxpayers were having in locating surety companies that offer surety bonds for LIHC buildings.

Revenue rulings (e.g. Rev. Rul. 99-24) are periodically published which give the taxpayer a bond factor amount to be used to arrive at the amount of the security which must be posted. The actual process is handled through the Bureau of Public Debt.

If you have any questions, or a taxpayer needs help, please call Angie Kaminski at the Philadelphia Service Center.

Federal Grants Reduce Eligible Basis

By Patty Bornheim, Revenue Agent

The routine review of the state application package revealed that a federal grant from the HOME program was included in the financing of the project. Since the eligible basis for the project had not been reduced by this grant, copies of the HOME grant and the partnership agreement were requested and inspected. The HOME grant was made to the general partner, a tax-exempt organization, who, in turn, loaned the funds to the LIHTC partnership.

The partnership agreement read, in part, that cash flow distributions were to occur on a regular basis and that repayment of the HOME loan would only take place after payment of other expenses, including other debt instruments.

An adjustment was proposed to reduce the basis of the project by the amount of the Federal HOME grant based on IRC §42(d)(5)(A), which states: "If, during any taxable year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of such grant is funded with Federal funds (whether or not includible in gross income), the eligible basis of such building for such taxable year and all succeeding taxable years shall be reduced by the portion of such grant which is so funded."

Also applicable is Revenue Ruling 96-35, I.R.B. 1996-31, 4, (Aug. 04, 1996) which cites Section 42(d)(5). It "provides that if, during any taxable year of the compliance period, a federal grant is used for a building or its operation, the eligible basis of the building for the taxable year and all succeeding taxable years is reduced to the extent of the federal grant."

The rationale for the adjustment is that since the "loan" of HOME grant monies is subordinate to other partnership debt, it is an indirect Federal grant. The taxpayer agreed to an adjustment to the eligible basis of the property.

Qualified Tenants & Records: Reviewing Internal Controls

In an article in the "Property Compliance Report", Jim Kohn states that a comprehensive software program forces a property manager to keep consistent and legible records. The author states that most tenant file problems stem from handwritten documents and manually maintained records and reports.

He cites as examples of errors he has encountered: certifications that had written-over birth dates and social security numbers, illegible names for family members, and rent rolls and certifications that did not agree as to occupancy. Mr. Kohn also points out that the use of a well-designed software program will result in completeness, consistency, legibility and timeliness in project records.

It should also be noted that the state housing agencies have the authority to require standardized documentation by projects. IRC §42(m) addresses the responsibility of housing credit agencies to administer the program and monitor taxpayer compliance. The Regulations outline the procedures a state agency must follow in monitoring for noncompliance and specifically provide that the monitoring procedures may contain additional provisions or requirements.

From an IRS auditing perspective, the requirement to evaluate a taxpayer's internal controls is found in IRM 4.2, Handbook for the Examination of Returns. The presence of a properly used software system and computerized records can minimize the amount of testing required. However, one must not assume that the taxpayer's stated internal controls are actually in place and effective unless they are tested. Good internal controls do not eliminate the need for certain basic steps, i.e. knowledge of the organizational structure and business operations, an understanding of its accounting system, and a tour of the project.

When cases of poor record keeping are encountered, issuance of an Inadequate Records Notice to get the taxpayer back into compliance may better reflect congressional intent than disallowing the credit. See IRM 4.2.8.15 for additional guidance. Factors to consider include:

- An alternative method was used to establish the amount of eligible basis, gross income, etc.
- Prior history and present degree of noncompliance
- Indications of willfulness or evidence of refusal to keep adequate records
- Inadequate records will result in significant underreporting of tax liabilities

Keep in mind that group manager involvement is required when considering issuance of a notice.

Reference:

- Jim Kohn, "The Pen vs. the Computer: Managing Low-Income Housing Properties with Assurance", Property Compliance Report, Novogradac & Company, LLP, Volume III, Issue IV.
- IRM 4.2.3
- Memorandum from National Director, Compliance Specialization to Regional Chief Compliance Officers dated 8/25/1999.

ERCS Tracking Code

The correct ERCS tracking code is 9812, not 9612 as previously reported.

Private Letter Rulings and Cases

PLR 9816018 – discusses eligible basis financed by tax exempt bonds.

PLR 9820015 – discusses correction of an administrative error that reduced the eligible basis of one building in the project.

PLR 9822026 – discusses qualification of the cost of a community building as eligible basis. Tenants were not charged a separate fee for use of the day care facility.

PLR 9830005 – discusses an exception to the 10-year holding period.

PLR 9831034 – discusses a carryover allocation that specified an incorrect number of buildings in the project.

PLR 9948025 – discusses why use of residential units for after school care rooms qualifies them as a common area functionally related to the project.

Richard E. Carp & Minda G. Carp v. Commissioner, T.C. Memo 1991-436 – discusses whether an amount designated as a development fee constitutes a qualified rehabilitation expenditure. The taxpayer failed to provide evidence that the expenditures were for the claimed purposes and did not submit sufficient evidence to enable an allocation under *Cohan*.

Fair Housing Act: Memorandum of Understanding Between HUD, Department of Justice and Treasury

A new Memorandum of Understanding (MOU) intended to promote compliance with the Fair Housing Act by LIHC property owners was signed by Housing and Urban Development (HUD), the Department of Justice (DOJ), and Treasury on August 11, 2000. The MOU will become effective on September 11, 2000.

The Fair Housing Act prohibits discrimination in the sale, rental, financing or advertising of housing on the basis of race, color, religion, sex, family status, national origin, or disability. The Act applies to conventional, as well as government subsidized, multi-family residential buildings, and includes LIHC properties.

The MOU includes provisions for HUD and DOJ to provide training and technical assistance to the IRS concerning civil rights and discrimination matters relating to the LIHC program and the IRS will provide technical assistance and training to HUD and DOJ regarding administration issues surrounding the LIHC program. In addition, the three agencies and other interested federal agencies will meet to discuss issues and ways to increase compliance with the Act. HUD and DOJ will also be working more closely with the state agencies

and providing training for developers, architects, property managers, and syndicators.

In addition to training and education activities, the MOU also provides for the coordination of owner/taxpayer notification procedures. HUD and DOJ will notify state housing agencies when:

- HUD has made a charge that the Act has been violated
- A probable cause finding under a substantially equivalent fair housing state or local ordinance has been made by a state or local agency
- A law suit has been filed by DOJ under the Act
- A settlement agreement or consent decree has been entered into between HUD or DOJ and the property owner

In turn, the state housing agencies will report this information us using Form 8823. The taxpayer will then receive notification that an adverse decision may result in the loss of low income housing tax credits. HUD and DOJ will also provide the IRS with information on the nature and dates of violations.

The MOU has been well received within the LIHC community; it emphasizes the participation of each segment of the industry, focuses on education, and provides an opportunity for continuous dialogue among the state housing agencies and the federal government.

More information about the Fair Housing Act is available at the HUD website "www.hud.gov".

Thanks and Best Wishes…..

A special note of thanks to Ms. Eleanor Scott, LIHC Coordinator in the former Georgia District, who prepared this newsletter. Eleanor has now retired and we wish her well in her post-IRS endeavors.

♫Grace Notes♫

As we begin FY 2001, it is appropriate to talk about priorities for the LIHC Program. One of our top priorities, in keeping with the new Internal Revenue Service Mission, is providing timely and quality service to members of the LIHC community. We can achieve this through enhanced communication with the taxpayer community and providing support to the state agencies.

One way to enhance our communication strategy is through the development of an Internal Revenue Service website where taxpayers can find PLRs, Revenue Procedures and Revenue. Rulings, the ATG and position papers specific to LIHC issues. Hopefully, the site will eventually be interactive so that we can respond directly to taxpayer questions. (We are looking for volunteers for this project. If you would like to help, please call me at (202) 343-0070.)

We can improve communication at the local level through presentations at conferences and meetings. Coordinators may be asked to accompany National Office, or even fly "solo". Don't panic!!! We will work with you to develop topics and content for any assignments.

Taxpayer service can be significantly enhanced by working with the state agencies responsible for allocating the credit and monitoring program compliance. It is my experience that taxpayers and the state agencies are actively interested in keeping LIHC properties in compliance with IRC §42 requirements. If we develop harmonious working relationships with the agencies and are easy to talk to, taxpayers will feel comfortable enough to approach us when they have questions, eliminating potential compliance problems, rather than feeling it's an "us versus them" situation.

Grace Robertson
202-343-0070
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 2 ***February 2001***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Congress Ups the Low Income Housing Credit Cap

Congress approved, and President Clinton signed, the Community Renewal Tax Relief Act of 2001, which included the following three changes to IRC section 42 which will immediately impact IRS audits of low income housing project. The Act also included significant changes to the qualified allocation plan and other state housing agency responsibilities. The changes are effective for credit allocations made after December 31, 2000.

- The per capita credit ceiling (currently $1.25) has been increased to $1.50 for 2001 and $1.75 for 2002. Thereafter, there will be a cost of living increase each year. It has been estimated that the increase will support an additional 180,000 low income housing units over the next five years. Further, the new law also establishes a minimum LIHC allocation for states with smaller populations: $2,000,000 in 2001 and 2002. The minimum allocation is also indexed to the cost of living. The minimum allocation will be applicable to 12 states, the District of Columbia, and the Virgin Islands in 2001.

- The deadline by which a project must meet the 10% test has been extended for projects receiving a credit allocation after July 1; the deadline is now six months after the date of the credit allocation.

- The adjusted basis (for purposes of computing the LIHC) of any low income building located in a qualified census tract can include the portion of adjusted basis of property (not to exceed 10%) used throughout the taxable year as a community service facility designed to service individuals whose income is 60% or less of the area median income. Facilities, for example, could be used for childcare centers, senior citizen programs, or job training services.

15 to 30 Years of Due Diligence After LIHC is Received

by Kent Rinehart, Revenue Agent

During the next two years, allocations of Low-Income Housing Credit (LIHC) will increase 40% over their current levels. With the competition for existing credits already widespread and intense, future applications for LIHC will be even more competitive.

I am impressed with the extent of due diligence, time and effort exerted by owners and developers when preparing their credit applications for consideration by the state agencies. During this time, owners and developers work their way through all the necessary paperwork associated with the state's application process. They also do extensive research, planning, and follow-up with the state. Finally, their efforts are rewarded with the issuance of Form 8609, Low-Income Housing Credit Allocation Certification, for their completed project!

It is at this point, however, where I have seen a sudden and distinct drop off in the due diligence exerted by owners and property managers to maintain their project according to the states requirements and IRC Section 42. Due diligence is defined *(Black's Law Dictionary [6th ed. 1990])* as: "Such measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances; not measured by any absolute standard, but depending upon the relative facts of the special case." In short, the due diligence standard is a judicially created test to determine the adequacy of the efforts exerted throughout all phases of any activity, including the LIHC program.

As part of my audit, I include a comparative analysis to ensure that taxpayers' due diligence is consistent throughout the entire LIHC project commitment. This includes checking due diligence for each of the following phases:

- LIHC Application and Development Process

The application/development process generally sets the standard for the level of due diligence the IRS expects to see throughout all phases of the project. Once a taxpayer has the credit allocation, I expect the taxpayer to continue with this same level of due diligence.

- During the Tenant Screening Process

I analyze the internal controls, personnel actions taken, and the care and oversight demonstrated during the critical initial lease-up period to determine if the taxpayer is continuing to exercise due diligence. How well does the property manager ensure that all adults' income is identified? How well does the property manager make inquiries regarding additional roommates when there are more bedrooms in the unit than tenants occupying the unit? How well does the property manager follow-up and verify the information provided by the tenants? I'm looking for evidence of the taxpayer's intent to provide qualified low-income housing—not just to secure the tax credits.

- Rental Monitoring and Property Maintenance

I also analyze the due diligence demonstrated by the property manager in overseeing all the physical aspects of the rental units and all other land, buildings, equipment and services that comprise the LIHC project. I check to see if the state housing agency or state inspectors noted any concerns or violations of health, safety, or building codes. Are all buildings and equipment in good shape or are they in need of repair? Is the property clean and safe or are there visible problems that appear to be creating unsafe or unhealthy conditions for tenants? How often does the property manager make physical inspections of the rental units? Further, I want to know how "problem" tenants are being handled. Does the property manager take prompt, remedial action to correct the tenant's behavior or do they look the other way and allow such conduct to continue? I can then make a determination as to the quality of housing, maintenance, and services provided by the property manager.

- Tenant Recertifications

I first review if the state issued any notices for late tenants recertifications. I want to ensure that a complete and accurate recertification is done rather than a property manager simply going through the motions, especially for qualified households that are good renters what pay timely and don't cause problems. How well does the property manager inquire about changes in household size or job status? Have any of the property manager's physical inspections identified changes in household size (e.g., more tenants in a unit than who initially applied, etc.). Overall, the recertifications are an annual requirement to keep the credit. A lot can happen to any household during the year and I just want to ensure that these recertifications are handled in the same manner as the initial tenant screening was done.

- Final Years of the Compliance Period

Due diligence becomes even more important once the project gets into its 11th full year of operation. All of a sudden, the LIHC incentive is gone! Generally, at this point, there are no more LIHC tax benefits, yet the property remains low income housing for the next five years. In addition, for all building allocated tax credits after 1989, IRC Section 42 requires owners of tax credit properties to enter into an extended use agreement. All in all, the taxpayer has made a commitment to maintain the property as a low income housing project for at least 30 years. Therefore, if the owner conveys to the state housing agency that they will maintain the LIHC property for 15 or 30 years, then I would expect them to maintain it all throughout this time with the same level of diligence that they acquired the LIHC from the state housing agency.

Overall, the IRS expects to see a high level of due diligence demonstrated throughout the entire LIHC commitment period. Anything short of that could result in changes to the low income housing credit during an audit.

Revenue Agents Attend NCSHA's Southeastern Regional Conference

By Betty Graydon, LIHC Coordinator

National Council of State Housing Agencies' Southeastern States met November 16-17, 2000 in Lexington, Kentucky to discuss LIHC issues of

common interest. The states were represented by staff from both their Credit Allocation and Compliance Monitoring areas. Revenue agents from Florida, South Carolina, and Virginia were invited to attend, as well as the Headquarters analyst for the LIHC program. The conference was conducted in a roundtable format, which was conducive to open discussions and participation among the participants.

An in-depth presentation was made on the TAMS, providing definitions of the different types of construction costs at issue and explanations of the law and its application to low income housing credit projects. Some of the issues discussed included:

- How the five recent TAMS addressing land costs would affect the 10% Test

Projects requesting carryover allocation are not affected. As stated in IRC 42(h)(1)(E), it is "10 percent of the taxpayer's reasonably expected basis in such property". The Code does not specify "eligible" basis; i.e., all costs (land and building) are included when determining whether 10% of the costs have been incurred.

- How the five TAMS addressing land costs would affect the allocation process and final certification of costs by the state agencies

We requested that the state agencies alert owners submitting their final cost certifications that they should carefully consider the guidance provided in the position paper. Taxpayers are subject to future audit and must correctly determine their eligible basis and limit the credit amount accordingly when filing their tax return. Taxpayer may wish to voluntarily amend their credit allocation request to reflect a revised basis. These requests should be honored and the credit amount adjusted accordingly.

- How to monitor compliance after the end of the 15-year compliance period.

The extended use agreements are the primary enforcement tool after the end of the 15-year compliance period. The agreements represent a contractual arrangement between the state agency and the owner and are governed by state law. State agencies can pursue civil action to enforce performance of the agreement, as well as modify or even terminate, an extended use agreement without IRS involvement. State agencies are cautioned, however, that they may be subject to civil suit by displaced or harmed tenants, another owner, or even an applicant who did not receive a credit allocation, when an extended use agreement is modified or terminated.

Land Value: What's Your Guess?

By Eileen Jones, Revenue Agent

The review of a partnership return showed a land value of $32,000 on the balance sheet and an eligible basis of $4,218,966 on Form 8586. The land value was selected as an audit issue and the following information was determined:

- One of the partners purchased the property for $1,325,000 in 1990.

- The same property was sold to a partnership for $1,700,000 eighteen months later in 1991. A due diligence report prepared by the partnership included a county appraisal listing the land value as $264, 300. Thus, according to the partnership, the value of the property increased $375,000 (1,700,000 – 1,325,000), while the value of the land decreased $232,300 (264,000 – 32,000) during the same time period.

- The credit application to the state housing agency listed the land value as $170,000.

- The general ledger land account had a beginning balance of $195,670.93. The ending balance was $32,000.

- An IRS engineer valued the land and determined a value of $255,000.

According to the partnership, the land value of $32,000 is based on an independent appraisal they had done in 1993. Their explanation for the other figures is that that the valuations are guesses made by non-experts. We, of course, are going with the $255,000 value, as determined by the IRS engineer.

(Editor's Note: if you would like to talk with an Engineer about land valuation, you can call Tom Kelley at (651)726-1512 .)

TAM's and PLR's

TAM 200044004 (July 14, 2000) Subject to some assumptions, a note for developer fees is includable in a partnership's eligible basis.

TAM 200044005 (July 14, 2000) Whether land preparation, construction loan, and construction contingency costs that a limited partnership incurred for a low-income housing project can be includable in eligible basis.

TAM 200043015 (July 14, 2000) Costs associated with the issuance of tax-exempt bonds used to finance the construction of a low-income housing building are not includable in eligible basis.

TAM 200043016 (July 14, 2000) Local impact fees and construction loan costs that a partnership incurred in the construction of a low-income housing building are not includable in eligible basis.

TAM 200043017 (July 14, 2000) Developer fees and construction loan costs that a partnership incurred in the construction of a low-income housing building are not includable in eligible basis.

PLR 200044010 (July 28, 2000): An extension to elect to treat its residential rental property as a qualified low-income housing project was granted to a partnership.

PLR 200046033 (August 23, 2000): No recapture of low-income housing credits will occur from a company's untimely election to be treated as a C corporation.

PLR 200105038 (October 31, 2000): The 10-year holding period requirement is waived for a limited partnership's acquisition of a low-income housing project development.

Criminal Investigation: LIHC is Designated "Emerging Issue"

CID has designated the Low Income Housing Credit program an "emerging issue"; they have dedicated resources, provided training to their agents, and monitor the industry. About half their leads come from the U.S. Attorney, while the other half comes from revenue agents and state agencies.

Some of the common fraudulent activities include paying or accepting bribes, falsification of property eligibility, false compliance documentation, falsification of tenant eligibility or altering tenant applications, and inflating occupancy rates.

In one case, the taxpayer altered lease agreements and forged employee signatures to misrepresent tenant eligibility and the amount of rent tenants were paying. He was convicted of defrauding the government of more the $426,000 in tax credit over a three year period, sentenced to two years in prison, and fined $97,000 in penalties.

(Editor's Note: if you would like to talk with CID's senior LIHC analyst about potential fraud in the low income housing industry, you can call Charles Jenkins at (202) 622-5221.)

♫Grace Notes♫

Remember our MOU with the state agencies? Since it was first issued in 1999, 13 states have signed up. We have, or are finalizing, agreements with Kansas, Georgia, North Carolina, North Dakota, Florida, California, Oregon, Mississippi, Hawaii, Ohio Washington, Virginia and West Virginia. Four state agencies have decided not to participate: Alaska, Indiana, Missouri, and South Carolina. Thanks to all of you for your efforts!

We've received feedback from the states, and based on their comments, the MOU has been updated to include instruction for completing Form 8821, clarify that tax information disclosed under IRC 6103(c) is not subject to safeguarding requirements, and outline the privacy principles we feel are appropriate to preserve the confidential nature of the information we are providing and the taxpayer's privacy. These are the same privacy principles that you are subject to when conducting audits. We hope these updates encourage more states to participate in the MOU.

The updated MOU was distributed by memorandum on January 24,2001 and sent by e-mail to the LIHC Coordinators on February 6, 2001.

Again, thanks for all your help.

Grace Robertson
202-343-0070
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 3 ***May 2001***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Touring LIHC Properties
What You See, Don't See, and Should See
By Kent Rinehart, Revenue Agent

IRM 4.2.3.3, Audit Techniques for Tours of Business Sites, provides an overview of touring business sites. This IRM was written after a quality improvement process analysis team discovered that an effective tour of business sites reduced examination cycle time. In addition to this, the team also identified other benefits when tours were conducted; examiners demonstrated a greater awareness of other critical aspects of their examination. By touring the LIHC property, an examiner will gain insight and a working knowledge to address tenant issues, land issues, qualified basis issues, and other LIHC issues for the taxpayer.

Prior to touring the site, contact the LIHC Compliance Unit at the Philadelphia Service Center (PSC) at (215) 516-7609 and inquire if any notices of noncompliance (Forms 8823) have been filed by the local state housing agency. Also ask if they have any other BINs for the same owner. You want to know if your taxpayer had any notices of noncompliance, whether the owner has other projects, and the extent of noncompliance reported on Form 8823 for these projects as well. If the Compliance Unit has something on file, they can either fax or mail it to you. *(Continued on page 2)*

Sometimes It Really Is Easy
By Janet Roxroth, Revenue Agent

I recently concluded an audit of a TEFRA partnership return with a low income housing tax credit. This return was classified because of a large difference between the basis of fixed assets on the balance sheet and the "qualified basis" shown on Schedule A of Form 8609 filed with the return. The taxpayer did not include the front page of the form.

The records maintained by the partnership and their accountants were excellent. Turns out the taxpayers were entitled to the 130% basis increase under IRC § 42(d)(5)(C)(i)(II). No adjustments were made to the credit amount.

This audit could have been avoided if a copy of the *entire* Form 8609 had been attached showing that the taxpayers were providing housing in a high cost area.

Assisted Living Facilities: Record Keeping Requirements and Optional Services
By Louann Denniss, Revenue Agent

A LIHC examination was initiated as a result of a referral from a state housing authority. The state's property review included a detailed inspection of 20% of the tenant files in an assisted living facility marketed to senior citizens. All of the files showed deficiencies, including:

- Failure to certify income, or failure to recertify income annually
- No leases, or leases for 60 days
- Using net, rather than gross, social security payments to compute annual income,
- Income apparently in excess of the limitation, and
- Rent charged in excess of the limitation [Reg. 1.42-5(c)].

The examiner's audit of the taxpayer's tax returns included a 100% review of the tenant files, going back to the first year of the credit period. The examiner found the same deficiencies the state had identified in more than 70% of the tenant files.

In addition, IDRS was used to determine the amount of income the tenants reported on their tax returns. None of the tenant files contained copies of tax returns, although the regulations mention tax returns as one way to verify income [Reg. 1.42-5(b)]. Several residents had income a few thousand more than the annual limit, and a few had more than double the allowable income.

The taxpayer originally claimed "applicable fractions" of nearly 100%. During the audit, the taxpayer provided revised figure, but could not provide the details of the computation; only how *many* units and how *much* square footage he used in his calculation. The specific units included in the computation could not be identified. As a result, it was not possible to compare the taxpayer's computation to the examiner's detailed analysis of the tenant files.

In addition to the record keeping deficiencies, it was also determined that the rent charged was in excess of the limitation because the services provided to the tenants were not optional [1.42-11(b)]. The brochures used for marketing the facility before the federal examination listed various services that were included in the rent. After the examination started, the brochures were changed to separately list the rent as an amount below the LIHC limit and the services as "optional". In these new brochures, the rent was listed at an amount equal to the maximum allowed by law, which also happens to be less than half of the rent that is charged to the tenants living in comparable units in a non-LIHC building that the taxpayer owns. The leases signed after the examination began are for 180 days rather than 60 days.

The taxpayer's position is that that tenants signed a services agreement stating that the services were optional, and that an applicant would not be turned down because they didn't need the services. The taxpayer also indicated that there had never been a resident who didn't avail themselves of the optional services. None of the files inspected contained the service agreement, except a few that had leases executed after the audit began.

Third parties contacts were made (using RRA'98 procedures) with some of the residents. Many of the tenants couldn't remember if they were told the services were optional, but most indicated that they were specifically seeking those services.

Eligible Basis Update: Land Cost

Last fall five Technical Advice Memoranda addressing the inclusion of certain land costs, including impact fees, in eligible basis were released. Here's the latest news-----

- The Service selected the inclusion of impact fees in eligible basis as one of seven issues to be addressed by the new pilot Industry Resolution Program (LMSB).
- Regulations for Section 42 are on Chief Counsel's 2001 work plan to be updated.
- Rep. Johnson may introduce legislation establishing a statutory definition of eligible basis.

…Touring LIHC Properties (continued)

An examiner can learn much simply by taking a drive-by tour of the LIHC project itself as well as evaluating the surrounding neighborhood. Some of the things to consider include:

What signage and advertising is associated with the LIHC property? Signs posted around the property and ads in local papers or yellow pages may give insight as to how the owner is trying to represent this property. Consider if there are any indications that the property is low-income, affordable housing or whether it is being presented as luxury or student housing.

What might the land have looked like prior to the development of the LIHC property? Try to envision the amount of land grading, clearing, grubbing, cutting, filling and rough grading costs the developer needed to get the land suitable to construction. Such costs are generally considered land costs.

What other non-household buildings are on the LIHC property? Garages, picnic areas, gazebos**,** laundry rooms, community rooms, and other buildings need to be considered when determining the qualified basis of the LIHC property. Also identify if the number of garages equal the number of rental units available. Eligible basis includes the cost of facilities for use by tenants to the extent there is no separate fee for their use and they are available to all tenants. It may also include the cost of amenities if the amenities are comparable to the cost of amenities in other units.

What do the buildings look like? Does the developer use wood, brick, stone, siding, or other material throughout the project? Is the building trim and other accents minimal or are there signs that much of the structure components and fixtures are upgraded? You can't judge a book by its cover, but it can give you an indication of whether or not the property is being represented as affordable or luxury.

Are the buildings and grounds well maintained and safe? Look at the buildings, windows, grounds, sidewalks, parking lot, dumpsters, common areas and landscaping to again get a sense of the owner's diligence in providing affordable housing.

What does the landscaping look like? How much landscaping is there? How well is the landscaping maintained? Is it trimmed? Is it overgrown or weedy? Is there a pond or lake on the property? If there is, consider if the taxpayer included these costs as qualified basis. This is not necessarily part of qualified basis. Rev. Rul. 74-265, 1974-1 C.B. 56, held that land preparation costs such as landscaping may be subject to a depreciation if such costs are so closely associated with a depreciable asset so that it is possible to determine an useful life. If the landscaping will be replaced contemporaneously with the related depreciable asset, or will require the physical destruction of the landscaping, this test will be considered satisfied.

What types of vehicles do the tenants drive? Much can also be learned by observing the assets of the tenants that live at the property. This is not an exact science, but the models and makes of cars will give you an indication of the tenants' income levels.

What is the economy like in the surrounding area? What businesses or employers are within close proximity? Is the immediate area considered white-collar, blue-collar, or other? Is the immediate area considered high-income, middle-income, or lower-income?

Are there any colleges, universities, or other educational institutions in close proximity? The student issue was, is, and always will be an issue to consider especially if such places are close to the taxpayer's LIHC project.

Is there a potential duplication or diversion of costs? If the owner has more than one project, remember to look at the internal controls to ensure all costs are properly attributable to the appropriate property. Try to ascertain (i.e., cost per square foot, or valuation of neighboring building, etc.) if the costs reflected on the return for the properties you toured match those reflected on the return. If the costs appear high on the return, carefully examine where the building materials were delivered.

Identify the similarities and differences between the projects. If an owner buys building materials and supplies in bulk, ensure that the appropriate materials (and appropriate amounts) were delivered and used at the intended site.

Also, if the owner is in relatively close proximity to the LIHC project, the owner should be considered a related party subject to the Required Filing Checks outlined in IRM 4.2.5.

What does the property look like on the inside? Also tour the structures on the LIHC property site. Keep in mind some of the points discussed above. Also, you will want to identify any common areas or non-rental areas that you may not have been aware of when you conducted your external tour.

Then, analyze what you saw, what you didn't see and what you expected to see. Does it make sense? Is what you saw consistent with the tax return and other supporting information available to you? If it doesn't make sense, chances are you will identify significant issues.

Finally, IRM 4.3.3.6(1) provides that "Examiners should document that a tour or inspection was completed and describe the results; including observations and resolution of any questions. The tour of the business site … should also be noted on the activity record." If a picture is worth a thousand words, then a tour of the business site is priceless. It is our right to tour the business site—it is our job to tour the business site—it is an invaluable tool to tour an LIHC business site.

Private Letter Rulings

LTR 200112051 - A partnership was granted an extension to elect to treat its residential rental property as qualified low income housing under IRC 42(g)(1). The taxpayers was required to file amended Forms 8609 for all open years, that included the intended election, within 45 days.

LTR 200107022 - A partnership was granted an extension to identify buildings as part of a multiple-building project under IRC 42(g)(3)(D). The taxpayer was required to file amended Forms 8609 for all open years to identify each of the buildings in the project.

Disclosing Tenant Information

Low income housing owners are required to determine whether potential tenants are income qualified using extensive verification procedures, including documentation with W-2's, check stubs and contacting employers. As part of an audit, examiners review the owner's procedures and records to confirm that tenants are qualified to occupy low income housing units; i.e., their income is less that the ceiling amount.

One simple and efficient audit technique we can use to verify that tenants are qualified is to identify all the returns with AGI's above the ceiling that were filed from the project's address. Then, examiners can review those tenant files.

Audits are considered tax administration proceedings subject to the disclosure provisions of IRC 6103(h)(4). This provision allows the disclosure of otherwise protected third party information under two specific conditions: (1) if the treatment of an item reflected on such return is directly related to the resolution of an issue in an examination (related parties), or (2) if there is a transactional relationship between the third party and the taxpayer which directly affects the resolution of an issue (landlord-tenant relationship).

Government Liaison and Disclosure (GLD) has advised us that IRC 6103(h)(4) does not force examiners to disclose information; it merely gives examiners the authority to disclose if any of the conditions are met. The discretionary ability provides examiners with leeway in terms of what needs to be disclosed to successfully complete the examination. It may not be necessary to disclose a tenant's specific AGI; simply that the tenant's AGI exceeds the ceiling. Certainly, the decision to disclose AGI amounts should be made on a case-by-case basis and with the involvement of management. If you need additional assistance, please call Michael Sincavage, of GLD, at 202-622-3406.

Who Do You Call?
The LIHC Compliance Unit

State agencies are responsible for monitoring LIHC properties for compliance with the requirements of Section 42; e.g., health and safety standards, rent ceilings and income limits, tenant qualification, and record keeping. State agencies perform desk audits, inspect housing, and review tenant files. When noncompliance is identified or there has been a property disposition, the state agencies notify the IRS using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. Seventeen categories of noncompliance are included on the form.

The states send the forms to the Philadelphia Service Center, where the LIHC Compliance Unit processes the forms. They send notification letters, identifying the type of noncompliance reported on Form 8823, to taxpayers with instructions to contact the state agency to resolve the issue. Once the issue is resolved, a "back in compliance" Form 8823 is filed by the state.

As a revenue agent, you can get information about the state's filing of Forms 8823 for the property you are auditing. Here's a list of people to call about Form 8823 filings, based on the states they work with. Please limit your calls to LIHC issues.

Sam Aloi: (215) 516-7609 - Arkansas, District of Columbia, Hawaii, Montana, North Dakota, Rhode Island, Pennsylvania, Virgin Islands, Vermont

Delores Failla: (215) 516-2541 - Connecticut, Delaware, Michigan, Nevada, Ohio, South Dakota, Utah, Wyoming

Ann Grey: (213) 516-7613 - Alabama, Kansas, Kentucky, Missouri, New York, Washington, Wisconsin

Vito Trimarco: (215) 516-7668 - Alaska, Georgia, Idaho, Indiana, Maine, New Mexico, Texas, West Virginia

Marcy Morales: (215) 516-2202 - Florida, Iowa, Illinois, Massachusetts, Mississippi, Puerto Rico, Tennessee

Bonnie King: (215) 516-7621- Nebraska, New Hampshire, New Jersey, Oklahoma, Oregon, South Carolina, Virginia

Carol Orzechowicz: (215) 516-7147 - Arizona, California, Colorado, Louisiana, Maryland, Minnesota, North Carolina

Just a Reminder….

Please update LIHC cases to Project Code 670 and ERCS tracking code 9812. The project code may drop off in favor of the TEFRA project code, but the ERCS code will not be affected and will allow us to track the case.

♫Grace Notes♫

In Kent's article about touring LIHC properties, he referenced the findings of a process analysis team studying the span of examinations. I thought I'd follow up with more information about the project and their findings.

The former Pittsburgh District studied the examination process using the closed case database, ERCS, EQMS and process measures data. The team then identified numerous potential root causes of poor performance and13 potential solutions.

One solution addressed touring business sites during the audit of corporate returns. Analysis indicated that the average cycle time dropped significantly when the taxpayer's business site was toured. Further, Pittsburgh also found the touring the business site impacted the technical quality of the audit..

When the business site was toured, agents:

- *Identified significant issues more often;*
- *Conducted better interviews with the taxpayers;*
- *Completed better evaluations of the taxpayer's internal controls;*
- *Completed the minimum income probes more accurately;*
- *Satisfactorily analyzed the taxpayer's financial status more often;*
- *Effectively considered prior, subsequent and related return more often; and*
- *Selected the appropriate audit techniques to complete the audit more often.*

Not only did Pittsburgh identify these relationships, but so did other process analysis teams. National Office duplicated Pittsburgh's analysis and also validated their findings.

Knowing that tours of business sites positively influence cycle time and case quality, Pittsburgh worked with experienced examiners to develop guidelines for touring business sites. The guidelines were included in IRM 4.2

While there are many factors that will influence the timely completion of any case, it is clear that touring business sites helps examiners "do their homework" and prepare for conducting quality examinations in a timely manner.

Grace Robertson
202-343-0070
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 4 ***October 2001***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

LIHC and Rehab Credit Cases Designated as Mandatory Audits

By Grace Robertson

In a memorandum to SBSE Compliance Directors and LMSB Industry Directors dated September 19, 2001, LIHC and Rehabilitation Tax Credit cases were designated mandatory audits. The memo was signed by Sharon Oliver for Martha Sullivan, Deputy Director, Compliance Policy (SBSE) and Thomas J. Smith, Industry Director, Heavy Manufacturing and Transportation (LMSB).

The mandatory audit designation will ensure that cases are given priority. The designation, however, does not establish a compliance "project" requiring that a certain number of audits be completed. Audits will be identified on a case-by-case basis.

The LIHC program is co-administered with state housing agencies that monitor properties for compliance with the requirements of IRC 42. When they identify noncompliance, they notify the IRS using Form 8823.

New procedures have been implemented to timely and routinely identify egregious noncompliance based on the Forms 8823 reports filed by the state agencies responsible for monitoring compliance. It is anticipated that only a small number of cases will be sent to the field for audit and the returns will reflect egregious instances of noncompliance. Some examples include selling a property without reporting the sale or recapturing the credit, claiming the credit for five years without signed Forms 8609 from the state agency, and plumbing that is not connected to the sewer system so that waste back ups into the houses. Nonqualified households can easily put the minimum set-aside in jeopardy; i.e., full-time students or transient tenants.

Cases will be sent to the field if there are major violations of health, safety and building codes; the taxpayer has not met the minimum set-aside; or if the state agency has removed the property from the program. Cases will also be sent to the field if the taxpayer disposed of a LIHC credit without either posting a disposition bond (or Treasury security), or did not recapture the credit.

Case files will include a classification checksheet with an explanation and all available information, such as Forms 8823 and backup documentation and research findings from property records or other sources. Files will also include copies of prior, subsequent, or related returns as background information.

If needed, Headquarters will provide technical assistance. If you need assistance, please call Grace Robertson at 202-283-2516.

…And Just a Reminder….

LIHC cases should be updated to Project Code 670 and ERCS tracking code 9812. The project code may drop off in favor of the TEFRA project code, but the ERCS code will not be affected and will allow us to track the case.

Recapturing Accelerated Low Income Housing Credits

By Kent Rinehart, Revenue Agent

The recapture of any LIHC is done under the provisions of IRC 42(j). Recapture is required, at any time during the 15 year LIHC compliance period, when:

- There is a decrease to qualified basis, or
- There is a disposition of a low-income housing building, or

- There is a disposition of an interest in a partnership that owns a low-income building.

The LIHC is really a 15-year credit. While the taxpayer is required to maintain the property as low income housing for 15 years (the compliance period), the credit is claimed in the first 10 years (the credit period). In effect, the last five *(of 15***)** years of the credit are accelerated into the first 10 years of the compliance period. The accelerated credit equates to an acceleration rate of 1/3 (or 5/15) that may be recaptured if the taxpayer does not maintain the property as low income housing at any time during the compliance period.

Thus, if any of the above recapture provisions apply, the accelerated portion (or one-third) of the credit claimed in earlier years is recaptured for all prior years. However, recapture is made only to the extent that taxpayers receive an actual tax benefit.

On full dispositions or if the LIHC project falls below its elected minimum set-aside percentage, the accelerated portion of the credit is recaptured and no current year credit is allowed on any units. Where there is a partial disposition or any other decrease in the qualified basis of the project, the accelerated portion of the credit is recaptured and the current year credit is adjusted to the extent of the units that are not in compliance.

And, in addition to recapturing the credit, IRC 42(j)(2)(B) provides that interest must be calculated at the overpayment rate of IRC 6621 for each prior taxable period starting with due date for filing the return for each prior taxable year involved. The current ATG provides additional guidance in Chapter 7, Recapture of the Credit.

All adjustments for the amount of recapture and recapture interest can easily be reflected on examination reports.

Individual Returns

Using the RGSNT software, you will need to create a new issue titled "Recapture Section 42 LIHC." However, no matter what you call it, this title will <u>not</u> appear on your examination report. The only wording that will appear on your report is "Other Taxes."

In categorizing this new issue, it is recommended that you select the "Taxes" option in the first pop-up menu. Then you will either need to select the "Additional Taxes" or the "Other Taxes" option two different times in the second and third pop-up menus that will appear. RGSNT has options for Recapture of Investment Tax Credit, Recapture of Education Credit, and Recapture of Federal Mortgage Subsidy, but does not have an option pertinent to recapturing LIHC.

To minimize any confusion, it is recommended that the heading in your explanation of items be entitled "Other Taxes – Recapture Section 42 LIHC." The "Other Taxes" ties in with the Form 4549 you give the taxpayer and the "Recapture Section 42 LIHC" provides a short clarification of why such other taxes are being adjusted.

And, as you do for other issues, you will need to input the "per return" amount, "per exam" amount, the reason code and form/schedule. The UIL Code you will need when creating this issue on RGSNT is 42-10-00. Save this new issue and then proceed to the interest computation for your recapture amount.

To compute the proper amount of interest, identify each of the tax years of recapture and the amount of LIHC recapture *for which the taxpayer received benefit*. Next, identify the date through which you want interest computed. If the case is unagreed, compute the interest through 30 days after the report date. If the case is agreed, then check with taxpayer about date of payment. Then, have someone in Examination Support and Processing function (ESP) run the computations for you. Also, because of the intricacies of interest netting, offsets, and IRC 6404(g), it will be necessary to have ESP compute the interest on your total examination deficiency as well. Once you have these figures, the next step is to reflect this information on your report.

In doing the tax computation of your RGSNT report, do not check the "Include Interest" box on the tax computation screen. In essence, your report won't show any interest, but you will be able to clarify this by going into the "Other Information Section" on the tax computation screen.

For the "Other Information" section, the following wording is recommended:

> Interest on the above deficiencies includes the following to the extent shown per the computations enclosed with this report and summarized below:
>
> IRC 6601 interest on examination tax year deficiencies $?,???.??
>
> IRC 42(j)(2)(B) interest on recapture of LIHC ?,???.??
>
> Total interest for this report computed through (date) $?,???.??
>
> Interest will continue to accrue in accordance with IRC 6601. This interest computation has been computed in accordance with IRC 6404(g) relating to the suspension of interest after 18 months from the due date of the returns under examinations. Interest will continue to accrue until such time that all amounts owed are paid.

The computations for each category of interest will need to be enclosed with the examination report. When closing the case for processing, Form 3198, Special Handling Notice, should reflect your IRC 42(j)(2)(B) interest in the Special Instructions to ensure assessment of the proper amount of interest.

Business Returns

RGSNT software is not yet available to recapture LIHC on Partnership, S-Corporation or C-corporation returns. You will need to use RGS software for your examination report.

You will need to create a new issue through the "Enter/Modify Form 4318 Adjustment" option. At the new adjustment screen's SAIN block, press the F4 button and select the Schedule K option from the pop-up menu. Scroll down to and select the appropriate SAIN number that categorizes your issue, from 912-02 through 912-05. At this point, you may accept the title that is in the issue block or enter one of your own. This does not appear on your examination report. Then enter the year and adjustments. In the categorize block, press D and then scroll over to the "SEPARATE" top line heading (upper right of screen next to QUIT) and select it. You will then need to select option A or B (from the pop-up menu) depending on whether or not IRC 42(j)(5) applies to your case with respect to certain partnerships. This categorization will allow the proper wording to be shown on the examination reports for the LIHC recapture adjustment.

As with individual returns, the recapture interest under IRC 42(j)(2)(B) must be considered. If you have a taxable return (i.e., corporation), when you get to the Tax Computation screen, you will need to select the "Tax Computation Only" block. [NOTE: If you have other penalties to be assessed on your case, you will need to clarify this in the "Remarks" section of RGS as there is no way to include penalties on an examination report, but at the same time exclude the interest computation—unless you use white out!]. For non-taxable BMF returns (partnerships, S-corporations), interest does not appear on RGS examination reports.

However, for all BMF returns, interest for the recaptured LIHC as well as for current year deficiencies, will be determined in the same manner as shown above for individuals. To clarify the interest adjustments, it is recommended that you summarize all interest adjustments by selecting the "Remarks" block on the Print Examination Report screen and using the text shown above. Also, remember to note the case file Form 3198 accordingly to ensure that all interest will be properly assessed at the time of closing.

Overall, the potential for credit recapture issues is increasing as more and more projects reach the end of their 10-year credit period for claiming LIHC. The recapture adjustment is dollar for dollar of the accelerated portion claimed by the taxpayer. In addition, the recapture interest represents an additional adjustment apart from all other adjustments. Whether you utilize RGS or RGSNT, hopefully you will find that presenting these issues on your report will be easy.

Remember Utility Allowances?

Staff Reporter

At a time when energy costs are rising, a review of the utility allowance rules might be in order. The cost of any utilities paid directly by the tenant, other

than discretionary services such as telephone or cable, should be included in gross rent (IRC 42(g)(2)(B)). That is, the maximum rent that may be paid by the tenant is to be reduced by a utility allowance. The allowance can be determined in one of the following ways.

1. If a building receives assistance from FmHA, or tenants in the building receive FmHA housing assistance, then the FmHA utility allowance must be used.

2. Buildings that are both HUD regulated and FmHA assisted must use FmHA utility allowance.

3. HUD regulated buildings shall use HUD utility allowances.

4. Other buildings occupied by one or more tenants receiving HUD rental assistance payments must use the applicable public housing authority utility allowances established for the existing Section 8 housing program. Other rent restricted units in the building use the public housing authority allowance as well, unless a utility company estimate is obtained and then that estimate becomes the appropriate allowance *for the building* (except for the HUD assisted units which will continue to use the public housing authority allowance).

5. If none of the buildings or tenants are subject to the rules described in 1-4, then the public housing authority allowance is used. However, if an estimate is obtained for any unit from a utility company, that estimate is used as the utility allowance for all similar units in the building.

Allowances should be updated at the time rents are revised, but no less than annually, and shall be used to calculate gross rents paid 90 days after the date of occupancy. If a utility company estimate is used, the update should be within 90 days after the date of the utility company estimate.

If the unit's applicable utility allowance changes, the new allowance must be used to compute gross rents of rent-restricted units beginning 90 days after the change.

Examiners should make sure that utility allowances are updated in a timely manner and that rent limits are properly reduced by the amount of the utility allowance.

♫ Grace Notes ♫

On September 11th I stood at my office window and watched black smoke billow from the Pentagon across the infamous Washington Beltway. A few minutes later we knew that the World Trade Center was also in flames, and within an hour our building was evacuated. An hour later I was home, and with the rest of America, watched the tragedy unfold on television. And like many of you, I was asking myself who I knew that might be in immediate danger….and what I found out was that I was on many of your lists. It was with selfish relief that my friends were safe and profound gratitude that I responded to your messages.

In a sense, there is an IRS family and within the Low Income Housing Credit "industry" there is another "family" into which I have been warmly welcomed. Combined, I stand at the nexus of a community. Yes, property owners have a profit motive and revenue agents audit returns, but there is also an understanding that our purpose is to provide decent, affordable housing to individuals and families who are in need.

Thanks to the owners and property managers, who provide safe, clean housing and services with commitment - and thanks to those that help them. Thanks to the state agencies who administer their programs with compassion and diligence. Thanks to the National Council of State Housing Agencies, with whom we work so closely. Thanks to my IRS Management, who support me and a program that reaches beyond our usual paradigm of tax law administration. And thanks to the examiners who fairly, and with integrity, administer tax law.
My thanks to all of you.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 5 ***March 2002***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

New Revenue Ruling: Impact Fees Includable In Eligible Basis

By Grace Robertson, Program Analyst for LIHC

Recently issued Rev. Rul. 2002-9 provides guidance for including impact fees for determining the eligible basis. The revenue ruling was issued as the result of an Industry Issue Resolution Program project to address an issue that has been controversial within the LIHC industry in recent months.

What are Impact Fees?

Impact fees are one-time charges imposed by a state or local government against new development or expansion of existing development to finance specific off-site capital improvements for general public use that are needed because of the new or expanded development. Taxpayers are required to pay impact fees to compensate the government entity for the financial impact of the taxpayer's development. The fees, for example, could be used to build a new school or expand a sewage system.

Findings

As outlined in the revenue ruling, impact fees are indirect costs under IRC § 263A because they directly benefit, and are incurred by reason of, a taxpayer's production activity. Impact fees are assessed because of a taxpayer's plans to construct a new residential building. Thus, in accordance with Treas. Reg. 1.263A-1(f), the taxpayer must allocate the impact fees to the property produced. Because impact fees are calculated based upon the characteristics of the building and the impact fees are generally refundable if the building is not constructed as planned, the fees are 100% allocable to the building.

Reasonable Developer Fees

Kevin Woodward, Revenue Agent

I recently concluded the audit of a TEFRA partnership return claiming the low income housing tax credit under IRC Section 42. One of the issues was the developer's fee. The taxpayer didn't have a developer agreement detailing the detailing the developer fee or any written description of the duties performed by the developer.

The Power of Attorney (POA) was able to provide a developer agreement currently used by the developer. The only written documentation for the developer fee was in the Partnership Agreement itself. The agreement stated the developer fee was "in order to compensate the General Partner for its construction-related activities".

The POA also provided a calculation taken from the Projected Cost Schedule showing the developer fee was 12% of the various cost categories. The state housing agency allows developer fees up to 15% of the various project costs as identified in the taxpayer's application package.

My primary concern about the developer's fee was the potential reallocation of a portion of the fee for the acquisition of the land. The taxpayer purchased the land for the apartment complex at fair market value from the developer, who was also the general partner. The taxpayer did not allocate any of the developer fee to the land acquisition activities.

Per the POA's oral testimony, the developer did not spend much time looking for land because he already had several parcels in his inventory for future development. An appraisal was done and the land was sold to the taxpayer at fair market value.

I verified the developer properly included the developer fee in income. The taxpayer's books and records were excellent and the taxpayer was able to substantiate all other amounts reviewed during the audit.

Based upon the facts and circumstances involved in this case, I concluded the amount of the developer fee included in eligible basis was reasonable. Although neither the taxpayer nor the POA could tell me how the dollar amount of the developer fee was arrived at and there was no documentation of the actual time spent by the developer doing "construction-related duties", the developer fee, in my opinion, was not inconsistent or excessive as compared to the total project costs. In addition, the taxpayer did not claim the maximum developer fee allowed by the state housing agency (15%).

As a result, I allowed the full amount of the Developer's Fee as claimed and included in eligible basis, primarily based on the reasonableness of the amount!

Real Estate Facilitator Training

Examination Specialization has provided training for new facilitators in the Real Estate market segment, which includes the LIHC industry. The training was held in San Diego, January 29th-31st. The training included a two hour overview of IRC § 42 and the low income housing credit program.

The facilitators are working agents and will be able to assist examiners conducting audits of LIHC cases. For example, if the LIHC property is located in a state other than the location of the audit, the facilitator can complete the tour of the business site or contact a state agency for an agent.

The facilitators are Cheryl Blackwell, Frank Brand, Charles Coons, Brigitte Doan, Lois Dunn, Paul Gilbert, Karen Graham, Rita Hessman, Patrick Jolley, Cheryl Kiger, George Krmpotich, Carol Powers, Deborah Robinson, Barbara Seeds, Donald Senna, Paul Shields, Kimberly Slack-Richardson, Joan Steele, Ron Theissen, Peter Toporowski, Daniel Tran, and Mike Whalin. If you would like to contact one of the Real Estate facilitators, you can find their phone numbers in Outlook or send them an e-mail message.

LIHC Cases and Penalties

By Kent Rinehart, Revenue Agent

If an examiner determines that an owner of LIHC property has been noncompliant, the next issue is to address the culpability of all parties involved. Culpability is identifying who is responsible for each noncompliant action and the extent of that responsibility.

Generally, a LIHC taxpayer is a partnership with 1% of the tax attributes assigned to a general partner and 99% assigned to limited partners. The general partner, however, is the tax matters person and quite often is responsible for the actual operation of the property. As the tax matters partner, the general partner will also represent the partnership during an audit. Examiners are familiar with IRC § 6662, accuracy related penalties, and IRC § 6663, the fraud penalty. However, these penalties are a percentage of the tax deficiency and are applicable to all partners. So, even though the examiner may determine that the general partner is culpable, these two penalties will be applied to all partners and only have a de minimis impact on the general partner.

But, if either of these penalties is warranted, they should be fully developed and assessed. If the limited partners do not agree with the assessment of penalties, the issue can be addressed through the Appeals process or they can take action against the general partner to recover any amounts they deem appropriate.

One Code section does allow examiners to directly penalize any culpable party for actions that result in an understatement of income tax. IRC § 6701, Penalties for Aiding and Abetting Understatement of Tax Liability, provides a penalty for any person who:

1) aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document,

2) knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and

3) knows that such portion (if so used) would result in an understatement of the liability for tax of another person.

Overall, these provisions could apply to far more people than just the taxpayers involved. This section can apply separately to any individuals, general or limited partners, accountants, consultants, syndicators, property managers, management companies and anyone else that contributes to the on-going compliance of a LIHC project.

People who are culpable don't need to have a tax liability before a penalty can be assessed. The penalty under IRC § 6701 is applied on a per occurrence basis. For a corporation, the penalty is $10,000 per occurrence. For all others, the penalty is $1,000 per occurrence.

For each person that warrants such a penalty, the examiner will need to initiate a separate penalty case file, apart from the ongoing income tax examination. Please refer to IRM 4.10.6 and IRM 20.1.6.6 for details.

As a practical example, imagine that a partnership that has 15 partners. Any wrongful understatement of tax will impact at least 15 Forms 1065, Schedules K-1. If someone is culpable under the provisions of IRC § 6701, the penalty equates to $15,000 (15 erroneous Schedules K-1 multiplied by $1,000). Now, imagine that three different people were responsible for actions that caused an under-statement on the same partnership return—the penalty under IRC § 6701 just increased to $45,000 (3 x $15,000). The only difference here is that you will have three different penalty case files—one for each culpable person.

LIHC examiners need to consider IRC § 6701 during the course of any examination where deliberate noncompliance can be attributable to a particular person. Often, it will be the general partner that bears the burdens of property management and tax responsibility. So, even though only a small percentage of the accuracy-related or fraud penalties may flow through to a partner, culpable parties should be aware that they could also be liable for additional penalties under the provisions of IRC § 6701.

And, when applying aiding and abetting penalties, examiner should consider whether harsher penalties are warranted against the culpable individuals and entities. The harshest penalty would be for someone to cease and desist their actions with respect to the LIHC activity. For this, the IRS needs an injunction against such individuals and entities. The Code includes three sections that allow examiners to request injunctions:

- IRC § 7402 – Jurisdiction of District Courts
- IRC § 7407 – Action to Enjoin Income Tax Return Preparers
- IRC § 7408 – Action to Enjoin Promoters of Abusive Tax Shelters, etc.

Enjoining is an order by the court to stop something – in this case it could be as limited as to stop selling promotions or preparing certain tax returns or as broad as to never prepare a returns again or to shut down a web site. If the court order is ignored, the promoter would be charged with violation of a court order and the penalties could include prison.

Contact issue specialist Jim South at (419) 522-2455 and visit http://abusiveshelter.web.irs.gov/ for more information about injunction actions, if you believe an injunction is warranted.

PLR's and Cases

PLR 200206037 A partnership's transfer of its title for LIHC housing project to its general partner will not result in recapture under IRC § 42(j). The project was subject to real estate taxes under state law. However, under state law, if the title should be transferred to the general partner, the property would not be subject to the taxes. The partnership intends to transfer record title in the project and then lease the project back from the general partner. The partnership would retain all the benefits and burdens of ownership. The Service concluded that the transfer of bare legal title does not constitute a disposition or change in ownership that would result in credit recapture under IRC § 42(j).

PLR 200147008, 200147009, 200147010, and 200147011 The redemption of tax-exempt bonds after a low income housing development is placed in service will not result in a determination that the project was *not* financed with tax-exempt bonds under IRC § 42(h)(4)(B).

Revising the Audit Technique Guide

We're in the process of revising the LIHC audit technique guide for recent changes in the law and new issues. Suggestions for topics, or if you would like to contribute material, please contact Grace Robertson at (202) 283-2516.

Reducing LIHC Carryforwards & Getting Credit For It On Form 5344

Did you know that the Examination Closing Record, Form 5344, contains four important blocks of information that allow examiners to account for adjustments that reduce a credit carryforward?

Blocks 44 through 47, on Form 5344, identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

So, even though you may have an LIHC case with no immediate tax potential and a large LIHC carryforward, Form 5344 allows you to identify the extent of any adjustment to the carryforward. As a result, you get the credit you deserve—once you do the paperwork!

…And Just a Reminder….

LIHC cases should be updated to Project Code 670 and ERCS tracking code 9812. The project code may drop off in favor of the TEFRA project code, but the ERCS code will not be affected and will allow us to track the case.

♫Grace Notes♫

As I work with the LIHC program, I often find myself explaining how we co-administrated the program with the state housing agencies. I thought I'd take a moment to explain the integral role the state agencies have in the success of this program

First, the agencies are responsible for determining the housing needs within their respective states. For example, they consider the needs of rural, suburban and urban areas, areas enjoying economic booms and communities suffering from depressed economies. They also consider the types of housing needed; e.g., housing for seniors, assisted living centers, single-family homes, apartments, or transitional housing. From all the information they gather, they develop a "Qualified Allocation Plan" or QAP to define their priorities.

The state agencies are also responsible for allocating low income housing credits to taxpayers. Each year the states receive a specific dollar amount of credit from the federal government based on their population. Credits are awarded to projects based on applications or bids presented by developers. The process is highly competitive and each application is scored (given points) according to their ability to meet the priorities in the QAP.

Once a developer receives a credit allocation, they complete their project. The state conducts a physical inspection of the property to ensure it is built as promised and a final review of the taxpayer's costs to make the final determination of how much credit is needed to support the project. The final approval is documented on Form 8609, which the states submit 8609 to the IRS, so that we know the projects are approved and authorized to take the credit.

Finally, the states are also responsible for ensuring that the properties remain in compliance throughout the 15-year compliance period. At least once every three years, the state performs a physical inspection of the property to confirm that the owner is providing safe and secure housing. The tenant files are also reviewed to ensure that the tenants are qualified and that the rents are properly restricted. When they identify noncompliance, they report it to the IRS on Form 8823, which lists categories of errors. The forms are submitted to the Philadelphia Service Center and are the basis for classifying returns for audit.

This is just a simple overview of the states' areas of responsibility, but their work is at the very heart of the program. I hope this gives you a better idea what they do. This is a complex program with many stakeholders playing important roles to ensure on-going success in providing affordable housing for those in need.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 6 ***June 2002***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Technical Issue: Claiming the LIHC Without Completing the Certification

By Grace Robertson, Program Analyst for LIHC

As part of our classification efforts, we have identified returns where the taxpayer is claiming the low-income housing credit, but for which the taxpayer has not yet received the signed Form 8609, Low-Income Housing Credit Allocation Certification, from the state agency. The form documents the state's approval of the finished project.

Generally, the taxpayer will complete Part II of the form to make the required elections for the first year of the compliance period. Part I, which is completed by the state agency, is left blank. The returns often include explanations that the Forms 8609 were self-prepared pending final approval of the project by the state agency.

Under IRC 42(l), a taxpayer must certify with respect to the first year of the credit period that:

1. the taxable year and calendar year in which qualified low income buildings were placed in service,
2. the adjusted basis and eligible basis of such buildings as of the close of the first year of the credit period,
3. the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under subsection (h),
4. the election made under subsection (g) with respect to the qualified low income housing project of which such building is a part, and
5. other information as the Secretary may require.

How Certifications are Made

The certification is made to the Secretary of the Treasury and must be made following the close of the first taxable year in the credit period for any qualified low income housing building. Unless it is shown that failure to certify the first year of the credit period is due to reasonable cause and not to willful neglect, no credit will be allowed with respect to such building for *any* year before such certification is made.

Treas. Reg. 1.42-1T(d)(8)(ii) states that housing credit allocations are deemed made when Part I of IRS Form 8609, Low Income Housing Credit Allocation Certification, is completed and signed by an authorized official of the housing credit agency and mailed to the owner of the qualified low-income building. The allocation must be made on Form 8609. Taxpayers are required to complete Part II of the Form 8609, Low Income Housing Credit Allocation Certification, on which a housing credit agency made the applicable housing credit allocation, and submit a copy of the form with their federal tax returns for each year of the 15-year compliance period. (Treas. Reg. 1.42-1T(e)(1).)

Carryover Allocations

Pursuant to IRC 42(h)(1)(E) or 42(h)(1)(F), a housing agency may make, in advance of a building's being placed in service, an allocation of housing credits. These "carryover allocations" are made with respect to qualified buildings, which will be placed in service no later than the close of the second calendar year following the calendar year in which the allocation is made. Carryover allocations alone do not constitute the certifications required by IRC 42(l). Taxpayers must file the Form 8609 (that was issued to them by the state housing authority after the building was placed in service) throughout the 15-year compliance period. (In the first year of

the credit period, the taxpayer must file the carryover allocation document along with Form 8609 [See Treas. Reg. § 1.42-6(d)(4)].)

Window of Opportunity

Under IRC 42, owners cannot request Form 8609 from the state agency until the property is placed in service and cannot claim the LIHC until the state agency sends them the form with Part I completed and signed. For most taxpayers, this creates a window of opportunity of about four months between January (after the close of the first credit year) and April (when their tax return is due) in which to apply for and receive the completed Form 8609 from the state agency.

However, it takes about 9 ½ months (on average) after placing the property in service, to get the project approved by the state agency. (The time period is about the same for all the state housing agencies.)

And thus the taxpayer's dilemma: (a) file the tax return timely without the signed Form 8609 or (b) request an extension and file the tax return later when the state sends the signed form. Most property owners are partnerships, and they almost always choose to file the return timely and distribute their K-1's to investors, even though they do not have the signed Form 8609 in hand.

Audit Issue

Generally, the cases sent to the field involve taxpayers who are filing returns without completed Forms 8609 attached to the returns and the failure to certify the first year of the credit period is *not* due to reasonable cause. In these cases, examiners have several options.

First, there is no prohibition against satisfying the certification requirements during the examination process. Our purpose is not to remove otherwise compliant taxpayers from the program simply because the taxpayer was unable to complete the certification process timely. The taxpayer should be given the opportunity to provide completed Forms 8609 (signed by the state) during the examination. This action is particularly appropriate when the taxpayer submitted documentation to the state in a timely manner and encountered difficulties.

- Verify that the eligible basis includes only costs incurred before the end of the first year of the credit period, and
- Ensure that the applicable fraction for the first year reflects the first-year lease up and that the minimum set-aside was met.

Second, if the failure to complete the certification process is due to willful neglect, the entire credit should be disallowed, and appropriate penalties applied, for all years open by statute until the requirement is met.

If it is anticipated that the taxpayer may eventually be able to complete the certification, then

- the taxpayer should be cautioned that statutes should be extended (or claims for refunds filed) to ensure that the taxpayer can claim the credits at a later date.
- the examination should include verification of eligible basis, applicable fraction, and minimum set-aside for the first year of the credit period as part of the audit.

Finally, there will be cases when the taxpayer will never receive the Form 8609 from the state and will never be able to claim the credit. Under certain circumstances, state agencies can reclaim previously allocated credits within 180 days following the close of the first tax year of the credit period.

Credits may be returned because a building is not placed in service within the required period, failed to meet the minimum set-aside requirements by the close of the first year of the credit period; was not in compliance with the terms of the allocation as agreed to by the state housing agency and the credit recipient in the allocation document; the allocation was cancelled by mutual consent; or if the amount of allocated credit was not necessary for the financial feasibility of the project. (See Treas. Reg. 1.42-14(d)(2)(iv).)

In these cases, based on the state's determination, the property should be removed from the program and the appropriate penalties applied.

Back to Basics: Planning the Audit of a Low-Income Housing Project

By Kent Rinehart, LMSB Revenue Agent

The Internal Revenue Code (IRC), regulations and other provisions that explain IRC §42 may seem cumbersome when preparing an audit plan. To keep each audit plan simple, examiners will need to address four basic issues:

- Rent restrictions
- Tenant eligibility
- Physical condition of the property
- Computation of Eligible and Qualified Basis

Addressing these issues requires the compilation of a significant amount of information from different sources. The following outline provides a basic plan to help organize the process.

Information from the LIHC Compliance Unit

- Secure all Forms 8823 for the return (LIHC project) under examination, which will identify noncompliance issues discovered by the state agencies during their inspections.
- Secure all Forms 8609 for the return under examination.
- Secure information about bonds posted by prior owners when they sold the property or their interest in the property.

Information from the State Housing Agency

- Review the administrative file including owner's application for the credit.
- Review the compliance monitoring file maintained by the state housing agency.
- Determine whether the owner has additional projects within the state.

Examine Rental Income

- Reconcile the books to the return.
- Ensure that rent does not exceed the allowable rent ceiling.
- Ensure maximum rent corresponds to the proper maximum rent level based on the number of bedrooms for each respective unit.
- Identify any government rent assistance payments made on behalf of tenants.
- Ensure that the owner is properly computing and accounting for utility allowances and other amenities.
- Identify any other payments that could be categorized as rent, or should be separately stated, such as payments for assisted living support.
- Identify how cash payments are handled.

Examine the Tenant Files

- Tour the property. Observe the general standard of living, such as age and value of cars, etc.
- Review initial year tenant files to verify the applicable fraction.
- Review tenant files in year(s) under examination; compare to the first year.
- Ensure that any students are properly accounted for, especially if the project is in a desirable location for students.
- Ensure that the number of tenants is reasonable compared to the number of bedrooms in the unit.
- Ensure that the tenant(s) can afford to live in the unit based on the information they provided on the application.
- Ensure that the owner secures all necessary application information from all adult tenants.
- Ensure that the owner solicits and accounts for non-taxable income and assets of the tenants.
- Research all IDRS sources.
- Determine if there is a pattern or frequency of income items that the owner is not considering or not considering properly.

Examine Eligible and Qualified Basis of the Project

- Tour the project. Note all structures, landscaping and all other depreciable assets.
- Note how well the property is maintained (both inside and out).
- Tour the immediate surrounding area to get an idea of any schools, businesses and other economic information about the socio-economics of the area.
- Reconcile the assets observed to the costs included in eligible basis and reflected on the tax return.
- Ensure that the taxpayer has properly allocated costs to land, land improvements and depreciable assets.

- Determine if any of these costs are for credit syndication fees or other soft cost.
- Determine to what extent costs qualify for the credit.
- Identify how many low-income projects the owner has within the state (and any adjacent state, if feasible). For multiple projects, match costs to each project and ensure that costs have not been duplicated.

With this information, the examiner will be off to a good understanding of the facts and circumstances of the LIHC project their assigned. For each examination, the plan is simply to start with what the IRS and the state knows—and then compare that to the taxpayer's books and records.

LIHC Compliance Unit Contacts

As a revenue agent, you can get information about the state's filing of Forms 8823, reports of noncompliance, for the property you are auditing. Here's a list of people to call about Form 8823 filings, based on the states they work with. Please limit your calls to LIHC issues.

Manager: Angie Kaminski (215) 516-4113

Sam Aloi: (215) 516-7609
Arkansas, District of Columbia, Hawaii, Montana, North Dakota, Rhode Island, Pennsylvania, Virgin Islands, Vermont

Sharon Digiulio: (215) 516-2541
Connecticut, Delaware, Michigan, Nevada, Ohio, South Dakota, Utah, Wyoming

Ann Grey: (213) 516-7613
Alabama, Kansas, Kentucky, Missouri, New York, Washington, Wisconsin

Vito Trimarco: (215) 516-7668
Alaska, Georgia, Idaho, Indiana, Maine, New Mexico, Texas, West Virginia

Marcy Morales: (215) 516-2202
Florida, Iowa, Illinois, Massachusetts, Mississippi, Puerto Rico, Tennessee

Bonnie King: (215) 516-7621
Nebraska, New Hampshire, New Jersey, Oklahoma, Oregon, South Carolina, Virginia

Carol Orzechowicz: (215) 516-7147
Arizona, California, Colorado, Louisiana, Maryland, Minnesota, North Carolina

New Project Code for Rehabilitation Tax Credit Cases (IRC §47)

Project Code 082 has been assigned to the Rehabilitation Tax Credit program. Rehab Credit cases are also mandatory audits and a new code was needed in order to track cases through the examination process. Up to now, both Rehab and LIHC cases were assigned to Project Code 670.

…And Just a Reminder (Again)….

LIHC cases should be updated to Project Code 670 and ERCS tracking code 9812. The project code may drop off in favor of the TEFRA project code, but the ERCS code will not be affected and will allow us to track the case.

♫Grace Notes♫

Over the last year, we have identified a limited number of taxpayers who have continued to claim the LIHC without have Forms 8609 signed by the appropriate state agency. While the issue is not common, we wanted to make sure you (examiners) have the information you need to develop and support the issue. Hopefully, the lead article will be helpful. If you have questions, please just give me a call.

You've also probably noticed that Kent Rinehart has been a regular contributor to the Newsletter. Kent is a LMSB Revenue Agent with a great deal of experience in the LIHC market segment and his Management has made him available to assist us with this program. If you need help with a case, you can reach him at 715-836-8751.

We'd also like to encourage you to write articles for the newsletters – share the issues you've found in your cases.

Have a great summer!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 7 ***August 2002***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Head's Up: Treatment of State-Based Low Income Housing Credits

By Don Modglin, Revenue Agent

The state of Missouri offers several tax incentives, a number of which concern the issuance of transferable tax credits. In addition to receiving a federal IRC §42 LIHC on a qualified affordable housing project, Missouri offers it's own state Low Income Housing Tax Credit. The Missouri credit totals 40% of the federal tax credit. Generally, the Missouri state credit has no value to anyone other than someone with a Missouri income tax liability.

As a result, a partnership will be formed; one of the limited partners will be a nationally syndicated group of investors and another limited partner will be a Missouri limited partner who is a syndicator of the Missouri credit. The Missouri limited partner has no profit or loss interest and only the minimum capital interest required under Missouri law of .01 percent (.0001). Even though documents provided by the partnership document how the capital contribution was calculated, all of them speak of "buying" and "selling" the credits based on the present value of the total credits to be issued by the state of Missouri. The payment to the partnership for the Missouri credit is treated as a capital contribution to the partnership rather than a sale.

So is this the correct treatment? This isn't any guidance on point for Missouri's housing credit. But Chief Counsel, in Field Advisory 200211042 (issued February 5, 2002), did offer guidance for another Missouri tax credit known as a "remediation" credit for cleaning up hazardous substance contamination. Chief Counsel determined that the tax consequences when a taxpayer sells the state tax credit to **a third party** is a gain equal to the amount realized; i.e., since the taxpayer paid nothing for the credit, the taxpayer has no "tax cost basis".

The issue to be determined is whether a partnership's transfer of state-based housing tax credits to a limited partner with .01 percent interest is really a "sale" resulting in ordinary income or a reduction of the **limited partner's** basis (capital contribution).

Posting Surety Bonds to Avoid Low-Income Housing Credit Recapture:

By Sam Aloi, Revenue Agent

Section 42(j)(6) provides that a taxpayer that disposes of a qualified low-income building, or an interest therein, may defer or avoid recapture by furnishing a bond to the IRS in an amount satisfactory to, and for the period required by, the Secretary. The only condition is that it must be reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period.

The minimum required bond amount is the product of:

(1) the total credits that the taxpayer has claimed, as well as any additional credits the taxpayer anticipates claiming (carry-forwards);

(2) the appropriate bond factor pertaining to the month in the compliance period during which the disposition occurred and the first year of the building's credit period: and

(3) the percentage of the taxpayer's total interest in the qualified low-income building disposed.

Guidance on the amount of the bond considered satisfactory by the Secretary and the period of the bond required by the Secretary under Section 42(j)(1) is provided in Revenue Ruling 90-60, 1990-2 C.B.3. The original bond amount may be increased, if necessary, with a strengthening bond. Replacement of the surety may be accomplished with a supplementary bond.

The bond must in place before the taxpayer submits the Form 8693. While IRC 42 and Rev. Rul. 90-60 are silent as to the submission date, the F8693 requests submission within 60 days after disposition of the property (or interest therein). Limited extensions may be approved based upon consideration of the facts and circumstances detailed in a written request to the IRS.

The term of the bond is equal to the remainder of the 15-year compliance period plus an additional 58 months.

The surety must be an approved company listed in the Financial Management Service/Department of the Treasury Circular 570. The bond number provided by the surety should be entered on the F8693 for identification.

The Form 8693 Worksheet for Computing Bond Amount should be accompanied by sufficient documentation to support the computation presented. The Building Identification Numbers (BIN), property addresses, and tax identification numbers of all participating entities will permit: (1) verification of the property to a valid Form 8609, Low Income Housing Credit Allocation Certification, that is approved by the state housing credit agency and (2) ensure future compliance. While not required, including the name and phone/fax number of an informed contact party reduces the processing delays due to computational /documentation inconsistencies.

If the Disposition Bond is accepted by the IRS, an approved copy of the Form 8693 will be sent to the principal as identified in Part 1 of the Form 8693. Compliance monitoring on the property will continue and reports of noncompliance may result in "calling the bond".

If the Disposition Bond is not approved, the owner must recapture the credit using Form 8611, Recapture of Low Income Housing Credit.

References: IRC §42(j), Rev. Rul. 90-60, TNT 180-62, and Form 8693, Low-Income Housing Credit Disposition Bond.

(Editor's Notes: Sam Aloi is the Revenue Agent for the Philadelphia LIHC Compliance Unit. He has been in civil service since 1980 with the Economic Development Administration and the IRS. He holds advanced degrees in Accounting, Management and Finance from La Salle University, St. Joseph's University and the Wharton School at the University of Pennsylvania. He can be reached at 215-516-7609, Fax: 215-516-2572/6071 or email: Samuel.MM.Aloi@irs.gov.)

…And Just a Reminder (Again)….

LIHC cases should be updated to Project Code 670 and ERCS tracking code 9812. The project code may drop off in favor of the TEFRA project code, but the ERCS code will not be affected and will allow us to track the case.

Interviewing Taxpayers & Others

By Kent Rinehart, Revenue Agent

IRM 4.10.3.2 provides examiners brief insights as to what an interview entails. For Low-Income Housing Credit (LIHC) cases, here are five "W's" that will guide you through the interview process.

Who Should Be Interviewed

The **Philadelphia LIHC Compliance Unit**, which is an IRS source and is not considered a third-party contact. They are the examiner's resource to obtain the following:

- Forms 8823, Low-Income Housing Credit Agencies Report of Noncompliance,
- Forms 8609, Low-Income Housing Credit Allocation Certification,
- Form 8693, Low-Income Housing Credit Disposition Bond, posted by taxpayers disposing of their LIHC property or interest therein, and
- Recertification Waivers under Rev. Proc. 94-64, which waives the required annual certification of income qualifications if low-income tenants occupy 100% of the units.

The **State Housing Agency** (SHA), which is a third-party contact. You need to ensure that proper notice has been given the taxpayer prior to contacting the SHA. The state housing agencies report noncompliance issues to the IRS on Form 8823. They have administrative files that are open to the public. They also have compliance files that are available to examiners which document exactly why the Forms 8823 were issued to the taxpayer. (Note: the amount and type of information SHA's share with examiners differs across the country.)

Note: Be aware that the owner of the LIHC property under audit may also own other LIHC properties. Therefore, when talking to the LIHC Compliance Unit and SHA, it is important to inquire as to whether or not there additional LIHC projects owned by the same taxpayer.

The **Owner**. If the owner is determined to be an active, "hands-on" individual that is involved in many aspects of the LIHC property, they are the best source of information. However, some owners are distant operators who rely on management companies and property managers to conduct the day-to-day business operations.

Note: please remember that, under IRC §7521(c), a taxpayer cannot be required to accompany an authorized

representative to an examination interview without an administrative summons. However, the taxpayer's voluntary presence at the interview can be requested through the representative as a means to expedite the examination process. (See IRM 4.10.3.2.1)

The **Property Manager or Management Company,** if a management company is involved. It is recommended that you interview both the management company, as well as each of the respective property managers. This enables you to determine the extent of internal control at all levels of the operation and ensure that both the property manager and management company are giving you consistent and accurate information.

What to Ask

IRM 4.10.6.3.1(1) states: "Questions asked during the initial interview with the taxp ayer and/or representative should provide the examiner with an understanding of the taxpayer's background and knowledge, familiarity with the business operations, and an overview of the taxpayer's books and records. It is also appropriate to ask the taxpayer if they are aware of any errors on the return and discuss any issues identified during the pre-audit analysis." Interviews are important because oral testimony can provide information not otherwise available and establish the taxpayer's intent and due diligence. (See IRM 4.10.4.2) This is your opportunity to:

- Assess the owner's and manager's overall knowledge of the LIHC property,
- Assess the owner's and manager's knowledge of IRC §42 and compliance requirements,
- Determine what the owner has done in response to Forms 8823 issued in the past by the state housing agency,
- Identify all books and records maintained by the owner and property manager,
- Identify how tenants' initial applications are solicited and screened,
- Identify all actions taken to verify application information,
- Identify how income recertifications are done, and
- Assess internal controls within the entity.

Where Interviews Should Be Conducted

IRM 4.10.3.2.2 states that the Secretary will set the time and place of interviews, as long as the interview is reasonably scheduled. IRM 4.10.2.7.6, Place of Examination, states that (generally), examinations should be conducted at the location where the original books, records, and source documents are maintained. Also, under Treas. Reg. §301.7605-1(d)(3)(iii), examiners have the right to tour the taxpayer's business to establish facts that can only be ascertained by a direct visit, regardless of where the examination takes place (See IRM 4.10.3.3.1). In short, conduct the interview anywhere that is reasonable and conducive to business.

When Interviews Should Be Conducted

In order to avoid subjecting taxpayers to repeated interviews, it is recommended that you defer the initial interview with the owner and property manager until after you gather all available information from the LIHC Compliance Unit and state housing agency. With this information, you should be able to better understand the type of LIHC project you are auditing.

Then, before conducting the interview, you should review all available books and records presented by the taxpayer in response to their initial Information Document Request (IDR). By doing this, you should be able to identify any inconsistencies between the IRS, state housing agency, and the books and records that should be discussed with the taxpayer or property manager.

Why Are Interviews A Good Audit Technique?

Because an effective interview is an excellent audit tool that will expedite any LIHC examination.

Contacting State Housing Agencies: Third Party Contact Notification

By Grace Robertson, Program Analyst

Under IRC §42, state housing agencies are responsible for allocating low-income housing credits, monitoring LIHC properties, and issuing notices of noncompliance to the IRS. As a result, the state agencies maintain complete property histories, beginning with the taxpayer's submission to receive a credit allocation, and are the best source for information (other than the taxpayer) about the property.

IRC § 7602(c) requires the IRS to provide advance notice to the taxpayer when contacts may be made with third parties (see IRM 4.10.1.6.12 for more details). Most likely, contacts with the state agencies will be to gather information that is consistent with open records laws, but repeated or in-depth contacts with a state housing agency may be perceived as adversely impacting a taxpayer's reputation or future ability to obtain allocations of credit.

Therefore, state agencies should not be contacted about specific taxpayers without first providing notice to the taxpayer. Agents should use Letter 3164E.

The best way to find your state agency contact is through the National Council of State Housing Agencies (NCSHA), which is a national, nonprofit organization created by the state housing agencies to assist them in increasing housing opportunities for lower income and underserved people. The NCSHA supports a website (www.ncsha.org) which includes links to the individual state housing agencies' websites, where you can find general information about the agency and contacts.

? *Grace Notes* ?

On August 26th, A&E aired a segment of Investigative Reports titled "Wage Slaves: Not Getting By in America". Frankly, not the kind of show I generally want to spend my "escape" time watching. However, because of my involvement with the LIHC program, I knew it was a program I ought to watch…and I want to share some of the information with you.

The program takes a look at how people working for hourly wages live. These are people working long hours at physically exhausting, mentally challenging jobs. As the narrator described them, these people are not the fringes, but are the very fabric of society.

- *¼ of the American workforce earns between $7 and $8 an hour or about $15,000 a year*
- *77 million American live in near poverty – 24% earn $16,000 or less a year*
- *The federal minimum wage is $5.15/hour – that's $206 per week BEFORE taxes*
- *20% of children live in poverty*
- *75% of single-parent families with two or more children have incomes that fall below minimum subsistence budget levels*
- *25% of low-income families are unable to make rent or mortgage payments at some point in a 12 month period and 40% of Americans are just two paychecks away from homelessness*
- *75% of low-wage workers have a high school education or less*

Okay, I can really understand why one interviewee described being a wage slave as living with anxiety: waking up to anxiety and, at the end of an anxiety filled day, going to bed with anxiety. I'd be anxious, too.

The program presented opposing views and pointed out that being poor in America is still much better than being poor anywhere else in the world, and even better than the middle class in many parts of world…(it's all relative). And yes, the working poor do have access to many more consumer goods (that may help to mask their poverty), but two big ticket items are still beyond the grasp of the working poor – adequate health care and housing. According to HUD, the median cost of a home in 1970 was $23,000. In 2001, the median cost was $148,000. And as property values increase, so do rents. Unfortunately (and in defiance of economic principles of supply and demand) the supple of affordable housing has not increased to meet the demand.

In 1986, Congress created the Low Income Housing Credit (IRC §42). Most people agree that the program is successful – certainly, it is not the only program, and it is definitely not the only answer, but LIHC properties are intended to meet help meet housing needs of targeted groups such as the working poor.

The program is co-administered with state housing agencies, who identify the specific needs in their states, select projects best meeting those needs, and then monitor completed projects to make sure those needs are meet. Simply put, the IRS makes sure that owners of LIHC properties who agreed to, but didn't provide safe, decent, and affordable housing with properly restricted rents to qualified tenants, don't enjoy the benefits of federal tax credits.

So, you might ask, just how much housing doe the LIHC support? According to the National Council of State Housing Agencies, the state agencies allocated $462,352,901 in credits in 2001 for 67,398 new and rehabbed low-income housing units. That equals $6,860 per unit each year or $68,600 total over the 10-year credit period. Under federal law, however, the compliance period is 15 years, so now the cost is really $4,573 per year for 15 years.

Wait a minute…the taxpayer also agrees to an "extended use" of at least another 15 years. (See IRC §42(h)(6).) So if you divided that original $68,600 by 30, the cost of a low-income housing unit to the American taxpayer is $2,287 per year for 30 years.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 8 ***December 2002***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Reviewing Tenant Files

By Kent Rinehart, Revenue Agent

You're been assigned a Low-Income Housing Credit (LIHC) case with information about non-qualifying households or the state agency has report that the owner's paperwork appears incomplete. Where do you start?

First, review the property manager's procedures for qualifying new tenants. Does the owner have written procedures for the manager to follow? Determine how the property manager conducts interviews, contacts third parties for verification, and maintains the files. You'll also want to ask how the property manager handles certain scenarios; e.g., the total anticipated income for the upcoming year is less than what it will cost to reside at the property or a one-person household requests a three bedroom unit. If the property is near a college or university, how do they verify student status? How does the property manager know when it is time for the annual recertification? What happens when a tenant is determined to be over-income at recertification?

Then consider the property manager's internal controls. All tenants (18 years or older) should be asked the same questions and all the files should have the same documentation. Some basic questions include:

- Does the manager use a standardized income certification document?
- Is a management company involved? If so, what do they do? Is the management company related to the general partner (this is a common practice for LIHC properties)?
- Who reviews the property manager's work?

Finally, review the tenant files for the year under audit.

- Are the files complete?
- Are the files consistent from unit to unit and building to building?
- Are there notations explaining unusual circumstances?
- Were the files prepared timely and concurrent to the events or reconstructed after the fact?

Okay, you've talked to the property manager and owner, reviewed the tenant files, and the documentation reconciles to the tax return. Do you "no-change" this issue? Not just yet!

Income

Under IRC §42, the tenant is to provide the owner with information about the household and the total anticipated income they expect to receive during the next twelve months. Income includes, but is not limited to, earned and *unearned* income from household members age 18 and older, unearned income of minor children, and income from assets.

One quick audit technique is comparing the information in the tenant file with the income reported on the tenant's tax return. You can identify the tenant's wages, interest, social security, annuities, alimony, and other taxable sources. Generally, if the taxable income is more than the LIHC income limit, there's a potential problem.

The tenant file should include a list of all sources of nontaxable income. Nontaxable income includes, but is not limited to, deferred compensation payments, employer non-accountable allowances or reimbursements, nontaxable social security payments, insurance annuities, nontaxable retirement fund distributions, disability or death benefits paid, welfare assistance payments, child support, and regular contributions and gifts from person(s) not residing in the unit.

Together, the income per tax return and the nontaxable income per tenant files will provide you with an estimate to compare to the tenant's total anticipated gross income for each year. Generally, if the tenant's taxable and nontaxable income is about the same as the anticipated gross income shown on the tenant certification, there is no issue. On the other hand, if there is a discrepancy, further analysis will be needed to determine whether the tenant is qualified.

Size of Household

Since the income limit is dependent on the size of the household, the next step is to determine whether the

tenant's file reflects all the members of the household. Indicators of potential problems include:

- One name on a lease for a unit with multiple bedrooms,
- The tenant's income (as reported in the file) is not sufficient to pay the rent and a reasonable estimate of living expenses,
- Rent payments from more than one person,
- Separate leases for amenities, such as garage space. You may find different names for rental of garage space than names on the rent roles.

Request a listing of all the tax returns filed with the LIHC project's address. If there are more names than the taxpayer provided, you probably have unrecorded household members.

Analysis

Analyzing all this information is not an exact science. You will need to evaluate the property manager's diligence and efforts to identify qualified tenants and satisfy yourself that you've accounted for all tenants for each unit of the property.

Basically, you are looking for what doesn't make sense. It is important for you to question certain things that are inconsistent with tight budgets. For example:

- Why would one tenant want to rent a three-bedroom apartment?
- How can this tenant pay for expenses when total income is less than half of what it costs to live in the unit?
- Why are there two separate rent payments being recorded each month for a unit with only one individual listed as the tenant?
- Why does this one tenant need two parking spaces?

If the facts don't add up, chances are there is an unrecorded tenant that the property manager knew, or should have known about.

Requirements for Participating Nonprofit Entities

Grace Robertson, Program Analyst

Under IRC §42(h)(5), Congress provided additional tax incentives for qualified nonprofit organizations to be involved in the development and management of IRC §42 properties. The nonprofit (usually a general partner with less than a 1% interest) is subject to specific requirements.

Last October, TEGE released their CPE material for 2002, which included a chapter on determining whether a nonprofit entity participating in the LIHC program is a qualified tax-exempt organization. The text was released to the public and has heightened awareness of the requirements for nonprofits participating in the program.

10% Set-Aside

Under IRC §42(h)(5), the state agencies responsible for allocating the low-income housing credit must set aside a minimum of 10 percent of their total credit ceiling for projects involving qualified nonprofit organizations. You can determine whether the LIHC project received an allocation from the 10% Set-Aside by contacting the state agency. If the taxpayer did not receive the credit allocation from the 10% Set-Aside, then the entity is not subject to the nonprofit rules.

Qualified Nonprofit Organizations Defined

A qualified nonprofit organization is any organization meeting the tax-exempt requirements of IRC §§501(c)(3) or 501(c)(4), and for which one of the charitable purposes includes the fostering of low-income housing.

Examiners can confirm that the nonprofit entity is a qualified tax-exempt organization by using the IRS website (www.irs.gov). Enter "78" into the "Search IRS site for" feature; the response will be "Most likely you are looking for Publication 78, Search for Exempt Organizations"; clicking on the underline portion will provide an alphabetical listing of exempt organizations.

Rev. Proc. 96-32, 1996-1 C.B. 717, provides guidance for determining whether a qualified nonprofit organization involved in low-income housing is pursuing a charitable purpose by fostering low-income housing; the determination is based on the percentage of low-income units provided and the income level of the tenants. These guidelines are applicable continuously throughout the 15-year compliance period. An organization must establish (for each project) that at least 75 percent of the units are occupied by residents whose incomes are 80 percent or less of the area's median gross income, and either

- 40 percent of the units are occupied by residents whose incomes are 60 percent or less of the area's median income, or
- 20 percent of the units are occupied by residents whose incomes are 50 percent or less of the area's median income.

Ownership Test

Qualified nonprofit organizations must have an ownership interest in the low-income housing project throughout the 15-year compliance period. The nonprofit can own an interest directly, or indirectly through a partnership, or

own stock in a qualified corporation that owns a low-income housing project. A qualified corporation must be a corporation that is 100-percent owned at all times during its existence by one or more qualified nonprofit organizations.

Material Participation

The qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period. IRC §469 is referenced as the definition of "materially participate"; IRC §469(h) defines material participation as activity that is regular, continuous, and substantial. Treas. Reg. 1.469-5T further defines "material participation" for individuals, but the general guidance can be used to address a nonprofit's requirements.

- The nonprofit must participate for more than 500 hours during the year; or
- The nonprofit's participation must constitute substantially all of the participation; or
- The nonprofit's participation must be more than 100 hours during the year, and this participation is not less than the participation of any other owner of the property; or
- The nonprofit's participation in multiple projects must exceed 500 hours, or
- Facts and circumstances show that the nonprofit's participation was on a regular, continuous and substantial basis.

Maintaining Control

Under IRC §42(h)(5)(C)(ii), the qualified nonprofit organization must maintain control over the partnership; that is, a developer acting as a co-general partner cannot control the partnership. The qualified nonprofit and for-profit organizations should not be related parties; i.e., share officers or board of directors. Such relationships may indicate that that the sole purpose of the nonprofit organization is to pass on the tax benefit to the related entity and shared officers.

The question is whether the nonprofit organization acts exclusively in furtherance of a charitable purpose or does the partnership (other partners) cause the organization to further the interests of private investors? Although there is no all-inclusive list, here are some indicators that the nonprofit entity is not acting exclusively to further the charitable purpose.

- The nonprofit not the only general partner,
- The nonprofit's minority general partner interest provides for minimal control over the LIHC operation,
- The nonprofit makes guarantees to the limited partners against loss of low-income housing credits, or
- Excessive private benefit resulting from real property sales, development fees, or management contracts,

LIHC Adjustments

As a matter of Compliance policy, the low-income housing credit will be disallowed in its entirety for the period of time that the nonprofit:

- is not a qualified tax-exempt organization,
- did not meet the requirements of Rev. Proc. 96-32,
- was controlled by a for-profit organizations, or
- did not materially participate in both the development and on-going operation of the project.

Owners may be able to correct the noncompliance and resume claiming the credit. For example, if the nonprofit losses its tax-exempt status, another qualified nonprofit entity may be substituted. However, depending on the facts, the credit may be permanently disallowed, which will trigger a credit recapture event under IRC 42(j).

? *Grace Notes* ?

Happy Holidays!!!!!
& Thanks for all your help and support!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 9 ***April 2003***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

A New Voice in Philadelphia

By Angie Kaminskt, Compliance Unit Manager

The states of Alaska, Georgia, Idaho, Indiana, Maine, New Mexico, Texas, and West Virginia all have a new contact person at the Philadelphia Campus. We welcome Jim McGoldrick to the LIHC Team. His phone number is (215) 516-7668. He may not have all the answers yet, but he knows how to get them!

First Year Applicable Fraction – Not as Simple as the Months in Service Divided by Twelve

by Nancy Rudolph, Revenue Agent

I have recently done two different LIHC cases. In both cases, the credit claimed by the taxpayers was computed by taking the total state allocation and multiplying it by a months-in-service fraction (number of months in service divided by 12 months in a year). Each taxpayer failed to consider their actual occupancy in the fraction.

IRC § 42(f)(2) provides for a special rule for the first year of the credit period. This section determines the first year credit by summarizing an applicable fraction for each month a building was in service during the initial year based on the percent occupied by low-income residents.

For example, suppose a taxpayer does not elect to defer the credit (see line 10a of Form 8609) to begin the first year after the building is placed in service. The building is placed in service September 10, 2001.

Low-income occupancy applicable fractions:

January – September	0 %
October	60 %
November	80 %
December	100 %
TOTAL	240 % / 12 months = 20%

A fraction for September is not included above because the building was not in service for a full month.

The part year fraction is both applied to the qualified basis and the state allocation. Therefore, if the state allocates $100,000 in credits and the applicable fraction is 20%, then the first year credit is limited to $20,000 ($100,000 times 20%).

This was an easy and substantial adjustment in both cases. Therefore, any time a taxpayer wants to claim a credit during the initial year, make sure they are in compliance with IRC § 42(f)(2) both in applying the fraction to qualified basis and to the state allocation.

Report Writing for an Unagreed Case—Getting Appeals and Others to Understand IRC § 42

By Kent Rinehart, Revenue Agent

For an agreed case, the shorter the explanation of items — the better—so long as the taxpayer agrees and signs the report.

But no matter how simple an LIHC issue appears to be, if the taxpayer does not agree, it is important to fully develop all aspects of each issue so that your manager, Appeals, and Counsel fully understands the issues and computations in your report.

To help with this, IRM § 4.10.7 focuses on Issue Resolution and all the legal authorities the IRS may use to make its case. The overview states that it is imperative that examiners identify the applicable law, correctly interpret its meaning in light of congressional intent, and, in a fair and impartial manner, correctly apply the law based on the facts and circumstances of the case.

And for unagreed cases, IRM § 4.10.8.10.2 describes what is involved with the preparation of Form 886-A, Explanation of Items. My personal experience has been that the two toughest areas for any unagreed Explanation of Items is the Applicable Law and the Argument sections.

For LIHC issues, Applicable Law includes, but is not limited to, everything from the Code (current and prior provisions), Federal Tax Regulations, Committee Reports (House, Senate, etc.), Code of Federal Regulations, Revenue Procedures, Revenue Rulings, Notices, IRS Publications (including form instructions and worksheets), tax cases, Private Letter Rulings, and more.

Also, LIHC issues are often intertwined with guidelines from the Department of Housing and Urban Development (HUD). Their manual also provides supplemental authority for determining the Area Median Gross Income and the income limits for qualifying tenants.

It may also be necessary to cite from the manuals and other authorities that each State Housing Agency uses to allocate and monitor the credits issued to taxpayer.

A taxpayer may even support a position by using hearsay, or oral testimony, from a person at the IRS, HUD, State or some other authority. They might even have a written document from someone that they are using to support their position.

Therefore, it is important for examiners to clearly illustrate, in narrative form, everything and everyone the taxpayer relied on in reflecting any amount in question on their return. The date of the evidence, the source of the evidence, and the authority of the evidence should be reflected in the explanation of items.

Examiners must show all of the different perspectives (IRS, HUD, State, etc.), law, guidelines or other authority that supports or refutes the taxpayer's position. Once all laws and arguments have been exhausted, examiners can arrive at their conclusion based on all this information.

As an examiner with an unagreed case, your goal is to convey everything you know about the issue to all interested parties. LIHC issues are unique and unfamiliar to many throughout the IRS. The more information they have about the entire issue—the better chance the issue can be resolved in a fair and equitable manner.

Overall, for any unagreed LIHC case—a bigger Explanation of Items is a better one!

Nonprofit Entities—Are they involved and do they have direct control?

by Christopher Ropa, Revenue Agent

IRC § 42(h)(5) provides that a portion of a State's LIHC ceiling will be set-aside for projects involving qualified nonprofit entities. At first glance, having a nonprofit entity involved might lend credibility to any LIHC project. However, one question that needs to be asked is: How involved are they?

In a memorandum dated January 13, 2003, from the Director, Reporting Compliance, the requirements for participating qualified nonprofit organizations are identified. Two of the requirements cited pertain to "material participation" and "maintaining control."

For material participation, the nonprofit participation must be determined to be one of the following:

- More than 500 hours during the year; or
- Constitute substantially all of the participation; or
- More than 100 hours during year and this participation is not less than any other owner; or
- Participation in multiple projects must exceed 500 hours, or
- Participation was regular, consistent and substantial

For maintaining control, the following are indications that a nonprofit does not have sufficient control over an LIHC project:

- Nonprofit is not the only general partner,
- Nonprofit's minority general partner interest provides for minimal control over the LIHC operation,
- Nonprofit makes guarantees to limited partners against loss of low-income housing credits, or
- There is an excessive private benefit resulting from property sale, development or management.

One document that establishes who participates and controls an LIHC partnership is the partnership agreement. The agreement should stipulate who has direct control, and to what extent, as well as who has the ultimate decision-making responsibility for the entity.

Other documents that need to be inspected include all management agreements, including all third party management company contracts. Examiners need to identify all parties responsible for making any decision pertinent to the operations of the LIHC project.

In the case of third party management companies, the examiner needs to determine whether the management company is acting as an agent of the taxpayer. This is

particularly important in determining whether or not the nonprofit owner materially participated.

Then, an analysis needs to be made of the project's internal controls to see how each decision-making process works. The question to be answered is: Exactly who is making the key decisions for the taxpayer?

The fact that an entity is labeled as nonprofit or tax-exempt does not mean that it is automatically compliant with the LIHC program.

If it is determined that a qualified nonprofit is not materially participating or maintaining control, then they are not allowed to claim LIHC received under IRC § 42(h)(5). However, owners may be able to correct the noncompliance and resume claiming LIHC. For example, if the nonprofit loses its tax-exempt status, another qualified nonprofit may be substituted. However, depending on the facts, the credit may be permanently disallowed, which will trigger a credit recapture event under IRC § 42(j).

Uniform Documentation Required to Comply with IRC § 42

By Kent Rinehart, Revenue Agent

A memorandum dated August 25, 1999, from the National Director, Compliance Specialization, clarifies the State housing agencies' authority to require standardized documentation of compliance with IRC § 42.

IRC § 42(m) outlines responsibilities of housing credit agencies for administering the program, including procedures for monitoring taxpayer compliance after receiving credit allocations. Federal Tax Regulation 1.42-5 outlines procedures state agencies must follow to monitor for noncompliance. Further, § 1.42-5(a)(2)(ii) specifically provides that monitoring procedures may contain additional provisions or requirements.

The IRS determined that because the compliance monitoring regulations under IRC § 42 established minimum standards, Agencies have the right to control the documentation required within their jurisdiction to fulfill their compliance monitoring responsibilities as outlined in Federal Tax Regulation 1.42-5(c)(2)(ii)(C), including the use of standardized forms or documents.

It is also reasonable for Agencies to request new or additional documentation from an owner, if they determine that the documentation provided by a property owner is not adequate. And, if such inadequate documentation prevents an Agency from determining if a project is in compliance with IRC § 42, then the Agency can properly hold that the project is out of compliance.

This memorandum continues to be in effect today as Agencies continue to make their own monitoring procedures more efficient and effective to ensure compliance with the LIHC program.

"I don't have Form 8609!"

by the Acting Answering Service for Grace Robertson

I've received a number of different phone calls about Form 8609, Low-Income Housing Credit Allocation Certification. And having worked cases where taxpayers claimed LIHC without any Form 8609—or claimed more LIHC than what was allocated on Form 8609—I wanted this opportunity to convey to readers my perspective of the importance of this form.

IRC § 42(l) provides for the certifications and other reports to the Secretary that are required of all taxpayers. In short, a Form 8609 must be filed before any credits are claimed.

If a taxpayer wonders how they can claim the credit on their initial return if they do not have Form 8609, the best answer is to file an extension and an amended return when a valid and signed Form 8609 is received from the State Housing Agency.

Along with having Form 8609, the form's Part II, First-Year Certification is equally important. IRC § 42(l)(1) provides that in the case of a failure to make the certification required on the date prescribed, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable by with respect to such building before such certification is made.

Therefore, Form 8609 and the first year certification go hand in hand. And, no credits are allowed until a valid Form 8609, including the first year certification are submitted to the IRS.

You, as an examiner, will need to consider any reasonable cause presented by the taxpayer and the certification can be made as part of the audit.

Some of this information can be corroborated with the State Housing Agency or some other reliable third party (e.g., extended use agreement). Other information may not be so readily available and examiners will need to review taxpayer's overall due diligence in handling all paperwork associated with the LIHC project.

When considering reasonable cause, examiners should analyze all documents the taxpayer provided the State Housing Agency. Some factors to consider are:

- Was the information provided by the taxpayer complete and accurate or was it necessary for the State Housing Agency to repeatedly follow up with the taxpayer for more information.
- Was the information submitted by the taxpayer timely or is there evidence of unnecessary delays.
- Were there extenuating circumstances that delayed the Form 8609 from being finalized (e.g., owner did not secure permanent financing).
- What actions did taxpayer initiate with the State Housing Agency and what responses were received pertaining to why Form 8609 was not issued.

The fact remains that a taxpayer is not entitled to any LIHC until they have Form 8609 in hand. Therefore, the burden of proof will weigh heavily on the taxpayer to show reasonable cause in claiming any credit prior to being issued a Form 8609 by a State Housing Agency.

The importance of Form 8609 for the LIHC program is analogous to Form W-2 for wage earners that have federal and state income taxes withheld from their pay. Wage earners can't file a return reflecting any income tax withholding on their return unless it is supported by a Form W-2 attached to the return. Likewise, why should any LIHC be claimed by a taxpayer that does not have Form 8609 from the State Housing Agency?

In classifying LIHC returns for examination, the first thing we look for is a valid Form 8609 attached. If none is attached, then examiners will need to closely scrutinize any reasonable cause offered by the taxpayer.

? *Kent's Comments* ?

"Relax! Grace is still in charge!"

She is still editor-in-chief and is the National Contact for the LIHC program. She is allowing me to step into her shoes for a few weeks. (It's just that I'm a bit taller and they don't make her shoes in my size!)

Grace and I are here to assist you with any question, concern, or suggestion you have about the LIHC program. We welcome your input and want you to share your accounts of cases that we can share with others in this newsletter.

Understanding all aspects of IRC § 42 is not easy. This newsletter gives you the "bigger" picture of the LIHC program from the perspective of National Office to that of examiners in the field. The perspectives we share from all of you will help all of us with future LIHC issues. Keep up the good work!

You can find me on Outlook. For the rest of the story, you can always contact:

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 10 ***August 2003***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

New Technical Guidance Website Includes LIHC Information

Reporting Compliance has launched a new website called Technical Guidance, which is designed to assist technicians with the day-to-day examination work. There is a section for the Low-Income Housing Credit. You'll find the ATG and position papers for specific issues, back issues of the LIHC Newsletters, contacts, and research material.

The address is **http://sbse.web.irs.gov/tg/**, then go to the "Industry and Issues" tab on the home page to find the link to Low-Income Housing Credit. The website is for internal use only, and is not available to the public.

"Calling" A Bond: Procedural Update

Under IRC §42(j)(1), if, at the end of any taxable year in the compliance period, the qualified basis of any building is less than it was at the end of the preceding taxable year, then the taxpayer must recapture the accelerated credit associated with the decreased qualified basis; i.e., there has been a disposition of property, or an interest therein, or a reduction in qualified basis for another reason.

In the case of a disposition of property, recapturing the accelerated credit can be avoided if an owner selling a building, or interest therein, posts a bond equal to the amount specified on Form 8693, Low Income Housing Credit Disposition Bond, and the LIHC project is expected to remain in compliance for the balance of the compliance period. As an alternative, under Rev. Proc. 99-11, taxpayers can pledge certain United States Treasury securities to the IRS as security.

When a LIHC noncompliance issue is identified during an audit that triggers the LIHC recapture provisions, examiners should include an adjustment to recapture the accelerated portion of the credit for all prior years of the credit period, as well as disallowing the low-income housing credit in the year under audit. In the event that the taxpayer under audit is not the owner throughout the compliance period, it will be necessary to "call" the bond to recapture the accelerated portion of the credit from the previous owner(s).

Audit Techniques

To timely identify properties that have changed ownership, examiners should:

- Ask the taxpayer during the initial interview,
- Compare the name and EIN on the Form 8609, Low-Income Housing Credit Allocation Certification, to the name and EIN on the tax return, and
- Review the Schedules K-1 from the prior, current and subsequent year returns to identify changes in the partnership ownership. (Schedule K-1 includes a line to be checked if it is the partner's final K-1.)

Since the entity under audit is providing affordable housing, it is likely that a prior owner placed a bond with the IRS. The LIHC Compliance Unit at the Philadelphia Campus maintains the bonds and Form 8693. If a prior owner is identified, call Sam Aloi at 215-516-7609 for information about existing bonds. Be prepared to provide the building identification numbers (BIN).

Audit Adjustments: Identified Prior Owner

If the audit of a LIHC property results in the recapture of accelerated credits, then:

- The audit report for the taxpayer under audit should be limited to recapture of accelerated LIHC for the years the taxpayer owned the property.

- When the case is settled, the LIHC Compliance Unit will be provided the following information. The information should be provided without regard to whether a prior owner posted bonds.

    1. Copy of the audit report indicating the adjustments to the LIHC, the reasons why, and the taxpayer's agreement report.

    2. A schedule indicating all BINs, the years impacted, and the amount of the accelerated credit to be recaptured for each year. The LIHC Compliance Unit will calculate the interest portion of the recapture.

The information should be sent to:

Internal Revenue Service SB/SE
Attn: Sam Aloi, Drop Point 607 South
Philadelphia Campus
P.O. Box 331
Bensalem, PA 19020

New Revenue Ruling for Community Service Facilities

As part of the Community Renewal Tax Relief Act of 2000, IRC §42(d)(4)(C) was added to include property used to provide services to nontenants as part of the eligible basis used for determining the LIHC amount. There are specific requirements:

1. The property must be located in a qualified census tract. (See IRC §42(d)(5)(C)(ii)(I).)

2. The property must be subject to the allowance for depreciation and not otherwise accounted for.

3. The property must be used throughout the taxable year in providing any community service facility.

The law applies to credit allocations after 2000 or, if the building does not need an allocation under IRC §42(h)(4), buildings placed in service after 2000.

Community Service Facility Defined

Under IRC §42(d)(4)(C)(iii), a community service facility must be designed to service primarily individuals whose income is 60 percent or less of the area median income. According to the revenue ruling, the requirement is satisfied if the following conditions are met:

- The facility must be used to provide services that will improve the quality of life for community residence; i.e., day care, career counseling, literacy training, education (tutorials), recreation, and out-patient clinical health care.

- The taxpayer must demonstrate that the service provided will be appropriate and helpful to individuals living in the area. This may be demonstrated in the market study required under IRC §42(m)(1)(A)(iii).

- The facility must be located on the same tract of land as one of the buildings that comprises the qualified low-income housing project.

- If fees are charged for the services, they must be affordable to individuals whose income is 60 percent or less of the area median income.

Limit on Cost

Under IRC §42(d)(4)(C)(ii), the cost of the community service facility cannot exceed 10 percent of the eligible basis of the qualified low-income housing project of which it is a part.

HUD Releases Revised Handbook 4350.3

HUD has released a new revision of their Handbook 4350.3, which includes guidelines for determining a tenant's income. The effective date is June 12, 2003.

The guidelines are used to determine whether a prospective household is income qualified for LIHC housing. To qualify for LIHC housing, each household must certify that their income for the 12-month period *following* the certification will be within the income limit. Income includes the income of the head, spouse or co-head, and other adult members of the household.

Guidance on Nonprofit Ownership of LIHC Projects Included on the 2003-2004 Priority Plan

Under IRC §42(h)(5), Congress provided additional tax incentives for qualified nonprofit organizations to be involved in the development and management of IRC §42 properties. A qualified nonprofit organization is any organization meeting the tax-exempt requirements of IRC §§501(c)(3) or 501(c)(4), and for which one of the charitable purposes includes the fostering of low-income housing.

Generally, it is an industry practice for investors (limited partners) in LIHC property to include guarantees and indemnification requirements in their partnership agreements with the general partner. When the general partner is a qualified nonprofit organization, the question arises as to whether the guarantees results in a profit motive sufficient to compromise the qualified nonprofit organization's charitable purpose and status under IRC §§501(c)(3) or 501(c)(4).

Chief Counsel has announced plans to update guidance addressing the requirements for qualified nonprofit organizations participating in the LIHC program. The guidance will help qualifying nonprofit organizations obtain exempt organization determination letters more quickly and provide criteria for evaluating the operation of existing LIHC properties that received LIHC allocations under IRC §42(h)(5).

Regulation Project to Update Rules for Utility Allowances

Under IRC 42(g)(2)(B), the maximum rent that may be paid by the tenant is to be reduced by a utility allowance. The rules for determining the utility allowance are included in Treas. Reg. §1.42-10.

Chief Counsel has received approval from the Treasury Department to open a project to review the methodologies used for determining the amount of the allowance. The IRS is concerned that there are barriers making it difficult for taxpayers to comply with the rules.

Frequently Asked Questions *(The States' Side)*

Question 1: Owners and property managers want to charge tenants a higher rent for month-to-month leases than for a longer-termed lease, such as six months. Is this okay?

Answer: The month-to-month lease "fee" is considered additional rent. As long as the rent plus the month-to-month fee plus the utility allowance doesn't exceed the rent limit, charging a month-to-month is acceptable. The important point is that it is considered part of the rent subject to restriction under IRC §42(g)(2).

Question 2: How is the compliance period calculated?

Answer: The compliance period begins on the first day of the taxable year that is the first taxable year of the credit period. In other words, the credit and compliance periods will begin in the same year.

For example, a building is placed in service on July 1, 2001. Most LIHC property owners are partnerships with taxable years beginning on January 1st, so the compliance period starts on January 1, 2001 and ends on December 31, 2015. See Internal Revenue Code §42(i)(1).

? *Grace Notes* ?

I'm back! And thanks to Kent Rinehart for taking over in grand fashion while I was gone.

As you can see, there are significant efforts being made to update the program and address issues directly impacting the production of LIHC housing and the accessibility to a growing population of households in need of affordable housing. We'll be talking more about the changes in the future, but I just want to take a moment to thank those who have worked to bring these efforts to completion….it takes a whole lot of patience!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 11 ***December 2003***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

This edition of the LIHC newsletter is dedicated to answering some of those little questions – like stocking stuffers! Happy Holidays!!!!

Noncompliance After A Disposition: *Who is Responsible?*

Question: A LIHC building was sold to a new owner who keeps the building in the program. Shortly after the purchase, a compliance review of a building revealed noncompliance that existed prior to the sale, is outstanding at the time of the review, and remains out of compliance at the end of the correction period. How should this be reported to the IRS?

Answer: The Form 8823 should indicate the date the noncompliance began (line7) and since the current owner has not corrected the noncompliance, the date the noncompliance was corrected is blank (line 8). The owner's information (lines 2 and 4) should identify the current owner. For purposes of reporting noncompliance, it doesn't matter whether the property was sold.

The new owner will be held accountable for correcting the noncompliance, even though the former owner is responsible for creating the noncompliance. There may be a disallowance of credit in years open by statute and recapture under IRC §42(j). If the former owner posted a bond, the IRS could collect the recapture from the bond.

Recapture Bonds: *Where can you find a bonding company?*

Bond companies can be found at www.fms.treas.gov/c570/c570.html

Recordkeeping: *How long does a taxpayer need to keep tenant files?*

Under Treas. Reg. §1.42-5(b)(2), taxpayers must retain records for 6 years after the due date (with extensions) for filing the tax return for that year. Treas. Reg. §1.42-5(b)(1) includes a list of 9 specific items taxpayers need to retain.

Example: A taxpayer files the 2001 tax return on May 20, 2002, (with an extension). 2001 is *not* the first year of the credit period. The records must be retained until May 20, 2008.

There is an exception for the first year of the credit period. These records must be maintained for at least six years after the due date (with extensions) of the tax return for the last year of the 15-year compliance period of the building, of 21 years.

Example: A taxpayer files the 2001 tax return on May 20, 2002, (with an extension). 2001 is the first year of the credit period. The records must be maintained until May 20, 2023.

Why so long for the first year?

The taxpayer will need the records to document the Applicable Fraction for Form 8609 Schedule A:

- Line 2, Applicable Fraction
- Line 7, Qualified Basis
- Line 17, the deferred credit

Form 8609, Schedule A, is filed with the taxpayer's tax return for *every year of the 15-year compliance period.*

Student Rules: *What if a newly married couple has never filed a joint tax return?*

Under IRC §42(i)(3)(D)(ii)(II), a unit will not fail to be considered a LIHC unit because it is occupied by a full-time students *if the students are married and file a joint return.*

If the couple is applying for a LIHC unit during the year in which they were married and, therefore, cannot provide a copy of a filed joint return, ask the couple for a copy of their marriage certificate to establish that the couple is entitled to file a joint return. They can provide a copy of their tax return when it is filed.

DDAs and Census Tracts: *What's the difference?*

Difficult to Develop Areas (DDA)

As defined in IRC §42(d)(5)(C)(iii)(I), Difficult to Develop Areas are defined as areas where the costs of construction, land, and utilities are high compared to the Area Median Gross Income. Under IRC §42(d)(5)(C)(i), the Eligible Basis of building in a DDA is "stepped up" to 130% of what it would otherwise be. In these locations, more credit is needed to subsidize costs that cannot be supported by debt or repayment from the future cash flow from rents.

Census Tracts

Census tracts are defined by the character of the population; i.e., more individuals fitting the "low income" definition within a limited area. Under IRC §42(d)(5)(C)(ii)(I), a "qualified" census tract is any census tract where:

- 50% or more of the households have income less than 60% of the Area Median Gross Income,

OR

- A poverty rate of at least 25%.

In addition to the 130% stepped-up basis under IRC §42(d)(5)(C)(i), the Eligible Basis of buildings in qualified census tracts can include the cost of community service facilities; the cost cannot exceed 10% of the eligible basis of the qualified low-income housing *project* of which it is a part. See Rev. Rul. 2003-77 for complete discussion.

Where can I find a list of DDAs and Qualified Census Tracts?

You can find lists of DDAs and Qualified Census Tracts at www.huduser.org/datasets/qct.html.

How do I know if the credit is computed on a "stepped up" Eligible Basis?

The percentage will be identified on Form 8609, Part I, line 3b.

Statutes of Limitations: *What are they?*

Generally, the statute of limitation is the amount of time the IRS has to audit or make a change to a tax return after it is filed. Normally, it is three years from the due date for filing the return or the date the return is actually filed, whichever is later. See IRC §6501(a).

What if a return is filed fraudulently?

In the case of a false or fraudulent return, or the willful attempt to evade tax, the assessment of tax can be made at any time. The IRS can also begin a proceeding in Court to collect tax. See IRC § 6501(c)(1) & (2).

What if a taxpayer doesn't file a tax return?

The statute of limitation doesn't begin until the tax return is filed. The assessment of tax, or beginning of a proceeding in Court to collect tax, can be made at any time. See IRC §6501(c)(3).

How do Statutes of Limitations apply to tax returns with IRC §42 credits?

Taxpayers claiming low-income housing credits are subject to the same rules as everyone else; i.e., there is a three-year statute of limitation triggered by the filing of a tax return.

However…

Because the taxpayer claims the credit over a ten-year credit period, but must provide low-income housing for a fifteen-year period, a portion of each year's credit is associated with the future provision of the housing. If the taxpayer does not provide the housing, there is a recapture event.

Under IRC §42(j), the IRS has authority to "recapture" the portion of credit from prior years associated with the promise to provide affordable housing in the future if the taxpayer does not provide the promised housing. Even though the statute of limitation may have expired, the credit can be recaptured from all the prior year returns for which the credit was allowable - *all the way back to the first year of the credit period* – because of this special rule. And interest will accrue all the way back to the time the credit was originally claimed.

IRS Audits: *What's the difference between the disallowance of credits and the recapture of credits?*

Disallowed Credits

When the IRS audits a LIHC tax return and determines that the taxpayer *claimed* too much LIHC, the amount of excess is "disallowed"; i.e., it is not allowable. This is an adjustment to *current* year credits.

Recaptured Credit

If, under the rules in IRC §42(j), it is necessary to "recapture" credits claimed in prior years because the taxpayer did not provide the affordable housing in future years. This is an adjustment to account for excess credit claimed in prior years.

? *Grace Notes* ?

At this time of year, when we reflect upon our accomplishments and set new goals for the coming year, I thought I would share the values included in the Kwanzaa celebration.

Umoja- Unity
Kujichagulia – Self Determination
Ujimaa – Collective Work and Responsibility
Ujamaa - Cooperative Economics
Nia – Purpose
Kuumba – Creativity
Imani – Faith

You can find out more about Kwanzaa at http://www.officialkwanzaawebsite.org

I like setting aside the week between Christmas and New Years, and focusing my attention on one value each day. I don't limit myself to the seven presented here, but include those that might have more immediate meaning in my life right now.

I hope that this holiday season of celebration will include a moment or two for reflection, gratitude and preparation for the coming year.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 12 ***February 2004***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Interviewing LIHC Property Owners: What to Ask?

For LIHC tax returns, the interview is an effective technique to gather information about the taxpayer, their business activities, and their on-going property management practices.

Preferably, since most LIHC tax returns are TEFRA partnerships, the Tax Matters Partner (TMP) should be interviewed. Although, as provided by IRC §7521(c), a taxpayer's presence is voluntary, the IRS has the right to interview the TMP, general partner, or a knowledgeable authority that has power to make decisions for the taxpayer. Since the financial structure and management of LIHC properties can be complex, consider issuing a summons if a representative cannot respond adequately to specific questions. (See IRM 4.10.3.2.1.)

Starting the Interview

A good place to start the interview is to confirm basic information about the person you are interviewing:

- Ask them about their background in dealing LIHC properties. What training or education have they had throughout their career?
- Ask them about how long they have worked with LIHC issues and how many different properties they've handled.
- Also, find out how long they have been working for this taxpayer. Were they employed last week or have they been with this project from the start?

Background Information

Now that you've put the interviewee at ease and found out a little bit of information about them, the interview should focus on the project you are examining:

- Ask the taxpayer to provide a basic history of the development of the property.
- Ask the taxpayer about the LIHC application process and their working relationship with the housing authority that allocated the credit. Find out if they encountered any problems and how they were resolved.
- Ask who developed the property, and if there is any relationship between the developer and either the general partner or the management company. If any of the three parties are related, you will want to take a closer look at the developer fee. See how much was included in Eligible Basis and whether there is a note payable or any conditions for payment (performance or subjugation to other debt). Find out how much of the fee has actually been paid and if the developer has foregone any payments (forgiveness of debt) and whether the rules for related-party transactions have been followed.
- How many buildings in the project? Are the buildings 100% LIHC units, or is this mixed-use property? Confirm the existence of any real property, other than the actual LIHC rental property, that was included in the *Eligible Basis*; i.e., a community club house, swimming pool, parking lots and storage units, or a community service facility under IRC §42(d)(4)(C).

- Ask the taxpayer to describe what you can expect to see when you conduct the tour of business. Ask the taxpayer about the external grounds to the property. Is there a retention pond? How much landscaping was brought in to accent this project? How did the taxpayer account for these costs?

- Ask the taxpayer to clarify the information on Forms 8609 filed with the tax return. While line 3 identifies the maximum *Qualified Basis*, you will need to know the underlying *Eligible Basis* and *Applicable Fraction*. For the Applicable Fraction, identify which method (units or floor space) the taxpayer used to determine the fraction used to compute the credit. Also confirm the date each building was placed in service.

- Part II, of Form 8609, includes elections specifying the conditions under which the property will be operated. Three of the more important elections are whether the building is part of a multiple-building project, the selection of the minimum set-aside, and whether the owner elected to postpone the beginning of the credit period to the year after it is placed in service. Confirm that the building is operating, and the LIHC was computed, according to these elections.

Ask the taxpayer to clarify the information on Forms 8609-A, which provide information specific to that year's operations. Particularly, how many units or how much floor space was in service at the end of the first year and qualifies for the full credit under IRC §42(a)? How many units, or how much floor space, was placed in service after the end of the first year of the credit period and is subject to the credit computation under IRC §42(f)(3). Lines 7-10 of Form 8609-A account for the additional qualified basis and reduced *Applicable Percentage.*

Project Financing

There are really four areas that need to be explored.

- How was the cost of acquisition (land and/or existing buildings) and construction financed, other than the equity investment? What you are looking for is financing from federal sources; loans and grants for which there are specific rules.

- Also ask if there were loans from the developer or a partner to the partnership; i.e., these loans may be disguised funds from federal sources. If there is a loan from a "related party", ask what the interest rate is. What are the terms of repayment? The actual costs included in *Eligible Basis* can be addressed when you review the books and records.

- How were the costs of forming the partnership handled? They should be identifiable in the taxpayer's books. These costs cannot be included in *Eligible Basis*.

- How were the costs of syndicating the LIHC handled? Again, they should be identifiable in the taxpayer's books and cannot be included in *Eligible Basis.*

Day-to-Day Operations

The focus should be on the taxpayer's internal controls intended to ensure that households are properly qualified, the rents are correctly restricted, and that the property is physically well maintained. While the TMP or general partner may be able to provide only a high-level overview of the procedures, the information will be valuable when touring the property and working with the site manager.

- Does the taxpayer manage the property, or is an *independent* management company responsible for day-to-day operations? If a management company operates the property, what kind of oversight does the taxpayer provide? Identify the individual who actually manages the property. Who do they report to? What is the chain of command from this point to the owner (or to the person you are interviewing)?

- How are potential tenants identified? Are they targeting a particular market segment or providing assisted living services?

- What advertising and marketing strategies does the taxpayer use to attract tenants? Ask what pamphlets, fliers, or other information they make available to the public that advertises their property. Ask if there is a web page for the property. Where possible, secure copies. Note if the information presented in these documents is consistent with the interviewee's oral testimony. This information is needed to evaluate whether the taxpayer has violated the Vacant Unit Rule under Treas. Reg. 1.42-5(c)(ix).

- What are the procedures for income-qualifying potential tenants and making sure the other requirements (like student status) are met?

- Ask the taxpayer to explain the procedures used to ensure that the Available Unit Rule under IRC §42(g)(2)(D) is not violated.

- How does the taxpayer identify and monitor changes in household size? What procedures are in place to do this? For these questions, you want to find out how diligent the taxpayer is in making sure that the actual size of the household matches tenant information in the file. (How easy is it for one person to rent a 3-bedroom unit and let two of his buddies have a room without the taxpayer knowing?)

- Ask whether or not the taxpayer has ever evicted a tenant. Along with this, inquire as to the procedures they use against an undesirable tenant.

- What procedures are in place to identify needed repairs or maintenance? Does the taxpayer make regular, physical inspections of rental units? What are some of the things that taxpayer has found when making such inspections? Who can approve minor repairs? Who can approve major repairs? Who follows up to ensure that such repairs are properly completed?

- While you can evaluate the physical maintenance of the property during the tour of the site, ask the taxpayer if reserves are required and maintained to ensure that repairs and routine maintenance is completed. How are these accounted for?

- Rent ceilings are determined by HUD, based on location, the location's median gross income, and the size of the household. During the audit, you will be confirming that the rent did not exceed the limit. However, there are adjustments to the rent limit, which should be addressed during the interview:

  → Payments under Section 8 of the United States Housing Act of 1937,
  → Utility Allowances if the tenant is responsible for paying utilities,
  → Fees for supportive services, and
  → Rental payments under Section 515 of the Housing Act of 1949

  See IRC §42(g)(2) for details.

<u>Form 8823 Notices of Noncompliance</u>

Since most audits are identified through classification of Form 8823, Report of Noncompliance, filed by the state housing agencies, you will most likely need to address the identified issues during the audit. The interview with the taxpayer is an ideal time to get information.

- Why did the noncompliance occur?

- What steps has the taxpayer taken to correct the noncompliance? And if it was possible to correct the noncompliance, when was it corrected?

- What steps has the taxpayer taken to ensure that noncompliance will not occur in the future?

<u>Due Diligence</u>

Did I say before that the rules for LIHC properties are complex?

- Ask what procedures and internal controls are in place to ensure that the property stays in compliance.

- Has an internal audit been conducted? If so, ask to see the report.

- Has the investment group (limited partners) conducted an independent review or audit? If so, ask to see the report.

- Has the site management employees received training? What type of training have they received? Is their work reviewed?

- What happens when noncompliance is identified, other than by the state housing agency during their review? Have the interviewee give you an example of such noncompliance that they have identified and corrected.

- How and where are the tenant files, as well as books and records maintained? Remember, you will need to review the tenant files for the first year as well as the year under audit

Conclusion

The interview topics addressed here are specific to compliance with IRC §42 and they are not all-inclusive to each LIHC project you will examine. Additional questions should be added for new large, unusual or questionable (LUQ) items you see on an LIHC return. You will also need to address topics applicable to all residential rental real estate; i.e., reporting of income, expenses, etc. This interview is generally your first chance—and best chance to obtain the necessary information to help you analyze all the issues that may arise under the provisions of IRC §42.

Computing the Credit for the First Year of the Credit Period: Impact on Subsequent Years' Computation

IRC §42(f)(2)(A) provides the methodology for computing the LIHC for the first year of the credit period. It is based on the number of units that were occupied by qualified households each month.

Audit Adjustment: The taxpayer may have computed the credit using a fraction based on the month the building was placed in service, not occupied.

Under IRC §42(f)(2)(B), the LIHC disallowed in the first year is allowable in the 1st year following the credit period. In English, that's the 11th year of the compliance period. This amount will be on line 17 of Form 8609-A.

Audit Adjustment: Since LIHC properties tend to change ownership as they approach the end of the credit period, it is important to recognize that the new owner in year 11 is entitled to the disallowed credit from year 1. Of course, this assumes that the new owner maintains the property as low-income housing and is in compliance. The point is, the disallowed 1st year credit is not treated like a carryforward of unused credit associated with the original owner.

Under IRC §42(f)(3)(A), if the *Qualified Basis* as of the end of any taxable year in the compliance period (after the end of the first year of the credit period) is more than the *Qualified Basis* at the end of the first year of the credit period, then the *Applicable Percentage* applied to the excess *Qualified Basis* is 2/3 of the *Applicable Percentage* which would otherwise be applied. And under IRC §42(f)(3)(B), the averaging rule for computing the credit for the first year is applied to any increase in *Qualified Basis* for the first year of such increase.

Audit Adjustments:

- For tax years after the 1st year of the credit period, the taxpayer claimed LIHC based on 100% of the *Qualified Basis*, rather than identifying the excess portion and reducing the *Applicable Percentage.* The computation is accounted for on Form 8609-A, lines 7-10. The potential issue is easily identifiable because lines 7-10 are left blank.

- Under Treas. Reg. 1.42-5(b)(2), the taxpayer must keep the records for the first year of the credit period until six years after the date for filing the tax return for the last year of the 15-year compliance period. Altogether, that's at

least 21 years! If the taxpayer cannot produce the records for the first year of the credit period, then the *Applicable Fraction* cannot be determined and the taxpayer not entitled to any LIHC under IRC §42. *OUCH!*

Revenue Procedure 2003-82: Qualifying Tenants Before the Beginning of the First Year of the Credit Period

How do you qualify tenants for LIHC units when you acquire an existing building with tenants, or tenants move into rehabilitated units before the beginning of the first year of the credit period? Rev. Proc. 2003-82 provides a safe harbor procedure.

A residential unit in an existing building under IRC § 42(i)(5) or a new building under IRC §42(e)(1) will be considered a LIHC unit at the beginning of the first taxable year of the building's credit period if:

1. The household in the LIHC was income qualified on the later of the date the building was acquired or the date the household occupied the unit,

2. The income of the household was first tested for purposes of the Available Unit Rule (IRC §42(g)(2)(D)(ii) and Reg. 1.42-15) at the beginning of the first taxable year of the building's credit period, and

3. The unit is rent restricted under IRC §42(g)(2) from the later of the day the taxpayer acquired the building or the date the household occupied the unit to the beginning of the first taxable year of the compliance period.

Question 1: What does it mean to "test" the income?

Answer: At the beginning of the first taxable year of the credit period, the owner should perform an income recertification.

If the original certification was done within 90 days of the required "test", it is not necessary to *verify* all the income information. Simply confirm with the household that the income anticipated has not changed. The annual recertification date will be based on the original certification date.

If the original certification was done more than 90 days prior to the beginning of the first taxable year of the credit period, it will be necessary to conduct a complete recertification, including the verification income information. The next recertification will be due a year later.

Example:

A taxpayer purchased an existing building on March 15, 2004 and anticipates beginning the credit period on January 1, 2005.

Household A occupied a unit at the time of the purchase and was determined to be income-eligible. On January 1, 2005, Household A would be recertified. All subsequent recertifications would be due on January 1st.

Household B was income qualified as a new tenant and moved into a rehabilitated LIHC unit on August 1, 2004. On January 1, 2005, Household B would be recertified. All subsequent recertifications would be due on January 1st.

Household C was income qualified as a new tenant and moved into a rehabilitated LIHC unit on November 15, 2004. On January 1, 2005, Household C's income was "tested", but it was not necessary to verify the income. All subsequent annual recertifications would be due on November 15.

Just an Administrative Reminder

All LIHC cases should include Project Code 670 and ERCS tracking code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

If you believe it is appropriate to survey a LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

? *Grace Notes* ?

Can't help but notice that this month's newsletter is…hmmm, shall we say… a little "long" and perhaps " narrowly" focused on a single audit technique? We all know how important a well-planned interview with the taxpayer is for any audit, and that is no less true for LIHC audits.

Often, the information provided by the taxpayer will explain what would otherwise be perplexing transactions or business practices. Of course, the most positive outcome is that the information provided by the taxpayer helps save everyone time and effort by eliminating insignificant issues

Another thing to keep in mind is that there will be a number of key people that you may formally interview, or informally talk to, about the LIHC property. If this is the case, you'll need to adapt the interview questions and format to gather additional information from these key people:

- *Owner (TMP)*
- *Management Company (especially if there are numerous properties),*
- *Property or Site Manager (for the LIHC property under audit)*

Because all these people have at least an ownership or employment interest with the taxpayer, they will have unique insights based on their different perspectives. Also, the state agency that allocated the LIHC will give you another perspective that will help provide a more complete picture of the taxpayer.

A good interview will also help you narrow the scope of the audit to the critical few large, unusual, or questionable items. But, for the IRC §42 credit, there's so much beyond the routine audit of the taxpayer's financial books and records! And now that you've asked the questions, and you've got loads of paper with detailed answers, how do you sort it all out?

Hang in there and take a deep breath! The next few newsletters will be follow-ups where we take each of the topics addressed in the interview and explain the associated issues in detail.

Also, please keep checking in with the Technical Guidance website, where we are adding more and more audit tools to help you. (http://sbse.web.irs.gov/tg/) Note: the web page is not available to external stakeholders.

Finally, thanks to everyone who has submitted questions and suggestions. Keep 'em coming!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 13 ***April 2004***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Reporting the LIHC Recapture Amount on Form 1040, Individual Income Tax Return

During 2003 you sold your LIHC building (or interest therein) and you've decided not to post a bond under IRC §42(j)(6). You diligently work your way through the computation on Form 8611 and get to Line 12. The instructions tell you to "enter the total on the appropriate line of your return." So, where's that?

The LIHC recapture amount is an increase in tax that should be included with "Other Taxes". For an individual, these additional taxes are included on lines 55-59 of Form 1040. So, you look at these lines, and there isn't a line for LIHC recapture. Now what do you do?

Recognizing that there isn't a specific line, write "LIHC Recapture F. 8611 and the dollar amount after "This is your total tax" on line 60. Then add the recapture amount to any other "Other Taxes" that need to be reported and report the total in the column for line 60.

What's NOT Included in Eligible Basis?

By Kent Rinehart, Program Analyst

As the needs of LIHC property owners change, so do the components of construction costs for such projects. Historically, LIHC properties have evolved from 100% low-income projects to more and more mixed-market projects. The evolution continues today, as it is not uncommon to see LIHC projects that now include commercial businesses, office space, community service facilities, and other common areas that warrant closer scrutiny when it comes to determining Eligible Basis.

IRC §42(d) lists all provisions for identifying Eligible Basis. For this article, we want to touch on some of the items that are not considered eligible basis.

IRC §42(d)(3) provides that Eligible Basis must be reduced by the cost of non-low-income units that are above the average quality standard of the low-income units in the building. If an owner is building one type of unit for LIHC households, and a much nicer unit for market rate tenants, the costs for such market rate units will not be included in Eligible Basis. There is an exception under IRC §42(d)(3)(B). If the difference in cost between the market-rate and LIHC units is not greater than 15% (and there's a definition for computing the 15%), then the taxpayer can elect to exclude just the excess cost from Eligible Basis.

IRC §42(d)(4)(A) provides that Eligible Basis is determined without regard to the basis of any property that is not residential rental property. Therefore, any commercial, industrial, retail or office space cannot be included as part of Eligible Basis. Likewise, land costs, the cost of permanent financing, syndication costs, and other non-residential rental property costs are not includable in Eligible Basis.

IRC §42(d)(4)(B) provides that common areas or amenities for LIHC projects are generally included in Eligible Basis, if the property is subject to depreciation. However, if the amenity is not designated for use by all tenants, the cost is excluded from Eligible Basis.

IRC §42(d)(4)(C) was recently added as part of the Community Renewal Tax Relief Act of 2000. It provides that costs for community service

property are included in Eligible Basis with a couple of restrictions. First, the allocable costs for such community service property shall not exceed 10 percent of the Eligible Basis of the qualified LIHC project. Also, the community service facility must be designed to serve primarily individuals whose income is 60 percent or less of the area median gross income.

IRC §42(d)(5) provides that Eligible Basis is reduced by all federal grants that finance the cost of construction.

With all of the above variables, how might you allocate costs when a mixed-use building has market rate units that are twice as nice as the LIHC units, the building has commercial businesses on the ground level, and there's a "members only" swimming pool? To answer this multi-faceted question, the thing to do is to find a reasonable manner through which to allocate costs. Unfortunately, a simple square footage analysis may not be the most reasonable method especially considering that construction costs for commercial, market-rate, or exclusive lounges are probably higher than the building costs for LIHC units.

The first step should be to determine what the overall cost of the project was, as well as the project's total square footage. You can then determine an average cost per square foot for this project as a whole.

Then, based on your physical tour and inspection of the types and quality of construction, you can identify areas where the square footage cost was higher. It isn't an exact science, but the fact remains that if more work went into constructing a particular area—then a higher square footage cost should also apply to this area. Conversely, the areas of lesser work (most likely LIHC units) would, in turn, reflect a lower square footage cost compared to the overall average.

With more and more factors to consider, it is important to remember what types of costs are not includable in Eligible Basis. Once you identify all the attributes of a particular project, you will be better able to establish your own reasonable methodology for determining the cost for each attribute compared to the project as a whole.

And Now There Are Two: New LIHC Analyst Joins the Team

Kent Rinehart, a former LMSB Revenue Agent, has been selected for a Program Analyst position on SBSE's Examination Specialization and Technical Guidance team. Kent will continue to support the LIHC program and provide technical assistance to the field. He can be reached at 715-836-8751, ext. 239, or on e-mail at **Kent.H.Rinehart39@irs.gov** .

Updated Contact Information for the LIHC Compliance Unit

As many of you know, the LIHC Compliance Unit is responsible for processing the Forms 8823 submitted by the state agencies. This form is filed to report noncompliance identified during a state agency's review of the tenant files or inspection of the physical property. The forms are also reviewed when selecting LIHC returns for audit.

Examiners can call the LIHC Compliance Unit to get more information about the taxpayer under audit. The LIHC Compliance Unit also has the Forms 8609, Forms 8693, and Recertification Waivers. Here are the contacts, by state:

Steve Kennedy: (215) 516-7624 - Arkansas, District of Columbia, Hawaii, Montana, North Dakota, Rhode Island, Pennsylvania, Virgin Islands, Vermont

Sharon DiGiulio: (215) 516-7196 - Connecticut, Delaware, Michigan, Nevada, Ohio, South Dakota, Utah, Wyoming

Ann Grey: (215) 516-7613 - Alabama, Kansas, Kentucky, Missouri, New York, Washington, Wisconsin

Jim McGoldrick: (215) 516-7668 - Alaska, Georgia, Idaho, Indiana, Maine, New Mexico, Texas, West Virginia

Angie Kaminski (temporarily): (215) 516-4113 - Florida, Iowa, Illinois, Massachusetts, Mississippi, Puerto Rico, Tennessee
Donzella (Bonnie) King: (215) 516-7621 - Nebraska, New Hampshire, New Jersey, Oklahoma, Oregon, South Carolina, Virginia

Carol Orzechowicz: (215) 516-7147 - Arizona, California, Colorado, Louisiana, Maryland, Minnesota, North Carolina

If you need to contact the LIHC Compliance Unit by mail, here's their address.

Internal Revenue Service
P.O. Box 331
Philadelphia Campus, LIHC Unit, DP 607 South
Bensalem, PA 19020

Monitoring LIHC Cases

Project Code 670 has been established for LIHC audits. If you expand an audit to include additional years or taxpayers, please remember to update the Project Code on the new returns. Same for the Tracking Code, which is 9812.

Surveying LIHC Returns

Should it become necessary to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be transmitted by e-mail or faxed to (202) 283-2240.

♫Grace Notes♫

We decided to include an article focusing on the costs NOT includable in Eligible Basis because determining the accuracy of the costs is a fundamental aspect of an LIHC audit. And it's not as if Eligible Basis is as straightforward as adding up the receipts!!!

Kent, in his article, identified attributes that will help you key in on audit issues:

- *Assets that are used for a purpose other than as residential rental property or a related amenity.*
- *Unequal treatment of market-rate households and LIHC households, such as access to amenities or the quality of the rental units.*
- *Duplicating of federal funds, such as a loan with below market rate interest.*

Of course, there are other considerations, as some costs should be associated with the land, or separate land improvements, and there are costs that should be allocated….and there are costs, such as the expense incurred to form a partnership, that are amortized independently…isn't accounting fun?

In future editions, we will continue to focus on these key areas of IRC §42. If there's something specific you would like us to address – just let me know.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 14 ***August 2004***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

IRS Chief Counsel recently released Revenue Ruling 2003-38 to answer frequently asked questions. While not all 12 questions are included in this newsletter, we want to alert you to those that will immediately affect the on-going operation of a LIHC building.

Frequently Asked Questions *(The Management Company's Side)*

Question 1: The first tenant for a newly constructed LIHC unit moved in on the last day of a month during the first year of the credit period. The unit was correctly rent-restricted and complies with all the requirements under IRC §42. There is a special rule for determining the Applicable Fraction for the first year based on a month-to-month consideration of occupancy. Is a unit occupied only the last day of the month treated as a low-income unit for that entire month?

The answer is provided in Rev. Rul. 2004-82, Q&A #4. Yes, the unit is treated as a low-income unit for the entire month if an income-qualified tenant resides in the rent-restricted unit on the last day of the month. However, the building must have been placed in service for the full month.

Question 2: The Vacant Unit Rule requires owners to make reasonable attempts to rent vacant LIHC units before renting market rate units. What are reasonable attempts?

The answer is provided in Rev. Rul. 2004-82, Q&A #9. The determination is made on a case-by-case basis, considering the facts and circumstances, and may differ from project to project depending on factors such as the size and location of the project, tenant turnover rates, and market conditions. Also, the different advertising methods that are accessible to owners and prospective tenants would affect what is considered reasonable. Question 9 in the revenue ruling included the following examples:

- banners and for rent signs at the entrance to the project,
- classified advertisements in local newspapers,
- maintaining a waiting list and contacting prospective low-income tenants, and
- using a local public housing authority list of Section 8 voucher holders to identify and contact potential tenants

Question 3: Is a signed, sworn self-certification by a tenant sufficient documentation to show that the tenant is not receiving child support payments?

The answer is provided in Rev. Rul. 2004-82, Q&A #12. Yes, a signed, sworn self-certification by a tenant is sufficient documentation to show that a tenant is not receiving child support payments. In addition, the self-certification should indicate whether the tenant will be seeking or expects to receive child support payments within the next 12 months. If the tenant possesses a child support agreement but is not presently receiving any child support payments, the tenant should include an explanation of this and all supporting documentation such as a divorce decree and court documents to enforce payment. Also, the self-certification should indicate that the tenant will notify the owner of any changes in the status of child support.

A housing credit agency's monitoring procedure, however, may not permit an owner to rely on a low-income tenant's signed, sworn statement if a reasonable person in the owner's position would conclude that the tenant's income is higher than

the tenant's represented annual income. In this case, the owner must obtain other documentation of the low-income tenant's annual child support payments to satisfy the documentation requirement.

In addition, a housing agency's monitoring procedure may continue to require that an owner obtain documentation, other than the signed sworn statement to support a low-income tenant's annual certification of child support payments.

Frequently Asked Questions *(The Taxpayer's Side)*

Question 1: State agencies require applicants to pay a nonrefundable application fee. If the state agency selects a project, an additional allocation fee is payable to the agency. Are the application fee and allocation fee includable in the eligible basis of the owner's low-income housing building?

The answer is provided in Rev. Rul. 2004-82, Q&A #3. Neither fee is includable in the eligible basis for computing the credit because the fees are not included in the adjusted basis used for computing depreciation. However, depending on the facts and circumstances, all or a portion of these fees may be required to be capitalized as amounts paid to create an intangible asset, or are deducted as an ordinary business expense.

Frequently Asked Question *(The States' Side)*

Question 1: The state agencies are responsible for monitoring LIHC properties for noncompliance with the requirements of the LIHC program and at least once every three years are required to review the tenant files and perform a physical inspection of the property. How long must the state agencies retain the documentation of the review and any forms 8823?

Under Regulation 1.42-5(e)(3)(ii), an agency must retain records of noncompliance or failure to certify for six years beyond the housing agency's filing of the respective Form 8823. In all other cases, the agency must retain the certification and related documents for three years from the end of the calendar year in which the agency receives them.

Question 2: And what about all the records that an owner must keep; can an owner comply with the recordkeeping and record retention provisions under Treas. Reg. 1.42-5(b) by using an electronic storage system instead of maintaining hardcopy (paper) books and records?

The answer is provided in Rev. Rul. 2004-82, Q&A #11. Yes, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97-22. However, *and this is really important,* complying with the recordkeeping and record retention requirements of the Service does not exempt an owner from having to satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the housing agency. For example, the housing agency may require the taxpayer to maintain hardcopy books and records.

For the basic requirements of maintaining records in an automated data processing system, including electronic storage systems, see Rev. Proc. 98-25, 1998-1 C.B. 689.

New Procedures for Income Recertification Waivers Under Revenue Ruling 2004-38

Owners of LIHC buildings are required to recertify each low-income household at least annually. The recertification process is identical to the initial certification in terms of documenting household composition, income, and income from assets. Owners must also verify income with third party sources to confirm that the tenant is disclosing all income.

Under IRC §42(g)(8)(B), the IRS may waive the requirement to complete annual income recertifications if the entire building is occupied by income qualified tenants. The waiver limits the intrusiveness of annual recertifications for the tenants and lowers the costs of recertification for the building owner.

Rev. Proc. 2004-38, affective for applications filed with the IRS after July 6, 2004, introduces

new procedures for obtaining the waiver. Waivers granted under Rev. Proc. 94-64 are still valid.

New Form

A new Form 8877 is used to document the owner's request for the waiver and facilitate timely approval by the IRS. Two important items have been added:

First, the state agency must confirm that the building is 100% low-income and provide the owner with an exemption from their annual income recertification requirements. The state agency's signature on the form replaces the separate statement formerly required under Rev. Proc. 94-64.

Second, the owner must agree to IRS disclosure of any subsequent revocation of the waiver to the state agency. The consent is included as Part II of the Form 8877. The IRS will not approve a waiver unless the owner has signed the disclosure consent.

Effective Date

The waiver is now effective on the date it is signed by the IRS, which is much earlier than the effective date under Rev. Proc. 94-64. It remains in effect for the remainder of the 15-year compliance period, unless it is revoked.

Grounds for Revocation

The waiver may be revoked for three reasons:

1. the state agency requests that the waiver be revoked,
2. the building ceases to be 100% low-income, or
3. the IRS determines that the owner has violated IRC §42 in a manner sufficiently serious to warrant revocation.

The waiver is automatically revoked if there is a change in ownership (including a termination under IRC §708). The new owner may apply for a waiver.

Tracking LIHC Exam Cases

Please make sure that your LIHC cases are properly identified for tracking purposes. Project Code is 670, the Tracking Code is 9812, and there should also be a "Y" Freeze Code. Should it become necessary to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be transmitted by e-mail or fax to (202) 283-2240.

♫Grace Notes♫

Every morning I eagerly open my e-mail, curious to find out whether someone has sent me an "interesting" LIHC question. Not long ago, I was asked why the IRS uses the acronym LIHC rather than LIHTC – like the rest of the world.

Well, not that the IRS is egocentric or anything, but including "T" in the acronym would be rather redundant for us – everything we do revolves around taxes – and of course a credit is a tax credit!

For the affordable housing industry, the story isn't quite so easy. There is a multitude of financing options to complement the IRC §42 incentive for equity investment – including, in some part of the country, a state income tax credit. Including "T" in the acronym really does help clarify what the credit is referencing.

As for the title of this newsletter - well, I'm a very efficient person and four key strokes for LIHC is one less the five for LIHTC! Given the number of times I type that acronym virtually every day – I must save at least three minutes of work every day!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

P.S. August is a traditionally quiet month here in DC. It is extraordinarily quiet this year! Hope you are all enjoying a very restive holiday.

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 15 November 2004

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Fiscal Year 2005 LIHC Priorities

As we begin a new fiscal year, it is time to review the requirements and priorities for conducting examinations of tax returns on which the LIHC under IRC §42 is claimed.

Issue Identification

State level housing agencies are responsible for monitoring LIHC properties for compliance. When noncompliance is identified, the state agencies notify the IRS using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. These reports of noncompliance are the primary source of information for selecting returns for audit.

Case Building

Returns sent to the field for audit will include case building documents including a classification checksheet identifying audit issues, copies of Forms 8823 and supplemental explanations submitted by the state agency, and technical guidance for specific LIHC issues.

Minimum Audit Requirements

At a minimum, examiners should complete the following minimum audit procedures:

- Noncompliance – determine the extent that the noncompliance identified by the state agency still exists.
- Eligible Basis – review the taxpayer's records to confirm that only allowable costs have been included in the computation.
- Habitation Standards – tour the property to ensure that the property is well maintained and suitable for occupancy.
- Tenant Eligibility – review the taxpayer's tenant files to ensure that households are properly qualified as eligible for LIHC housing.
- Rent Limits – ensure that the restricted rent is correctly computed and allowances under IRC §42(g)(2) are correctly computed.

Failure to Certify under IRC §42(l)

If the taxpayer cannot provide Forms 8609, Low-Income Housing Credit Allocation Certification, signed by the state agency, then the entire LIHC should be disallowed and accuracy-related penalties considered because the taxpayer has knowledge that the completed building/project was not approved by the state agency and the taxpayer is attempting to circumvent the certification requirement under IRC §42(l).

LIHC Recapture under IRC §42(j)

If the state agency has reported an LIHC recapture triggering event, or that the taxpayer is no longer participating in the program, the audit can be limited to consideration of the recapture provisions under IRC §42(j).

The LIHC recapture adjustment has two components; (1) the amount of accelerated LIHC claimed in prior years (IRC § 42(j)(2)(A)) and interest, at the *overpayment* rate, for each prior taxable period that accelerated LIHC was claimed, starting with the due date for filing the return for each prior taxable year involved (IRC § 42(j)(2)(B)) and ending on the due date of the return under examination. From that point forward, the regular *underpayment* interest rate will apply to the LIHC recapture adjustment and any other adjustments made to that return.

Investor Returns

Investor returns are also selected for audit when the taxpayer failed to correctly recapture the LIHC under IRC §42(j) or did not correctly and/or timely secure a surety bond/securities under IRC §42(j)(6).

Getting a LIHC Recapture Adjustment onto the Examination Report

IRS software for examination reports is continuously updated and upgraded. Here are some tips that will get your LIHC recapture adjustment on your report.

For individual and C corporation returns, LIHC recapture is the equivalent to an "Other Tax" adjustment. For flow-through entities, LIHC recapture will be a Schedule K adjustment that ultimately flows to each respective return that claimed the accelerated LIHC.

Historically, the software that the IRS has used did not provide a clear or exact title for an LIHC recapture adjustment. The key is to ensure that the "Other Tax" or "Schedule K" adjustment amount on your report matches your adjustment for the LIHC recapture issue. Then, you can better illustrate and explain how you arrived at the total recapture amount in your Explanation of Items that accompanies the examination report.

In the Explanation of Items, you should clearly illustrate how the total LIHC recapture amount was determined. Because LIHC recapture amount is the total of the accelerated LIHC plus interest, it is recommended that you reflect each adjustment year by year to explain how the recapture amount was computed.

The accelerated portion (IRC § 42(j)(2)(A)) of LIHC claimed in prior years is the easiest component of the overall recapture adjustment. A taxpayer will know what LIHC was allowable for a building in prior years and can also determine one-third of this amount for each year.

The interest component of the recapture adjustment is a bit more complex. In its simplest context, once you know the accelerated portion of LIHC to recapture in each year, you compute interest, at the overpayment rate, from the due date of each return on which accelerated LIHC was claimed through the due date of the return you are examining.

Therefore, if you are recapturing from five prior years to the year you are examining, you will need to make five different interest computations under IRC § 42(j)(2)(B). Each computation will have a different start date for interest, but have the same ending date.

Overall, the amount of any recapture interest on accelerated LIHC is computed through the due date of the return you are examining. From that point forward, underpayment interest will apply to the LIHC recapture amount as it would for any other issue that you adjust during your examination.

Just remember, your examination report simply needs to reflect the proper number as an "Other Tax" or "Schedule K" adjustment—your Explanation of Items can do all the rest.

Transferring Tenants Between Buildings Under Rev. Rul. 2004-82

Rev. Rul. 2004-82, Q&A #8, provides guidance for transferring a tenant to a LIHC unit in a different building.

Q-8: On July 1, 2003, an income-qualified household (Household) initially occupied a rent-restricted residential rental unit in Building 1 of Project. On October 31, 2003, the property manager moved Household (and transferred Household's lease) to a similar rent-restricted unit in Building 2 of Project that was not previously occupied. Household occupied the Building 2 unit at the end of 2003. The unit Household vacated in Building 1 was unoccupied during November and December. Are both units in Buildings 1 and 2 low-income units at the end of 2003?

A-8: No. While a vacant low-income unit generally retains its character as a low-income unit, where an owner simply moves a tenant from a unit in one building to a unit in another building in the same project, both units may not be treated as low-income units; rather, only the unit that the tenant actually occupies at the end of a month in

the first year of the credit period and at the end of each year in subsequent years qualifies as a low-income unit. Thus, in this situation, while the unit in Building 1 vacated by Household was treated as a low-income unit during the months it was occupied by Household, the unit ceased to be treated as a low-income unit when Household vacated the unit. At that time, the vacated unit would be treated as a unit not previously occupied.

Follow-Up Questions

Question 1: Must the household certify as a new household when they move to a different building?

No. The lease, as well as the underlying income certification, moves with the household to the new LIHC unit as part of the transfer.

Question 2: Does it matter why the tenant moves?

No. The household moved at request of the owner in the revenue ruling example, but a transfer can occur at the request of the household as well. The purpose of this rule is to increase the owner's flexibility and ability to accommodate a household's changing needs without jeopardizing the LIHC.

Question 3: If a tenant moves out of a unit in building A during the first taxable year of the credit period to occupy a unit in building B and the unit in building A is not occupied by a qualified household by the end of that first year, will the LIHC unit in building A qualify for the full credit?

No. The unit in building A swapped status with the unit in building B, and is considered to be a "never occupied" unit at the end of the year. Under IRC §42(f)(3), the Applicable Percentage is 2/3 of the applicable percentage used for units first occupied during the first year of the credit period and the first year computation rule.

Question 4: Does the rule apply throughout the compliance period, or just the first year?

The rule applies throughout the 15-year compliance period.

Question 5: What is the household's income is more than 140% of the income limit at the time of the transfer?

The units "swap" status. The unit the household moves to turns into an "over-income" unit subject to the Next Available Unit Rule.

Resident Managers' Units: Treatment Under Rev. Proc. 92-61

Under Rev. Rul. 92-61, a unit occupied by a full-time resident manager is included in the Eligible Basis of a qualified low-income building under IRC §42(d)(1), but the unit is excluded from the applicable fraction under IRC §42(c)(1)(B). The unit is considered a facility required for the benefit of the project.

Question 1: Must the resident manager be income eligible for LIHC housing?

No, the resident manager is not required to be income qualified.

Question 2: Can the owner charge the resident manager rent?

No, the unit is considered a facility required for the benefit of the project. If the owner charges the resident manager rent, then the unit is a rental unit and must be included in denominator when calculating the Applicable Fraction. The unit is a market rate unit if the resident manager is not income-qualified and/or the rent not restricted.

Question 3: Can a unit be turned into a LIHC rental unit if no longer needed for a resident manager?

Yes. Changing a unit from a resident manager's unit to a LIHC rental unit is permissible. The unit will be included in the numerator and denominator of the Applicable Fraction for that year. Rev. Rul. 92-61 addresses this circumstance.

Question 4: If a unit is no longer needed as a resident manager unit, can a unit be used for another purpose that qualifies as a facility required for the benefit of a project?

Maybe. Since the state agencies generally approve the use of a rental unit for a resident manager, an owner should make sure the state agency approves any alternative use. Once the state agency's approval is secured, an owner needs to request a private letter ruling to obtain IRS approval since

Rev. Proc. 92-61 is specific to the use of a LIHC unit as a resident manager's unit and cannot be cited as authority using a LIHC rental units for other purposes.

Treatment of Application Fees: PLR 9330013

Application fees may be charged to cover the actual cost of checking a prospective tenant's income, credit history, and landlord references. The fee is limited to recovery of the actual out-of-pocket costs; no amount may be charged in excess of the average expected out-of-costs for checking tenant qualifications at the project.

As an alternative, it is also acceptable for the applicant to pay the fee directly to the third party actually providing the applicant's rental history.

Documenting Households with Zero Income

Under Regulation 1.42-5(b)(1)(vii), owners of LIHC properties must document each low-income tenant's income certification with documents such as federal income tax returns, Forms W-2, etc. But, how far does the IRS expect a LIHC property manager to go when a prospective tenant claims to have zero income?

The regulation cited above makes an exception for tenant receiving housing assistance payments under Section 8. The requirement is satisfied if the public housing authority provides a statement to the owner stating that the tenant's income doesn't exceed the income limit.

In other cases, the prospective tenant may sign an affidavit attesting to the fact that they have no income. But, like verifying assets with a value of $5,000 or less with affidavits, owners may not rely on a low-income tenant's signed, sworn statements if a reasonable person would conclude that the tenant's income is higher than what the tenant has represented. In such cases, the owner must obtain other documentation of the low-income tenant's annual income to satisfy the documentation requirements.

The best way to determine whether a prospective tenant is income qualified is to conduct a detailed interview with the tenant. An interview can be used to follow up on information disclosed on the application, surface information that would not otherwise be known, and help the property manager make an informed decision.

Here are some questions that might be helpful.

- Ask if the prospective tenant has held a job or worked in the past. If the tenant has a work history, why isn't the tenant working now, or seeking employment? If the tenant *doesn't* have a work history, ask how the prospective tenant covered their expenses for the past year.
- Ask whether the prospective tenant has income from specific sources – workman's compensation, unemployment insurance, an inheritance or an allowance from a trust, for example.
- Ask how the prospective tenant intends to pay for living expenses, such as groceries and clothing in addition to rent for the next year (less than $5,000 per year equates to total expenses of less than $417 per month).
- Ask to see documentation of checking and saving account balances. If bank statements are provided, inspect the extent of deposits and withdrawals into and out of the accounts provided. Follow up to determine how the prospective tenant was able to save money.
- Ask to see loan documents; who is making the loan and how does the prospective tenant intend to repay the loan?
- Ask whether the prospective tenant has had roommates in the past. Any additional roommate can share living expenses and make a big difference. A tenant may not be hiding income from you, but may be hiding the fact that an additional tenant will be occupying the unit!

There will always be situations where it will be difficult to estimate income or determine the prospective tenant's intent. While we are discussing prospective tenants with zero income, the concept is equally applicable to tenants that

work sporadically or seasonally. In such cases, property managers and owners are expected to make reasonable judgments as to how to best estimate the income the tenant will receive in the coming year.

Ultimately the prospective tenant may be accepted as a resident of LIHC housing, and a detailed (and well documented) interview is good evidence that a property manager is applying the necessary due diligence.

New Address for Grace Robertson

Please send all correspondence to:

Grace Robertson
Program Analyst, Examination Specialization & Technical Guidance, SE:S:E:EP:ESTG
Internal Revenue Service
1111 Constitution Ave, NW, NCFB C9-466
Washington, DC 20224

LIHC Compliance Unit Address

Need to send something to the LIHC Compliance Unit in the Philadelphia Campus? Here's the address that will get all correspondence (postcards to boxes) directly to the group:

Internal Revenue Service
P.O. Box 331
Attn: LIHC Unit, DP 607 South
Philadelphia Campus
Bensalem, PA 19020

Updated Project Code – 0670

Project Codes are now four digits. Please make sure that your LIHC cases are properly identified as Project Code "0670"; the tracking code is still 9812.

"Y" Freeze Code & Surveying LIHC Returns After Assignment

LIHC Cases include a "Y" Freeze Code. Should it become necessary to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be transmitted by fax (202) 283-2240 or by e-mail to **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I thought I'd do something simple this time, and just find some Thanksgiving trivia on the Internet. But as I wandered around the net I couldn't find anything I really liked, and my mind began to wander, too

I thought about my early Thanksgivings, when my brother (ten years my senior) was still living at home and how adding just two close family friends around the tiny kitchen table created a logistics problem – no one could reach the gravy!

I remember the Thanksgiving when my cousins showed up – all of them! So Thanksgiving dinner was suddenly moved to the garage and dinner was served on a table made of plywood and saw horses while a fire blazed in the old coal stove.

There's the Thanksgiving spent with friends while living far away from home. We scrounged up two cans of soup (different flavors) that we mixed together, made rice salad (mostly rice), and miraculously, three tiny puckered apples turned into pie enough for all. Dinner tasted as wonderful as any of the feasts my mother prepared!

There are other memorable Thanksgiving dinners with unrecognizable dishes (duck?), new recipes (rum cake, anyone?), and unusual traditions like a spaghetti dinner! And, of course, there are all the Thanksgivings in between, whether with family or friends, as hostess or guest, among strangers, or celebrated in solitude.

But it really wasn't the menu that mattered then, or that is important now. It is the gratitude we feel and the thanks "giving" we express – all in our own individual way, wherever we may be.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 16 ***April 2005***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Auditing Eligible Basis

By Kent Rinehart, Program Analyst

In non-LIHC real estate rental projects, there's no need to worry about "Eligible Basis"—only the total cost of construction. For an LIHC project, total cost of construction does not equal Eligible Basis. There are costs that are not included in the Eligible Basis used to compute the amount of allowable LIHC. These costs may not be eligible because of their character, the timing of the expenditure, or because of the type of funding used to pay for the cost. In short, Eligible Basis is a term unique to LIHC (IRC §42) projects. Here are some steps to help identify the costs to which the credit applies.

Step 1: Is the cost "depreciable"?

To be eligible for LIHC, the cost must be depreciable. For example, land costs are not included in Eligible Basis. Neither are expenses related to permanent financing (loans) for the project, syndication fees, or costs related to the selling of an equity interest in a project. These costs must be either permanently capitalized, expensed, or amortized, depending on their tax purpose as provided in the Internal Revenue Code.

Step 2: Is the cost associated with residential housing?

To be eligible for Eligible Basis, the cost must also be for residential housing. This includes the costs of personal property for use by the households, such as appliances. It can also include the cost of facilities, such as garages, swimming pools and parking lots, as long as there is not a separate fee charged for the use of the facility and the facility is available to all households. For example, if the project consists of 100 units (or households), but there are only 30 garages available, the garages are not considered residential housing and cannot be included in eligible basis.

Step 3: Is the cost related to the construction of a new building or the substantial rehabilitation of an existing building?

The main thing to be aware of here is the timing difference between these two types of buildings. New building owners will make an election as to when their LIHC credit period will begin. Their eligible basis costs must be incurred by the close of the taxable year so elected.

For existing buildings with substantial rehabilitation, the cost of the acquiring the building is included in eligible basis. Substantial rehabilitation is defined in IRC §42(d)(2)(D) to mean amounts that equal or exceed 25 percent of the adjusted basis of the building. However, the owner elects a 24-month period, during with to incur and perform the substantial rehabilitation and these Eligible Basis costs end on the last day of the 24-month period elected.

Step 4: In which year does the LIHC credit period begin? [IRC § 42(d)(1)]

As indicated above, new building owners make an election that starts the LIHC credit period. IRC §42(d)(1) provides that the Eligible Basis of a new building is its adjusted basis as of the close of the 1st taxable year of the credit period. If an owner elects to claim the credits starting the year the building is placed in service (or, checks "no" on line 10a of Form 8609), the Eligible Basis is limited to all costs incurred as of the close of the year the building was placed in service. As a result, certain costs that may have been incurred

after that time (e.g. landscaping, common areas, etc.) cannot be considered part of eligible basis.

If the taxpayer elects to postpone the beginning of the credit period for a year, then the taxpayer may incur more expenses after the end of the year in which the building was placed in service. There are many reasons why a taxpayer may elect to postpone the beginning of the credit period and the taxpayer should be asked why.

Step 5: What type of financing for construction is involved?

IRC § 42(d)(5) and Treas. Reg. § 1.42-16 provide that if, during any taxable year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with federal funds, the eligible basis of the building for the taxable year and all succeeding taxable years is reduced by the portion of the grant that is so funded. Therefore, for any federal grant included as part of financing, ensure that the Eligible Basis has been reduced for such amount.

Step 6: What costs are, or are not, eligible?

In its simplest context, if the cost is directly attributable to the depreciable, residential rental property, then it should be included in Eligible Basis. For example, costs such as engineering studies, architectural specifications, pertinent legal and accounting fees, construction period interest and taxes, and general contractor fees are most often found to be directly attributable to building costs.

The costs associated with the primary residential buildings are generally pretty easy to identify and often include expenditures for accent features (like a gazebo) and landscaping directly around and adjacent to a LIHC building. As a rule of thumb, consider whether the accent feature or landscaping would be destroyed in the event a building needed to be razed. If so, then the cost is sufficiently attributable to the building to be included in Eligible Basis.

Developer Fees

Developer fees are generally included in Eligible Basis provided that the fee is reasonable. Most of the state agencies have set limits on the amount of developer fee that can be included, and the IRS generally honors these limits as "reasonable". Just be sure that any notes for developer fees actually represent debt and payment is not contingent upon the performance of the property over time – if payment is contingent on performance and the developer is also the managing partner, then the fee is really for successfully managing the property and is characterized as an operational cost. Most likely, there should also be an allocation to associate at least part of the developer fee to activities such as buying the land, syndicating the credit, and putting together the partnership. Developer fees that are essentially paid to-and-from the same person or paid to related party warrant closer scrutiny.

Land Improvements

Other costs an owner may consider attributable to their residents may require a more in-depth analysis. For example, a retention pond, no matter how beautiful, is still a retention pond and its costs are associated with land. Also, most costs of getting land in suitable condition for construction (grading and reshaping, filling, excavating, dynamiting, etc.) are also considered land costs and are not includible in eligible basis.

Conclusion

In looking at eligible basis overall, a good starting point is with the local state housing agency to see how the taxpayer presented the costs in their final cost certification. Here, you can determine what costs were excluded from eligible basis on the front-end by and whether the taxpayer had access to federal grants or loans. At this point, reconcile the taxpayer's books and records and the actual final costs and determine whether or not the taxpayer included them in Eligible Basis. It is not uncommon to discover a taxpayer that has a higher Eligible Basis than what was originally conveyed to the state, however, it is important to follow the steps above to ensure that each cost is includable.

Private Letter Rulings

By Grace Robertson, Program Analyst

Got a tax question about your LIHC property? What do you do? Call someone, of course. And after calling several people, and no one knows the answer, someone inevitably suggests that you request a private letter ruling. Sounds absolutely like something you really don't want to ever do this side of recapturing credits, but at some point it become inevitable. So, what's a private letter ruling anyway? Here's the "condensed" answer.

Private Letter Ruling (PLR) Defined

A PLR is a written response issued to a taxpayer when the taxpayer asks a question (in writing) about the tax effects of its acts or transactions. The PLR interprets and applies the law to the taxpayer's specific set of facts and the taxpayer who requested the PLR can rely on the conclusions expressed in a private letter ruling. You cannot rely on a PLR issued to another taxpayer, no matter how similar the fact pattern. Private letter rulings for IRC §42 credits are under the jurisdiction of the Associate Chief Counsel (Passthroughs and Special Industries).

Annual Revenue Procedure

Updated instructions for submitting a request for a private letter ruling are provided as the first Revenue Procedure of each calendar year; e.g., this article is a summary of Rev. Proc. 2005-1.

When to Request a PLR

The PLR should be requested prior to the filing of the tax return on which the tax effects or transaction at issue are to be reported. If you do file a return reflecting the issue after requesting a PLR, you must notify the Associate Counsel and attach a copy of your request to the tax return.

Generally, the Service will not issue a PLR to a taxpayer if the issue is being examined on the taxpayer's return for an earlier year, is being considered by Appeals on the taxpayer's return for an earlier year, or is included in a pending Tax Court case involving the taxpayer. There are (of course) exceptions to the rule, but the basic idea is to request the private letter ruling before the tax return is filed.

The Service may decline to issue a letter ruling when appropriate in the interest of sound tax administration or on other grounds, whenever warranted by the facts or circumstances of a particular case. As an alternative, the Service may issue an information letter calling attention to well-established principles of tax law.

Content

While the format of a private letter request is not dictated, specific information must be included with a request for a private letter ruling.

1. Complete statement of facts, including:
   (a) Identification of all interested parties,
   (b) Disclosure of annual accounting periods,
   (c) Description of the business activity, business reasons for asking the question, and
   (d) Detailed description of the problem for which the request is being made.

2. Documentation to support those statements; i.e., contracts, agreements, etc., that are pertinent to the issue. Translations of documents written in foreign languages must be included.

3. An analysis of the facts and explanation of why they are important to the issue.

4. Statement that none of the taxpayer's tax returns, or the tax returns of related parties that might be affected by the outcome, are under audit, before Appeals, or before a federal court. You must also notify the Associate Counsel if an audit is started after submitting the request.

5. Statement that no PLR was previously requested by the taxpayer or ruled upon for the same or similar issue, nor is a PLR pending on the same or similar issue. You must also notify the Associate Counsel if another PLR is submitted after submitting this request.

6. Identify the authorities that you believe support your position; i.e., sections of the Internal Revenue Code, etc. Of course, you are also expected to identify and discuss any contrary authorities, tax treaties, and pending legislation pertinent to the issue. Presenting both sides helps Service personnel understand the issue and relevant authorities more quickly. You must also notify the Associate Counsel if you become aware of relevant pending legislation after submitting this request.

7. Since private letter ruling are made available to the public, you also need to identify any information that you want deleted from the copy provided to the public.

8. Requests must include a statement, under penalties of perjury, that the information provided contains *all* the relevant facts relating to the request, and that such facts are *true*, *correct*, and *complete* to the best of your knowledge and belief. This statement must be signed by the taxpayer –not a representative. Just like signing your tax return.

9. Requests for private letter rulings must be signed and dated by the taxpayer or taxpayer's representative. If your representative signs the request, be sure to include a completed Form 2848, Power of Attorney and Declaration of Representation.

10. To help make sure your request is complete, Chief Counsel provides a checksheet, which is also completed and submitted with the request.

Procedures

- How many issues am I addressing in my request? The Service may issue separate rulings upon request.

- How many copies of my request do I need to submit? Generally, you need to submit the original request and one copy. If more than one issue is included in the request, submit additional copies.

- You can request a "two-part" letter ruling if requesting a particular conclusion.

- You can request expedited handling, but it is granted at the Service's discretion and, in fairness for all taxpayers, only in rare and unusual circumstances.

- You can request a pre-submission conference (by telephone or in person) to informally discuss the technical or procedural aspects of the issue.

- You can request a post-submission conference to discuss the issue when you submit the request, or in writing soon after.

- The request for a private letter can be submitted using normal mail, private delivery service or hand delivered. You will receive an acknowledgement letter.

- There is a user fee for submitting private letter ruling requests, payable with the submission. Beginning on March 1, 2005, the cost is $7,000. Departments, agencies, or instrumentalities of the U.S. are exempt from the user fee requirement if they certify that they are seeking a letter ruling on behalf of a program or activity funded by federal appropriations.

Then What Happens?

Within 21 days, you (or your representative) will be contacted to discuss procedural issues, and where possible, technical issues such as how the Associate Counsel may rule on the request, if additional information is needed, or if modification of the facts would render a more favorable outcome.

You may withdraw your PLR request at any time before the ruling is signed by the Service, but the user fee ordinarily is not returned. However, if the Associate Counsel declines to issue a ruling, the user will be returned.

Once completed, the private letter ruling will be sent directly to the taxpayer. The Service may send copies to the representatives designated on Form 2848, but not more than two. The Associate Counsel also sends a copy to the Service official

that has examination jurisdiction over the taxpayer's tax return.

The PLR should be attached to the affected tax return when it is filed. If your tax return has already been filed, the PLR should be included on an amended return or claim for refund.

Revoking or Modifying a PLR

A taxpayer may be audited after a PLR is issued. The audit will include determining whether the PLR conclusions are correctly reflected on the return, whether the representations upon which the PLR was based are accurate, whether the issue was resolved as proposed, and whether there has been change in the law that applies to the issue or any continuing series of issues stemming from the PLR. The Associate Counsel may revoke or modify a PLR based on the results of an audit it is determined to be in error or there has been a change in law.

Monitoring LIHC Cases

Project Code 0670 has been established for LIHC audits. If you expand an audit to include additional years or taxpayers, please remember to update the Project Code on the new returns. Same for the Tracking Code, which is 9812.

Should you need to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be transmitted by e-mail or faxed to (202) 283-2240.

♫♥♫ Grace Notes ♫♥♫

It was Valentine's Day – really rainy and depressingly gray outside, and I was not looking forward to a long drive home. It had been a busy day full of distractions, and as I hurriedly multi-tasked through assignments, my mind drifted, I found myself thinking back to Valentine's Day when I was in the second grade – when the most urgent task was delivering Valentine cards and running back to my desk to count the dime store cards that I had received in return. It's really rather silly, isn't it – Valentine's Day Cards given to somehow provide tangible evidence of a much deeper immeasurable emotion?

For some unfathomable reason, I thought about the box of business cards I keep on my desk. You know, all the cards from meetings and conferences –most of them given to me with a "call me if there's anything I can do to help" look and a smile. And I remembered the day someone called me, very distressed, with a problem that I just didn't have a clue how to handle…. and there, on the top of the pile was just the name I needed. And then I realized that the very card I needed was there more than just once or twice.

And being the sentimental person I am, my box of business cards suddenly seemed like a box brimming over with the sincerest Valentine's Day cards an IRS analyst could ever wish for, because people really do reach out and help when I call them.

So, although it may be a bit late, my sincere thanks and appreciation to those who have helped me, and helped me help others. And if I haven't called you yet, consider yourself warned!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

.

Special Edition
Low Income Housing Credit Newsletter

Internal Revenue Service
Issue No. 17 *June 2005*

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Read All About Them! Acquisition-Rehabilitation LIHC Projects Take Center Stage

(Follow-Up & Clarification of Information Presented in the April 2005 Edition)

While we generally think of the LIHC supporting the construction of new residential rental housing, IRC §42 also provides a tax incentive for acquiring existing buildings and "rehabilitating" them for use as LIHC residential rental housing. New buildings are defined in IRC §42(i)(4) as buildings for which the original use begins with the taxpayer. Existing buildings, then, are defined in IRC §42(i)(5) as buildings that are not new buildings.

Credit for Acquisition of Existing Building

Under IRC § 42(b)(1)(B)(ii), the applicable percentage for acquiring existing buildings was 4% in 1987, the first year of the LIHC program. For years after 1987, as described in IRC §42(b)(2)(B)(ii), the applicable percentage is 30% of the qualified basis discounted using a present value computation outlined in IRC §42(b)(2)(C). So, the "acquisition" credit is sometime called the "4%" credit, and the "30%" credit other times; either way works.

Qualifying Acquisition Costs

Under IRC §42(d)(2), the eligible basis of an existing building is its adjusted basis at the end of the first year of the credit period, but only if it meets four requirements:

1. the building is acquired by purchase,
2. there is a period of at least 10 years between the acquisition date and the later of:
   a. the date the building was last placed in service (see IRC §42(d)(2)(D)(ii) for rules for certain transfer and IRC §§ 42(d)(6) and 42(f)(5)(B) for an exception for federally-assisted buildings),

      or

   b. the date of the most recent nonqualifying substantial improvement of the building. Nonqualified substantial improvement is defined in IRC §42(d)(2)(D) as costs of 25% or more of the adjusted basis without the improvements, within any given 24 period.
3. the building was not previously placed in service by the taxpayer or by any person related to the taxpayer at the time it was previously placed in service, and
4. the building qualifies for the rehabilitation credit under IRC §42(e), which we will be discussing later in this article.

Generally, if the building does not meet all four requirements, then the eligible basis for the acquisition credit is zero….after consideration of the exceptions!

Credit Period for Existing Building

Under IRC §42(f)(5), the credit period for an acquisition credit cannot begin before the first year of the credit period for the rehabilitation expenditures.

Acquiring Building Within Compliance Period

Under IRC §42(d)(7), a taxpayer acquiring a LIHC building during the 15-year credit period steps into the shoes of the previous owner.

1. the building is not eligible for acquisition LIHC, and
2. the credit allowable to the new owner after the acquisition is equal to the amount allowable to the prior owner, and the new owner must maintain the property as LIHC property for the remainder of the compliance period.

Finally, under IRC §42(f)(4), if a building is disposed of during the 10-year credit period, the credit is allocated between the parties on the basis of the number of days during the year the building (or interest) therein was held by each. *(Note: In Revenue Ruling 91-38, Q&A #5, the parties can also allocate the credit according to the number of months each party held the property.)*

And, in such cases, proper adjustments are made in the application of IRC §42(j), which are the recapture rules.

Credit for Substantial Rehabilitation

IRC §42(b) doesn't identify the applicable percentage for rehabilitation costs, but IRC §42(b)(3)(A) provides a cross reference to IRC §42(e), which outlines the requirements for treating rehabilitation costs as a separate new building. This is important, because new building are eligible for the "9%" credit under IRC §42(b)(1)(A), also known as the "70%" credit under IRC §42(b)(2)(B)(i).

Qualifying Rehabilitation Costs

Under IRC §42(e)(2), the rehabilitation expenditures are amounts for property (additions and improvements) that is subject to depreciation of a building. In other words, the costs must meet the definition of Eligible Basis as outlined in IRC §42(d) – basically, depreciable residential rental buildings, property used in common areas or provided as amenities, and (if the property is located in a qualified census tract) a portion of the costs associated with a community service buildings.

Substantial Rehabilitation

To qualify for the 9% credit, the owner must perform substantial rehabilitation to 1 or more rental units, or substantially benefit the rental units. Substantial rehabilitation is defined in IRC §42(e)(3) as the expenditures during any 24-month period that are the greater of either:

1. 10% (or more) of the adjusted basis of the acquired building as of the first day of the 24-month period,

   or

2. the qualified basis (applicable fraction x eligible basis) attributable to the rehabilitation costs is $3,000 or more. This is not a unit-by-unit determination; just divide the qualified basis by the number of LIHC units.

There is just one exception to the 10% test under IRC §42(e)(3)(B) for buildings acquired from a government unit. The taxpayer can elect not to apply the 10% test and use the 4% credit amount.

Also, be careful not to confuse the test for nonqualifying substantial improvements associated with the acquisition LIHC with the "substantial rehabilitation" test associated with the rehabilitation LIHC. Both use 24-month periods, but the percentages are different.

Placed in Service Date

As described in IRC §42(e)(4)(A), expenditure qualifying as "substantial rehabilitation" are treated as if placed in service at the close of the 24-month period. This is important because, under IRC §42(f), the credit period begins with the taxable year in which the building is placed in service, unless the owner elects to delay the beginning of the credit period until the subsequent taxable year.

Rehabilitation Costs Included in Eligible Basis

Once a determination has been made that the owner did substantial rehabilitation to an existing building, the owner can treat all the rehabilitation costs as if it is a separate new building. As noted in IRC §42(d)(1), the eligible basis for a new building is its adjusted basis as of the close of the first year of the credit period.

Applicable Fraction

The applicable fraction is the percentage of LIHC units or floor space occupied by income-qualified tenants. Under IRC §42(f)(2), there is a special rule for determining the applicable fraction for the first year of the credit period. Based on the month the unit is first occupied, the rule is an average of the applicable fractions on a monthly basis; i.e., the sum of the monthly applicable fractions divided by 12.

In the case of buildings that were acquired and then rehabilitated, there are two separate allocations of credit documented on two Forms 8609 – one at 4% for the acquisition and a separate allocation at 9% for the rehabilitation. However, the owner is not required to determine two applicable fractions. Under IRC §42(e)(4)(B), the applicable fraction for the 9% substantial rehabilitation credit will be the same as the applicable fraction for the 4% acquisition credit.

Qualifying Households

Because LIHC buildings can be acquired and rehabilitated, or constructed, over a two-year period, or the beginning of the credit period can be delayed to the year subsequent to the year the building is placed in service, it is reasonable to expect that LIHC units may be rented to income-qualified households *before* the beginning of the credit period. For this situation, the owner must demonstrate that the household was income-qualified *at the beginning* of the first year of the credit period to include the unit in the applicable fraction. The IRS has provided a safe harbor for this situation in Revenue Procedure 2003-82.

Under Rev. Proc. 2003-82, a unit occupied before the beginning of the credit period will be considered a low-income unit at the beginning of the credit period, even if the household's income exceeds the income limit at the beginning of the first year of the credit period, if the unit is rent restricted and the following two conditions are met:

1. The household must be income-qualified at the time of acquisition or time of move-in, and
2. The household's income must be tested at the beginning of the first year of the credit period. If the household's income has increased to 140% or more of the income limit, the Available Unit Rule (IRC §42(g)(2)(D) is applied.

Summary

If there's one thing that's clear, executing the development of an acquisition/rehabilitation LIHC property requires a thoughtful consideration of unique ownership and timing issues. Pass the aspirin!

Welcome to Barbara Dougherty, Acting Manager for the LIHC Compliance Unit

Barbara Dougherty has accepted a temporary assignment as manager of the LIHC Compliance Unit in the Philadelphia Service Center. We wish her a warm welcome as she learns all about the program….Forms 8823,.. 8693, ….8609,…. 8610, ….. …..8877 …..

In the meantime, Angie Kaminski will be working as an analyst on the embedded quality program.

Monitoring LIHC Cases

Project Code 0670 and Tracking Code 9812 have been established for LIHC audits. If you expand an audit to include additional years or taxpayers, please remember to update the Project Code and the Tracking Code on the new returns.

Should you need to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be faxed to (202) 283-2240 or transmitted by e-mail.

♫Grace Notes♫

I admit it; I'm a Star Trek fan….I remember the first time, a particularly meaningful episode of TOS, and I watched the original airing of every episode of TNG, DS9, Voyager, and Enterprise. Believe me, I came up with some really creative excuses for not being where the adults in my life thought I (a high school senior) ought to be on Saturday mornings, just so I could watch the animated series.

Wondering where I'm going with this confession of the soul? In an episode titled "Unnatural Selection", Dr. Pulaski, the passionately dedicated doctor aboard the Enterprise, convinces Captain Picard (much against his better judgment) to allow her to help a desperately ill colony of scientists even though doing so would risk exposing herself to a deadly pathogen (an unintended outcome of the scientists' research). Of course, the doctor contracts the deadly disease, but (as you might expect), the crew of the Enterprise figures out an elegant solution and the doctor is saved.

Here's the relevant part. The voice over during the last scene of the episode is a log entry by Dr. Pulaski. She writes, "Scientists believe no experiment is a failure. That even a mistake advances the evolution of understanding. But all achievement has a price…" The point is, even though there is always a risk of failure and sometimes the price of failure is high, our mistakes help us learn, perfect our skills, and expand our knowledge.

I would contend that we (the LIHC community) are like scientists in our attempts to unravel the mysteries of IRC §42. While tax administration isn't generally an issue of life or death, there is a risk of error that can affect the financial well being of America's taxpayers, and more specific to the LIHC program – those in need of affordable housing. We might not look at it as over whelming, but every time we distribute a LIHC newsletter, there is an inherent risk.

This edition of the newsletter is dedicated to discussing the law pertaining to "Acquisition-Rehabilitation" LIHC housing projects. We decided that this topic deserved the focused attention because of the responses to the last newsletter. Despite the fact that Kent and I double check each other's work, I started getting e-mails about a single sentence that wasn't…well, as precise as it might have been. Within an hour of distribution, I learned several things:

The newsletter is read soon after its distribution. I've never received such immediate feedback! And, the newsletter is read thoroughly. Our error pertained to an important point, but it was buried within a paragraph deeply embedded in the article.

Researching and writing this newsletter also expanded my knowledge, as I "put all the pieces" spread out over IRC 42 into one place and could see how it all fits together.

And, it's nice to know we are not alone in our trek through IRC §42. Your responses provided detailed explanations that helped us understand the problem and were so tactfully worded! We appreciate your graciousness. Thank you.

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Postscript: Just in case you aren't a Star Trek fan, TOS is the acronym for "The Original Series" with Captain Kirk, TNG is the acronym for "The Next Generation" with Captain Picard, and DS9 is the acronym for "Deep Space 9" with Captain Sisko.

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 18 ***August 2005***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Frequently Asked Questions *(The Revenue Agent's Side)*

Question 1: I've been assigned a partnership return for audit. The taxpayer owns low-income housing and is claiming the LIHC. Where should I begin my pre-contact analysis?

Answer 1: A good place to start is an analysis of the Forms 8609 attached to the return, which are used by the state agency to document the completion of LIHC buildings and terms of the credit allocations. If you have multiple Forms 8609, using a spreadsheet to summarize the credit on a project basis is helpful.

Form 8609, Part I

Line C identifies the owner to whom the allocation was made. If the identified owner is not the taxpayer under audit, ask the taxpayer about the circumstances under which they acquired the building. This taxpayer under audit is liable only for the period for which they had ownership.

Line 1a is the date of allocation. The building must be placed in service within two years as identified on line 5, and the credit period may be postponed one year beyond that, as elected by the taxpayer on line 10a. Combining the three dates will give you a good estimate of key events for the development and implementation of the building as low-income housing.

Line 1b is the maximum allowable LIHC the taxpayer can claim each year. Line 15 on Form 8609, Schedule A should never exceed this amount. Schedule A should also be attached to the return; it is used to compute the credit each year.

Line 2 is the maximum applicable credit percentage. The applicable percentage is determined by the state agency and is seldom an audit issue. However, if LIHC units were first occupied by income-qualified tenants after the end of the first year of the credit period, then the unit qualified for an LIHC computed using 2/3 of the maximum credit percentage. The Schedule A computation accounts for this lesser credit by subtracting out the 1/3 portion of the credit that isn't allowable (see Schedule A, line 9).

Line 6 includes seven descriptors for LIHC allocations that impose different requirements on the owner. Identifying the relevant descriptions and understanding the unique requirements imposed will help you quickly evaluate the taxpayer's compliance.

Form 8609, Part II

Line 7 is the Eligible Basis. Basically, eligible basis is depreciable residential rental property; i.e., buildings and amenities such as common areas and facilities (IRC §42(d)(4)). Under IRC §42(m)(2), most state agencies require taxpayers to provide a summary of the costs qualifying as Eligible Basis that was prepared and certified by a CPA. The taxpayer should be able to provide you with this document.

Line 8a is the original qualified basis of the building at the close of the first year of the credit period. IRC §42(c)(1)(A) provides that:

Qualified Basis = Eligible Basis x Applicable Fraction

Line 8b: Multiple Building Project – Under IRC §42(g)(3)(A), the dates for meeting certain requirements changes if a building is part of a project consisting of multiple buildings. The

requirements are outlined in the Form 8609 instructions for line 8b.

Line 9 includes elections the taxpayer must make before claiming the credit.

1. Line 9a, Election to Reduce Eligible Basis – If there are federal subsidies, then a new building does not qualify for the full 9% credit unless the basis supported by the subsidy is excluded from Eligible Basis (IRC §42(b)(1)(A) and IRC §42(i)(2)). If box 6a or 6d is checked, then the state has identified sources of federal subsidies.

2. Line 9b, Disproportionate Standards – If the cost of the non-LIHC units is greater than the LIHC units, then the cost of the more expensive non-LIHC units cannot be included in the Eligible Basis. Alternatively, the taxpayer can elect to reduce eligible basis by the excess cost of the non-LIHC units over the LIHC units if the difference in cost is not greater than 15% (IRC §42(d)(3)).

Line 10 also identifies elections the taxpayer must make, but these elections are identified in the Code as irrevocable.

1. Line 10a: Postpone first year of the credit period (IRC §42(f)(1)(B)). The taxpayer must demonstrate that they have acted in a manner consistent with such an election. This is an important decision because it will effect the computation of the Eligible Basis and Applicable Fraction – both determined as of the last day of the first year of the credit period.

2. Line 10b: Large Partnership Election under IRC §42(j)(5)(B) – Streamlines recapture of the credit for large partnership with 35 or more partners. Very few LIHC property owners that are partnerships have 35 partners at the first tier level. Even if your taxpayer meets the requirements and makes the election, TEFRA still applies.

3. Line 10c: Minimum Set-Aside – Taxpayers must provide a minimum amount of LIHC housing to qualify for any credit. If the minimum set aside is not met for the first year of the credit period at the *project* level, the project does not qualify as LIHC housing and does not generate any LIHC for the 10 year credit period. Failure to meet this requirement in years after the first year will result in the disallowance of the credit for that year, but the property can generate credit in subsequent years if the minimum set-aside is restored (IRC §42(g)(1)).

4. Line 10d: Deep-Rent-Skewed-Project – Under IRC 142(d)(4)(B) a taxpayer may elect to serve population at low income levels. See instructions for Form 8609 for additional explanation.

Analyzing the Form 8609 will help you understand the parameters under which the LIHC project is operating. You will also be able to anticipate what you should see in the books, records and tenant files. Finally, Form 8609 will help you identify potentially large, unusual or questionable items that should be raised as audit issues.

Question 2: I've factually developed an LIHC issue, but there isn't any guidance on how this unusual issue should be treated. The taxpayer and I agree that a request for technical advice from Chief Counsel is appropriate. How do I do that?

Answer 2: Requesting assistance will result in the issuance of a Technical Advice Memorandum (TAM) to establish how the Internal Revenue Code should be applied to a specific set of facts. It is the Service's position and an examiner must following the position presented in the TAM.

Formal procedures are outlined in the second revenue procedure issued each year; e.g., Rev. Proc. 2005-2.

Key Points

Taxpayers can initiate a request for technical advice during an audit. If this is the case, a taxpayer must provide a statement of the facts, issues, and their position.

If an examiner initiates the request, the taxpayer is notified that the request is being made. The taxpayer is given time to

indicate whether there is any factual disagreement. Taxpayers are encouraged to submit a statement of their position.

There are opportunities for both Service representatives and the taxpayer to meet with Chief Counsel before the TAM is issued.

The Technical Expedited Advice Memorandum is a program intended to streamline the issuance of Technical Advice Memoranda and eliminates requirements for a TAM that can frustrate the process, such as the requirement that the taxpayer and examiner agree on facts.

References

1. IRM 4.2.3.4, Technical Advice Memorandum
2. IRM 4.8.8.12.4, Requests for Technical Advice

Frequently Asked Questions *(The Owner's Side)*

Question 1: I'm in the eleventh year of the compliance period and I need to compute the credit under IRC §42(f)(2)(B). I know the total amount of credit claimed the first year, but I don't have the tax returns or tenant files, and the general partner has changed several times. How do I prepare the tax return for the eleventh year if I can't compute the credit on a BIN by BIN basis?

Answer 1: Not to be painfully obvious, but…..

IRC §6001requires *every* taxpayer to maintain records sufficiently detailed to prepare a proper tax return, including permanent books and records sufficient to establish the amounts of gross income, deductions, *credits*, or other matters to be shown on the taxpayer's return.

Treas. Reg. §1.42-5(b)(2) requires LIHC property owners to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the 15th year of the compliance period of the building.

Owners may use electronic storage systems instead of hardcopy (paper) books and records to retain the required records. Rev. Rul. 2004-82, I.R.B. 2004-35, Q&A #11 is specific to the LIHC program. However, the electronic storage system must satisfy the requirements of Rev. Proc. 97-22.

The lesson learned is that the first year tenant records should be added to the list of documents transferred to a new owner upon purchase of the property. Not that this is particularly helpful to a taxpayer preparing a tax return for year 11. Here are some suggestions:

The state agency may have records noting which units actually qualified as low-income units at the end of the first year of the credit period.

If the tax return was prepared by a paid preparer, they may be able to provide a copy.

The IRS may be able to provide a copy, particularly if the return was late filed. The IRS maintains individual returns (Form 1040 series) for 7 years, and other returns may be available for a longer period of time. A taxpayer would need to file a Form 4506, Request for Copy of Tax Return. For a partnership return, any person who was a member of the partnership during any part of the tax period being requested can sign the request.

Question 2: The state agency reviewed my property and filed a Form 8823 notice of noncompliance with the IRS before I could correct the problem. I subsequently corrected the noncompliance and another Form 8823 was filed indicating that I was back in compliance. I've just been notified that I'm going to be audited. Why am I being audited when the noncompliance has been corrected?

Answer 2: The filing of a Form 8823 with the IRS is not a good thing, if for no other reason that it draws attention to the taxpayer. And it is reasonable to conclude that if the noncompliance

has not been corrected, the attention may be a little more focused.

However, LIHC tax returns may be selected for audit *even if the noncompliance is corrected.* Perhaps the notice of corrected noncompliance had not been filed at the time the return was selected or, even though corrected, the noncompliance results in a loss of credit. When reviewing the tax return, tax issues unrelated to the reported noncompliance could have been identified.

And then…tax returns are selected for audit through a variety of methods. An LIHC return could be audited for an entirely different reason, and the report of noncompliance is just a coinciding series of unfortunate events.

Frequently Asked Questions *(The Management Company's Side)*

Question 1: A woman moved into our property. The woman provided us with a divorce decree indicating that she had joint custody of her little girl with her former spouse, and said the child would be living with her. Based on the income limits for a two person household, the household qualified. However, the woman alone would have been over the income limit for a one person household.

Her former spouse applied for housing at another LIHC property in the area. He included his child as a member of the household and was income qualified based on a two person household. Alone, he would not have qualified based on the income limit for a one person household.

When we found out the child was included in both households, we questioned the mother. She admitted that the child didn't actually live her, but sometimes visited on weekends. Her former spouse has physical custody of the child. Can the parents "split" the child for LIHC purposes?

Answer 1: Children are not "split" between households. According to HUD manual 4250.3, section 3-8, when determining family size for income limits, children in joint custody arrangements are included in a household when the child is physically present 50% or more of the time. In this case, the child cannot be included when determining the family size of the mother's household.

Question 2: Where in the Code does it say that a student cannot be a low-income tenant?

Answer 2: This is a unique situation where a rule is referred to, but is not actually included in, the Internal Revenue Code. Instead, the general rule is found in the legislative history, and reads:

> "In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return."

Under IRC §151(c)(4), we're basically talking about full-time students.

The Code does include four exceptions to the student rule in IRC §42((h)(3)(D).

1. An individual who is a student and receiving assistance under title IV of the Social Security Act.
2. An individual is enrolled in a job training program receiving assistance under the Job Training Partnership Act or under similar Federal, State or local law.
3. Units can be occupied entirely by full-time students if the students are single parents and their children, and such parents and children are not dependents (under IRC §152) of another individual.
4. Units can be occupied entirely by students that are married and file a joint return.

Frequently Asked Questions *(The Accountant's Side)*

Question 1: Is there a difference between the Minimum Set-Aside and the Applicable Fraction, or is the computation the same?

Answer 1: Yes, there is a difference and no, the computations are not the same.

The Minimum Set-Aside is strictly a count of the number of low-income *units* in the *project* as of the last day of the taxable year.

The Applicable Fraction is the percentage of a *building* dedicated to low-income residential rental units. Under IRC 42(c)(1)(B), the Applicable Fraction is the smaller of the unit fraction or the floor space fraction.

Example

A mixed-use LIHC project consists of one building with a hundred units. The Eligible Basis is $1,000,000 and the Applicable Percentage is 8.93%. The taxpayer elected the 40/60 minimum set-aside and maintains only the minimum 40 units to qualify for the credit. The other 60 units are rented at fair market value. At the end of the taxable year, the taxpayer computes the Applicable Fraction.

Using the Unit Fraction, the taxpayer meets the minimum set-aside as anticipated; i.e., the fraction is 40% (40/100).

However, when the taxpayer uses the floor-space method, the Applicable Fraction is only 37.3%. The fraction is lower than the fraction computed using the Unit Fraction method because smaller units were occupied by income-qualified households and larger units were rented to households paying fair market rent.

Therefore, the taxpayer met the minimum set-aside requirement and will claim IRC §42 credit in the amount of $33,309 each year. The computation is:

Eligible Basis:	$1,000,000
Applicable Fraction:	x 0.373
Qualified Basis:	$373,000
Applicable Percentage:	x 0.0893
Annual LIHC:	$33,309

Explanation: So, it is possible to claim credit based on an Applicable Fraction that is less than the minimum set-aside – as counter intuitive as that may seem.

Question 2: My client wants to sell her LIHC building, which is a single family home with a 1989 credit allocation. And since the allocation was made before 1990, there isn't a restrictive covenant. The first year of the credit period was 1991, and was first occupied be a qualifying tenant in September of that year. 2005 is the 15th year of the compliance period. When can my client sell the home without triggering a recapture event - January 1st or October of 2006?

Answer 2: Under IRC 42(i)(1) the compliance period is defined as the period of 15 taxable years beginning with the 1st taxable year of the credit period. Under IRC 42(f)(1) the credit period is a ten-year period beginning with the year in which the building is placed in service, or if elected, the succeeding taxable year.

Assuming that your client is a calendar year taxpayer, both the credit and compliance periods began on January 1, 1991and the compliance period will end on December 31, 2005.

The confusion arises because the credit for the first year is based on the number of months within the first year that the LIHC units were occupied by qualified tenants, and the credit that isn't claimed in the first year is allowable in the 11th year under IRC §42(f)(2)(B). It really is logical to think the credit period begins when the units are first occupied, but logic does not always prevail in the world of taxes. The credit periods follow the taxpayer's taxable year, which is almost always the calendar year.

Just an Administrative Reminder

All LIHC cases should include Project Code 670 and ERCS tracking code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♫Grace Notes♫

This newsletter was easier than most to write. Every time someone asked a really good question, I'd not only find the answer and respond, but I'd copy it from my e-mail response right into my draft of the newsletter. Isn't Microsoft Word grand!?!

So, as I was editing and making sure I've included all those little words in the right places –really slows down the typing when you've got to quote correctly and check your references- I realized that these questions really focus on the little quirky twists and turns of IRC §42.

Let's face it – IRC §42 isn't your normal in-the-box debit-and-credit accounting type of issue, and it takes a while to figure out the vocabulary! Applicable Fraction is not the same as the Applicable Percentage, and well – "eligible basis" and "qualified basis" still get twisted on my tongue. I'm still wondering what to do if parents with joint child custody actually document an exact 50%-50% split, and I, too, once searched IRC § 42 looking for the student "rule". The question about the minimum set-aside and applicable fraction really twisted my brain as I'd never thought about it before and one little word escaped me on ALL my previous readings! The answer to the question about finding a really old tax return actually came from a consultant (thank you very much) helping a client.

As much as I like my life stable, or at least predictable, and I'd really like to make a CORRECT intuitive guess just once in awhile, IRC §42 just doesn't allow for such ease of mind.

When I was in junior high school, with a major headache over quadratic equations, I asked my mother (sincerely) when I might possibly be asked to solve such an equation in the real world. After explaining to my mother what a quadratic equation was, and her thoughtful pause, this is what she told me.

First of all, she said, I should seize (yes, that was her word) the opportunity to learn whenever the occasion presents itself – you never know when whatever you are learning might just come in handy.

Second, I might actually need to solve one of these equations someday, and without learning how now, I might not even recognize that the problem involves a quadratic equation.

And finally, at her pragmatic best, my mother pointed out that school – the forced learning of a whole bunch of stuff, most of which doesn't have an apparent immediate use and isn't remembered - is really about learning how to learn. She refers to learning as "brain gymnastics".

Thanks for the exercise!!!

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

P.S. My mother is a wise woman and practices what she preaches. "Learn to learn, and never stop learning", she says. She's 82 and now writing her memoirs. English is a second language for her, so she sends me drafts to check for spelling and grammar mistakes. We're both learning.

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 19 ***December 2005***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Hurricane Katrina

Hurricanes Katrina is one of the most devastating storms in American history, resulting in a major loss of life and massive destruction in Louisiana, Mississippi, and Alabama. The flooding of New Orleans required an extraordinary evacuation effort and more than a million people have been displaced.

In response, the IRS issued Notice 2005-69, which provides that owners of LIHC properties throughout the United States, in coordination with their state agencies, may offer temporary housing to individuals who were displaced by Hurricane Katrina, without regard for whether the displaced person qualifies as low-income. To qualify, the displaced persons must have (1) resided in jurisdictions designated for Individual Assistance in Alabama, Louisiana, and Mississippi, and (2) their residences were destroyed or damaged as a result of devastation caused by Hurricane Katrina.

Relief measures are also available to owners of LIHC property in areas identified in major disaster declarations issued by the President of the United States under the Stafford Act on or after January 1, 1995. See Revenue Procedure 1995-28.

Rent Limits & Providing Services: Regulation §1.42-11

A unit qualifies as an LIHC unit when the gross rent does not exceed 30% of the income limit for the unit. The income limit for a low-income housing unit is based on the minimum set-aside election made by the owner under IRC §42(g)(1). This election is documented on Form 8609, Part II, line 10c. Under Treas. Reg. 1.42-11(b)(3), the cost of services that are required as a condition of occupancy must be included in gross rent even if federal or state law required that the services be offered to tenants by building owners.

Optional Services

Units may be residential rental property qualifying for the LIHC even though services other than housing are provided. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent. A service is optional when the service is not a condition of occupancy and there is a reasonable alternative. For example, for a qualified low-income building with a common dining facility, the cost of meals is not included in gross rent if payment for the meals is not required as a condition of occupancy and a practical alternative exists for tenants to obtain meals other than from the dining facility. See Treas. Reg. 1.42-11(b)(1) and Rev. Rul. 91-38, Q&A #12. There is one exception under Treas. Reg. 1.42-11(b)(3)(B) for mandatory meals in any federally-assisted project for the elderly or handicapped in existence on or before January 9, 1989 that is authorized by 24 CFR 278 to provide a mandatory meals program

Continual or Frequent Services

If continual or frequent nursing, medical, or psychiatric services are provided, it is presumed that the services are not optional and the building is ineligible for the credit. For example, a hospital, nursing home, sanitarium, life care facility or intermediate care facility for the mentally and physically handicapped, would not be considered residential rental property qualifying for the IRC §42 credit. Treas. Reg. 1.42-11(b)(2) cross references Treas. Reg. section 1.42-9(b), which explains the general public use rule.

Tenant Facilities

No separate fees should be charged for tenant facilities (i.e., pools, parking, recreational facilities) if the costs of the facilities are included in eligible basis.

Supporting Services

There is an exception for fees paid for supportive service. A fee, in addition to rent, may be charged for services provided under a planned program that enables tenants to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. If the building is transitional housing for the homeless or single-room occupancy housing, supportive services includes helping tenants locate and retain permanent housing.

Prohibition Against Evictions Without Good Cause

Under IRC §42(h)(6)(B)(i), an extended low-income housing agreement must include a prohibition during the extended use period against (1) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit (no-cause eviction protection) and (2) any increase in the gross rent with respect to the unit not otherwise permitted under §42. See Rev. Rul. 2004-82, Q&A #5 and Rev. Proc. 2005-27.

Noncompliance must be reported to the IRS if:

extended use agreement does not include appropriate language;

the owner fails to certify annually that for the preceding 12-month period no tenants in LIHC units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42;

If a tenant is evicted or tenancy is terminated for other than good cause; or

the gross rent increases in a manner not permitted by IRC §42.

Rent Limits & Utility Allowances: Regulation §1.42-10

An allowance for the cost of any utilities, other than telephone, is paid directly by the tenant(s) is included in the computation of gross rent. The utility allowance is computed on a building-by-building basis. Under Treas. Reg. §1.42-10, there are specific rules based on the type of assistance provided to the building or the tenants within the building, specifically:

1. buildings receiving assistance from Farmer's Home Administration (FmHA)
2. tenants in the building receive FmHA housing payments,
3. buildings regulated by HUD
4. tenants receiving HUD rental assistance
5. If none of the rules in 1 through 4 apply, then the appropriate utility allowance for the rent restricted units in the building is the public housing authority estimate unless an interested party has obtained a utility company estimated cost of that utility for a unit of similar size and construction in the geographic area in which the building containing the unit is located.

If, at any time during the building's extend use period, the applicable utility allowance for a unit changes, the new utility allowance must be used to compute gross rent of the rent-restricted units due 90 days after the change.

Available Unit Rule: IRC §42(g)(2)(D) and Reg §1.42-15

The determination of whether a tenant qualifies for LIHC housing is made on a continuing basis, considering both the tenant's income and the qualifying area median gross income (AMGI), rather than on just the date the tenant first occupied the unit. However, Congress did not intend that tenants be evicted to bring the unit back into compliance with the program requirements for housing income-qualified tenants.

IRC §42(g)(2)(D) says that, "notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation…such unit shall continue to be treated as a low-income unit if the income of such occupants initially met the income limitation and such unit continues to be rent-restricted."

However, if the income of the occupants of the unit increases above 140 percent of the income limitation, the unit will cease to be a low-income unit if any residential rental unit in the building (of a size comparable to, or smaller than, such unit) is occupied by a new resident whose income exceeds the income limitation.

In summary, the next "available unit" must be rented to a qualified low-income tenant if the income of occupants of an LIHC unit increases above 140% of the applicable income limit.

The rule for deep rent skewed projects described in IRC §142(d)(4)(B) is slightly different. If the income of the occupants of the unit increases above *170* percent of the income limitation, the unit will cease to be a low-income unit if *any low-income unit in the build is occupied by a new resident whose income exceeds 40 percent of area median gross income.*

For example, a resident qualifies at move-in and continues to be income-qualified at the time of the first annual income recertification. At the time of the second annual recertification, the resident's income exceeds the income limit by less than 2%. The resident can continue to live in the LIHC unit and the owner can continue to claim the credit. At the time of the third annual recertification, the resident now has income of more than 140% of the income limit. The resident can continue to live in the LIHC unit and the owner can continue to claim the credit, *as long as the next available unit of comparable size is rent to an income-qualified tenant.*

Suitability for Occupancy: IRC §42(i)(3)(B)

In order to be treated as an LIHC unit, the unit must be suitable for occupancy. The Code provided authority for the IRS to determine whether the housing is suitable, considering local health, safety and building codes.

The instructions for the October 2003 revision of Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, provides an in-depth discussion of IRS expectations for LIHC housing, and is the basis for our discussion here.

State agencies must use the local health, safety and building codes or the Uniform Physical Condition Standards (UPCS) when conducting physical inspections of LIHC properties, but not a combination. If a state agency chooses to use the UPCS, then HUD's Dictionary of Deficiency Definitions to determine the severity of the violation.

The IRS adopted the Dictionary of Deficiency Definitions to provide objective standards that can be applied consistently by all the state agencies. The UPCS include five major categories:

> the site, including components such as fencing and retaining walls, the grounds, parking lots and play areas;
>
> building exteriors, including fire escapes, foundations, and roofs;
>
> building systems such as domestic water, electrical system and elevators, fire protection and sanitary systems;
>
> dwelling units, including electrical systems and outlets, hot water heaters, functional bathrooms and kitchens, lighting, smoke detectors, stairs, walls and windows;
>
> common areas, such as garages, utility rooms, laundry rooms and trash collection areas.

HUD's Dictionary of Deficiency Definitions also includes descriptions to gage the extent of the noncompliance with the UPCS: (1) minor, (2) major, and (3) severe. The descriptions often include threshold measurements that must be met before noncompliance is reportable. For example, it may be found that the shower, tub, components, or hardware such as grab bars and shower doors, are damaged or missing

> Level 1, Minor – a stopper is missing. However, this is not a violation if the

stopper is visibly observable near the tub or shower.

Level 2, Major – the shower or tub can be used, but there are cracks or extensive discoloration in more the 50% of the basin.

Level 3, Severe – the shower or tub cannot be used for any reason. The shower , tub, faucets, drains, or associated hardware is missing or has failed.

The state agencies must report all noncompliance to the IRS on Form 8823:

regardless of whether the noncompliance is corrected at the time of the physical inspection.

regardless of the extent of the noncompliance (minor, major, or severe).

IRS Releases Revised Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

The IRS has revised Form 8823 to improve the filing processing and enhance internal analyses. State agencies started using the new form on October 1, 2005.

The most visible change is the use of bar coding. State agencies use a PDF fillable form which creates a bar code in the upper right hand corner as entries are made for each line item. The IRS will scan the document to extract data for a database. This improvement will increase the accuracy of the data collected and significantly reduce the time to input the data. Other changes include:

identification of amended Forms 8823, which are filed to correct previously reported information, and

reporting of the total allowable credit allocated to the building (BIN).

The categories of noncompliance (lines 11a-q) have also been updated.

Separate lines for reporting noncompliance associated with the initial tenant income certification (line 11a) and the subsequent annual tenant income recertification (line 11b). Failure to maintain tenant files and documentation of the tenant's initial eligibility and subsequent recertification are also reported using these categories.

All violations of the Uniform Physical Condition Standards or local inspection standards are reported on line 11c, regardless of the severity (minor, major, or severe).

Violations of the Available Unit Rule and the Vacant Unit Rule are reported on separate lines (11i and 11j respectively).

How a Form 8823 Turns Into an IRS Audit

By Kent Rinehart, Program Analyst

For many taxpayers, the first indicator that they get about an IRS audit comes on the day they open their mail, or on the day they receive a phone call, from the Department of Treasury that starts out something like: "Your return has been assigned to me for examination…".

For owners of Low-Income Housing Credit (LIHC) properties, their senses may be prompted a little earlier should the state housing agency issue the owner a Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition.

Although a return can be selected independently for a number of reasons and audited by the IRS for any large, unusual or questionable issue, one Form 8823 puts any return much closer to an IRS audit simply because it has identified an LIHC owner (taxpayer) that is not in compliance with section 42 of the Internal Revenue Code. Any Form 8823 puts a taxpayer four steps closer to an IRS audit. Let's take a look at how:

Step #1: When the state agency sends a Form 8823 to the IRS, the LIHC owner receives a copy.

When a Form 8823 is issued by the state agency, it is generally not an instant decision on the part of any agency unless the form is issued because of one defining event, such as a building disposition. The overall process of monitoring project compliance is ongoing between each state agency

and building owner. The state agency may make numerous contacts with the building owner and property managers to resolve noncompliance issues identified through their reviews of the tenant files and inspections of the property.

Regardless of whether the noncompliance is subsequently corrected, the state agency will send a Form 8823 to the IRS Philadelphia Campus, with a copy sent to the owner. Receiving a Form 8823 may just be the motivating factor that finally gets the noncompliance corrected. And for the agency—that's a good thing! But whatever happened to that initial Form 8823 that went to the IRS?

Forms 8823 are initially screened, and may be immediately selected for further audit consideration. The state agency's "property owner" is now the IRS' "taxpayer" and the first step is to match the Form 8823 with the taxpayer's tax return for the year of noncompliance. The IRS then determines whether the owner's tax return should be audited.

Step #2: Even if the LIHC owner corrects the noncompliance after the Form 8823 was issued, the IRS will review the tax return because of the initial Form 8823 issued by the agency.

One Form 8823 gives the IRS a reason to look at a tax return. It is a notice that something is wrong with respect to IRC § 42, the Low-Income Housing Credit. At this point, the IRS not only analyzes the return for IRC § 42 issues, but will also consider any other item that appears large, unusual or questionable.

A corrected Form 8823 may be a good thing for the state agency, but it may arrive at the IRS a couple of days, weeks, months, or even years after the original Form 8823 was received, and perhaps long after the original Form 8823 and corresponding tax return have been reviewed for audit consideration.

A corrected Form 8823 will not reverse the IRS' process for identifying tax returns for audit. Even though the noncompliance may have been corrected, the potential still exists for a portion of the current year credit to be disallowed and recapture of prior year credit. This is especially true when a portion of the building was found not to qualify for IRC § 42 credits and the noncompliance was not corrected until after the close of the tax year.

Step #3: The number of Forms 8823 issued by the agency on a LIHC project, <u>or</u> the type of noncompliance item checked on the form, <u>or</u> the number of noncompliance items checked on the form are considered to determine if an IRS examination is warranted.

Taxpayers are always trying to figure out how the IRS picks returns for audit, and LIHC property owners are no different. For example, taxpayers may believe that the number of Forms 8823 issued on a LIHC project are an indication of either how isolated, or how widespread, the noncompliance may be. For example, if a project consists of ten different buildings, and a noncompliance issue for each building is reported to the IRS, it indicates a high level of widespread noncompliance.

On the other hand, a taxpayer may worry when a Form 8823 is filed for noncompliance with a single requirement, which could result in some type of credit adjustment or recapture; e.g., the household's income is above the income limit upon initial occupancy; the project failed to meet minimum set-aside requirement, or the project is no longer in compliance or participating in the IRC §42 program. Noncompliance issues are not only tough to correct, but they can be widespread and significantly reduce the amount of credit the taxpayer can claim.

Of course, a taxpayer might also be concerned about repetitive noncompliance. Even if a tax return is not selected for audit, all Forms 8823 issued by the agency are retained by the IRS and can be associated with any future Forms 8823 they receive from the agency.

The three factors we've discussed here are logical and make sense. Surely, these indicators of noncompliance are somewhere in the mix. The problem with speculation, however, is that there's just no way of knowing for sure how much weight these factors are given when the IRS reviews a specific tax return for audit.

Step #4: The tax return is reviewed for all other items that are large, unusual or questionable.

Once the IRS has the tax return, it is not good business sense to simply analyze the return for IRC §42 issues. There are hundreds of other Code sections that potentially could impact the taxpayer. So, in addition to IRC§ 42 issues that originated with Form 8823, the IRS will take the time to see if any other large, unusual or questionable issues warrant examination. The issue may not be part of the Low-Income Housing Credit program—but the issue may warrant an audit just the same.

Overall, an analogy can be made between a Form 8823 and a spark. It's hard to start any fire without a spark, and one spark generally does not start a fire—but it could. More sparks means a greater chance for a fire and hotter issues for any IRS examiner.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

All LIHC cases should include Project Code 670 and ERCS tracking code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♫Grace Notes♫

The Monday before Thanksgiving I found myself meandering around the beltway during a torrential rainstorm for several hours, with more than sufficient time to muse upon the trivial happenings of my day and the great mysteries of life. Do we make a difference? Have we done any good? You might consider these are odd questions to ask an IRS employee, and particularly a revenue agent auditing the owner of an LIHC property, so maybe rephrasing the question will help.

a. *Are we helping taxpayers understand and comply with the requirements of IRC §42?*

b. *When evaluating a taxpayer's compliance with IRC §42, do we apply the Internal Revenue Code with integrity, which results in impartial conclusions after consideration of all the facts?*

c. *When determining the consequences of noncompliance, do we apply the Internal Revenue Code fairly so that all taxpayers are treated equitably?*

Actually, we ask these questions when auditing any tax return, and in fact, I derived these questions from our mission statement. But there's something else we need to keep in mind. IRC §42 is more than tax Code. Congress created the Low-Income Housing Credit to meet specific housing needs of particularly vulnerable members of our community. To ensure we meet this objective, we also need to ask whether we are administering the Low-Income Housing Program so that clean and safe affordable housing is available for those who need it. Has anyone's burdened been lightened? Have we helped anyone in need?

Grace Robertson
Phone: 202-283-2516
Fax: 202-283-2240
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 20 ***April 2006***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Notice 2006-11: Relief from Certain LIHC Requirements Due to Hurricane Rita

On February 13, 2006, the IRS released Notice 2006-11. Similar to relief granted under Notice 2005-69, which addressed devastation caused by Hurricane Katrina, this notice includes:

1. *Temporary* suspension of income limitations for certain low-income housing projects approved by the state housing credit agency to rent vacant units to displaced individuals. The state housing credit agency will determine the appropriate period of temporary housing, but not to extend beyond September 30, 2006.

2. The non-transient use requirement will not be applied to any unit providing temporary housing for a displaced person during the temporary housing period.

3. All other rules and requirements of IRC §42 continue to apply during the temporary housing period.

To qualify for the relief offered under this notice, the following requirements must be met:

1. The displaced individual must have resided in a Louisiana or Texas jurisdiction designated for Individual Assistance by FEMA as a result of Hurricane Rita,

2. The owner must obtain the state housing credit agency's approval to provide temporary housing,

3. The owner must collect, certify and maintain documentation pertaining to each displaced person temporarily housed in the project,

4. The owner must list the project on the FEMA registry for assistance,

5. Rents for the low-income units housing displaced individuals must not exceed the rent-restricted rates for the low-income units under IRC §42(g)(2).

6. Existing tenants in occupied low-income units cannot be evicted or have their tenancy terminated as a result of efforts to provide temporary housing for displaced individuals.

Updated Regulations and Revised Forms 8609 and 8609-A, What's the Difference?

Beginning January 27, 2004, Treas. Reg. §1.42-1(h) stated, specific to Form 8609:

> Filing of forms. […] A completed Form 8609, "Low-Income Housing Credit Allocation and Certification," must be filed with the owner's Federal income tax return for each of the 15 taxable years of the compliance period. Failure to comply with the requirement of the preceding sentence for any taxable year after the first taxable year in the credit period will be treated as a mathematical or clerical error for purposes of section 6213(b)(1) and (g)(2).

This regulation was updated, beginning November 7, 2005, to state, specific to Form 8609:

> Filing of forms. […] Unless otherwise provided in forms or instructions, a completed Form 8609, "Low-Income Housing Credit Allocation and Certification," (or any successor form) must be filed by the building owner with the IRS. The requirements for completing and filing Forms 8586 and 8609 are addressed in the instructions to the forms.

The important change is that the specific requirements for filing Form 8609 will be outlined in the instructions for the form rather than in the regulation.

Revised Form 8609

A month after updating the regulation, in December of 2005, the IRS revised Form 8609, Low-Income Housing Credit Allocation and Certification, to include the penalty and perjury statement and a signature line for the taxpayer at the bottom of Part II. (When the form was revised in November, 2003, these items were removed from the form so that partnerships owning LIHC properties could file tax returns electronically.)

The significance of this revision is that an owner will no longer complete the certification required under IRC §42(l)(1) by filing a completed Form 8609 each year with its tax return. Instead, all owners of IRC §42 properties filing tax returns for years 1 through 15 of the 15-year compliance period are required to make a **one-time** submission of the completed form to the IRS, even if the form was previously filed with tax returns. **Just file the one-page form –no attachments other than the list of buildings in a multiple-building project.**

Using Different Versions of the Form 8609

Since there are multiple versions of Form 8609 in use, the instructions for making the one-time certification are specific to the revision of the form.

Revision date of January 2000 or earlier – Send a copy of the completed and signed version of the form.

Revision date of November 2003 – Copy the information from the November 2003 revision onto the December 2005 revision. Include from the "Signature of Authorized Housing Credit Agency Official" area on the November 2003 revision the name (but not the signature) of the authorized official and the date. Sign and complete the signature area of Part II of the December 2005 revision and submit it, and keep a copy for your records.

Revision date of December 2005 – After you have received Form 8609 with a completed Part I from the housing credit agency, complete and sign Part II and submit it. Part II must be completed and signed even if an allocation of credit by a housing credit agency is not required, as in the case of a building financed by tax-exempt bonds.

Buildings Financed with Tax-Exempt Bonds

The requirements for buildings financed with tax-exempt bonds have also changed. Temporary Treas. Reg. §1.42-1T(h) formerly provided an exception for low-income buildings financed with tax-exempt bonds. Specific to Form 8609, paragraph 2 read:

> *Manner of filing.* […] A completed Form 8609 (or copy thereof) shall be filed with the owner's Federal income tax return for each of the 15 taxable years in the compliance period. If a housing credit allocation is not required to be received by an owner under paragraph (f) of this section, the owner shall obtain a blank copy of Form 8609 and fill in the address of the building and the name and address of the owner in Part I. Part II of Form 8609 shall be completed by the owner of the qualified low-income building only for the first year the low-income housing credit is claimed by the building owner. Part III of Form 8609 (statement of Qualification) shall be completed by the owner of the qualified low-income building for each year of the 15-year compliance period

Paragraph 2 no longer exists and Temporary Treas. Reg. §1.42-1T(h) now refers you to Treas. Reg. §1.42-1(h), which refers you to the instructions included with the form. The newly revised instructions state:

No housing credit allocation is required for any portion of the eligible basis of a qualified low-income building that is financed with tax-exempt bonds taken into account for purposes of the volume cap under section 146. An allocation is not needed when 50% or more of the aggregate basis of the building and the land on which the building is located …is financed with certain tax-exempt bonds for buildings placed in service after 1989. However, the owner still must get a Form 8609 from the appropriate housing credit agency (with the applicable items completed, including an assigned BIN).

Submission to the IRS

Once completed and signed, the forms should be sent to the IRS at the following address:

Internal Revenue Service
P.O. Box 331
Attn: LIHC Unit, DP 607 South
Philadelphia Campus
Bensalem, PA 19020

Be sure to keep a copy of the completed forms for your records.

New Form 8609-A

In January 2006, Schedule A (Form 8609), Annual Statement, was replaced with Form 8609-A, Annual Statement for Low-Income Housing Credit. The format has been updated and the questions in Part I have been renumbered. The computation of the annual credit in Part II, lines 1-18, has not changed.

Form 8609-A is used to report compliance with the low-income housing provisions and calculate the low-income housing credit.

Form 8609-A must be filed for each year of the 15-year compliance period that begins after 2004. File one Form 8609-A for the allocation(s) for the acquisition of an existing building and a separate Form 8609-A for the allocation(s) of rehabilitation expenditures.

New Form 8823: Follow-Up Questions (and Answers)

In the last newsletter, we provided a brief summary of recent changes to Form 8823. Now the follow-up questions:

1. When should an amended Form 8823 be filed? If an amended Form 8823 needs to be filed, how should it be filed?

An amended Form 8823 is used to correct an error on a previously filed Form 8823. For example, an incorrect building identification number is used or the wrong category of noncompliance is selected.

The form should be completed just as if it was the original - the only differences should be that (1) the error is corrected, (2) the box for "amended form" is checked and (3) the date of signature. The state agency can also include an explanation in a cover letter to identify when the incorrect Form 8823 was filed and the nature of the change.

2. How long is the correction period and when does it begin?

Generally, the correction period is 90 days, beginning on the day the *owner* is notified of noncompliance. The period can be shorter; i.e., when severe physical deficiencies need immediate attention. The state agency can also extend the correction period to a total of 180 days.

3. If a state agency identifies multiple noncompliance issues at the time of inspection, and all the violations are corrected within the correction period, how should the Form 8823 be filed?

Select that category of noncompliance that best matches the noncompliance and check both the “out of compliance” and the “noncompliance correct” boxes.

4. How should noncompliance be reported if a building has multiple issues and some are corrected within the correction period and some are still outstanding when the correction period expires?

If filing a Form 8823 when some of the noncompliance remains uncorrected, but the noncompliance in other categories has been entirely corrected, the state should check both "out of compliance" and "noncompliance corrected" boxes if the noncompliance is *entirely* corrected, and just the "out of compliance" box for those categories where some noncompliance remained outstanding. The correction date on line 9 would be left blank since not all the noncompliance was corrected for *all* categories.

5. If the noncompliance isn't corrected within the correction period, but the noncompliance is corrected at a later time, do all issues need to be corrected before submitting an 8823 showing both the out of compliance and noncompliance corrected boxes marked?

Yes. State agencies should not wait for the owner to correct noncompliance. The initial Form 8823 indicating noncompliance must be submitted timely (within 45 days after the end of the correction period), regardless of whether the noncompliance is corrected. When filing subsequent Forms 8823 later, all noncompliance for the category must be corrected, and all categories of noncompliance must be completely corrected. In other words, all noncompliance must be corrected before a subsequent Form 8823 is filed. A state agency must file the "back in compliance" Form 8823 if the noncompliance is corrected within three years.

6. Form 8823 now identifies the amount of credit allocated to the building on line 5. How is that amount computed?

Enter the amount shown on Form 8609, line 5. If there are multiple Forms 8609, enter the total amount. Do not include Forms 8609 for which the compliance period has ended.

7. The low-income project includes multiple buildings with noncompliance issues. Can just one Form 8823 be filed for the whole project?

No. A separate Form 8823 must be filed for each BIN.

8. Category 10m, Owner failed to maintain or provide tenant income certification and documentation, has been removed from the list of noncompliance categories. How should failure to maintain adequate documentation be reported?

Owners must provide documentation that the unit is occupied by an income-qualified household. If the owner cannot provide that documentation, then the household is not considered an income-qualified household. Therefore:

> If the documentation is inadequate for the income certification upon initial occupancy, report the noncompliance under 10a, Household income above income limit upon initial occupancy.
>
> If the documentation is inadequate for the annual income recertification, report the noncompliance under 10b, Owner failed to correctly complete or document tenant's annual income recertification.

9. The IRS has adopted HUD's Dictionary of Deficiency Definitions. Where can I find a copy? Must all deficiencies be reported?

The Dictionary of Deficiency Definitions is available at HUD's website: **www.hud.gov**. Just enter "Dictionary of Deficiency Definitions" in the search feature.

If using the Uniform Physical Condition Standards (UPCS) and the physical deficiency fits the description in the dictionary, the noncompliance must be reported, regardless of whether it is minor, major or severe.

If using local inspection codes and the physical deficiency fits the inspection code's description of noncompliance, the noncompliance must be reported.

In addition, remember that even if using the UPCS definitions for inspection, if a state agency becomes aware of a violation of a local code, it must be reported.

Computing Applicable Fractions: A Fundamental Math Puzzler

Under IRC §42(c)(1) the applicable fraction, or percentage of low-income units in a building, is determined as of the close of the taxable year.

The taxpayer must calculate the applicable fraction using both the Unit Fraction method and the Floor Space method, and then use the *smaller* of the two fractions to calculate the Qualified Basis.

Unit Fraction

The unit fraction is a straightforward computation. Without regard to size or amenities, a unit is a unit and the fraction is:

$$\frac{\text{Number of Low-Income Residential Units}}{\text{Total Number Residential Units}}$$

Floor Space Fraction

The floor space fraction is a bit more onerous, as the owner needs to know the floor space of every unit in the building, and which units are occupied by qualified tenants. Generally, we measure floor space in square feet (sq. ft.). Do not include the floor space of common areas, amenities, hallways, or any other space – just the actual floor space of the residential rental units.

$$\frac{\text{Total Sq. Ft. of Low-Income Residential Units}}{\text{Total Sq. Ft. of Residential Units}}$$

Decimal Places

Following the instructions for Form 8609, Schedule A, line 2, the Applicable Fraction should be carried out four decimal places. Hence 50% = 0.5000. Use accepted conventions to round the fifth decimal place; i.e., numbers 5 and higher will result in "rounding up" and 4 and lower are "rounded down." For example, 0.50005 rounds up to 0.5001 and 0.50004 rounds down to 0.5000.

Applicable Fractions and Noncompliance

To include a unit (or the floor space of a unit) in the numerator of the Applicable Fraction, the unit must be in compliance. Without discussing all the nitty-gritty details, there are four basic criteria:

1. The unit must be occupied by an income-qualified household (or last occupied by a qualifying tenant and currently made available for rent),

2. The unit must be suitable for occupancy based on the UPCS or local inspection standards,

3. The unit must be used other than on a transient basis (except for transitional housing under IRC §42(i)(3)), and

4. The unit must be rent restricted as defined in IRC §42(g)(2).

Applicable Fractions and the Minimum Set-Aside

The Applicable Fraction is used to determine how much LIHC the owner can claim for a *building* each year. However, in order to claim any credit, the owner must provide a minimum amount of low-income housing. This minimum amount of housing is known as the Minimum Set-Aside.

The owner makes two elections impacting the determination of whether the minimum amount of low-income has been provided.

Making the Minimum Set-Aside Election

First, the owner must decide whether to make at least 40% of the units available to individuals whose income is 60% or less than the Areas Median Gross Income (the 40-60 Test) or to make 20% of the units available to individuals whose income is 50% or less than the Area Median Gross Income (the 20-50 Test). This election is documented on Form 8609, line 10c, and is irrevocable.

Defining a Qualified Low-Income Project

Second, the owner must decide how to group buildings together as a project. Low-income housing can be developed as a single building, multiple building on a single site, or multiple buildings on scattered sites (within a short period of time or in distinct phases). Any single or combination of these development opportunities will generally be called a "project". However, for purposes of IRC §42, the word "project" has a very specific meaning.

Basically, the owner must decide how to group the buildings together as a *project* for purposes of applying the Minimum Set-Aside rule. The exact language is in IRC §42(g)(1), which reads:

> IN GENERAL – The term 'qualified low-income housing project' means any project for residential rental property if the project meets the requirements of subparagraph (A) or (B) whichever is elected by the taxpayer.

Subparagraph A is the 20-50 Test and subparagraph B is the 40-60 Test. The building will be treated as a single building project unless the owner elects to treat the building as part of a multiple building project on Form 8609, line 8b. In addition, the owner must attach a statement to the Form 8609 disclosing information about the project. Refer to the instructions for completing Form 8609, line 8b for the complete list of information.

Comparing the Two Rules

The Applicable Fraction and Minimum Set-Aside or two distinct rules, but because they both involve percentages, it can be confusing.

The Applicable Fraction is:

Calculated as the smaller of the Unit Fraction method or the Floor Space Fraction method
Applied at the building level
Fluctuates from tax year to tax year during the 15-year compliance period.

The Minimum Set-Aside is:

Always computed as a percentage of residential rental units,
Applied at the project level
A constant throughout the 15-year compliance period.

There are helpful mathematical relationships between the Applicable Fraction and Minimum Set-Aside for low-income buildings *if the Applicable Fraction is calculated using the unit fraction.*

If the Applicable Fraction for each building in the project is equal to or greater than the Minimum-Aside percentage, then the Minimum Set-Aside at the *project* level is met.

It is possible in multi-building projects for the Applicable Fraction of individual buildings to be less than the project's Minimum Set-Aside percentage and the *project* as a whole will still meet the requirement.

Converting 100% Low-Income Buildings to Mixed-Used Buildings

For any number of unanticipated reasons beyond an owner's control, an owner of an IRC §42 100% low-income building may decide that residential units should be rented at the market rate. But what's the effect on compliance with the requirements of IRC §42?

This is not intended to be a complete list of things to consider, but these issues come quickly to mind.

Available Unit Rule – every LIHC unit of comparable size or *larger* than the smallest market rate unit in the building occupied by a household with income more than 140% of the Area Median Gross income (or 170% in deep rent skewed developments) will lose its status as a low-income unit.

Income Recertification Waiver – if you have a waiver of the annual income recertification under IRC §42(g)(8)(B), determining which households are actually over-income might be difficult since you aren't even completing annual tenant income certifications. A unit is not considered a qualified low-income unit unless the owner can document that the household is income-qualified. And the waiver, under either Rev. Proc. 94-64 or 2004-38, will be revoked by the IRS.

Applicable Fraction – the owner must now track the square footage and status of every unit and calculate the Applicable Fraction using both the Unit Fraction and Floor Space Fraction methods. The applicable fraction will no longer be predictable from year to year.

Minimum Set-Aside – the grouping of buildings to form the project for purposes of meeting the minimum set-aside requirement also needs to be considered. Just how many units within the project can be rented at market rate without jeopardizing the entire credit?

Vacant Unit Rule – to be in compliance with this rule, reasonable attempts must be made to rent vacant low-income units (comparably

sized or smaller than the vacated units) to tenants having a qualifying income before any units are rented to nonqualifying tenants. This is a conundrum: how does an owner make reasonable attempts to rent vacant low-income units to income-qualified tenants when attempting to convert at least some of those vacant units to market rate?

Extended Use Agreement – the applicable fraction for the building for every year of the extended use period (at least 30 years), which includes the 15-year compliance period, must be identified in the agreement. If the owner wants to the change the applicable fraction by converting units to market rate, the agreement must be updated. Add a meeting with the state agency to your list of things to do.

Recapture of Credit – converting units to market rate will result in a decrease in the building's qualified basis. Correct me if I'm wrong, but I'm pretty sure that this is a recapture event under IRC §42. The further you are along in the 10-year credit period, the larger the recapture amount will be. However, in years 12-15, after the end of the credit period, the amount of accelerated credit recaptured starts to decrease. Did I mention that there's a tax benefit rule under IRC §42(j)(4)(A) to consider? Add a meeting with the partners to your list of things to do.

When considering your options, be sure to identify all the outcomes and the potential impact on compliance. I've come up with seven major considerations without much effort. I'm sure the legal-eagles out there can come up with more interesting and subtle nuances.

Auditing Related Investor Returns

In addition to IRS efforts to identify and audit tax returns of LIHC properties warranting examination, the tax returns of investors in LIHC properties may also be identified for audit. The following analyses should be completed if you are independently auditing the return of an LIHC investor.

Required Filing Checks (Partnerships and Other Flow-Through Entities)

If your investor's return is a partnership, it is likely that the partnership has invested in multiple LIHC properties. The investment may be made directly as a partner in the partnership owning the LIHC property, or through tiers of flow-through entities.

1. Reconcile the amount of credit identified on Schedule K to the K-1s received from the partnerships through which the credit is flowing.

2. Since it is unlikely that an investor will have ready access to the returns from which the K-1s were received, determine whether those entities have filed tax returns using IDRS research (see IRM 4.10.5.2.1) if your investor has a significant interest in the entity. This analysis should be limited to the entities from which the investor received K-1s. If the entity has not filed a tax return, call Grace Robertson at 202-283-2516. To protect the Government's interest, the LIHC, losses, and deductions reported on the K-1 should be removed from the taxpayer's return

3. Review the taxpayer's portfolio of investments in LIHC properties and determine whether the taxpayer has disposed of any investments. The partners are subject to the recapture provisions of IRC §42(j).

4. Finally, determine whether the composition of the partnership has changed. Any partner leaving the partnership is subject to the recapture provisions of IRC §42(j).

Required Filing Checks (Corporations)

Complete the same analyses as for partnerships, except:

For (1), also reconcile the amount of credit claimed or carried forward into the tax year with the ordering rules in IRC §38(d) and carryforward/carryback rules in IRC §39.

For (3), determine whether the taxpayer has divested itself of any investments. If so, the recapture provisions under IRC §42(j) apply to your taxpayer.

Since corporations are not flow-through entities, (4) does not apply,

Required Filing Checks (Individuals)

Complete the same analysis as for corporations, and in addition, apply the passive activity rules under IRC §469.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

All LIHC cases should include Project Code 670 and ERCS tracking code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♫Grace Notes♫

For some unfathomable reason, my work group was moved to a different floor in the building. I can no longer just brainlessly push the top button in the elevator in the morning and I have to consciously navigate through a new maze to get to my cubicle, which is now in the middle of the room. What's worse, I came back from lunch one day to find an IT person sitting at my desk gleefully installing the latest version of Office. For some inexplicable reason, the automatic upgrade didn't download through the server. Did you know that workers in France, who felt their livelihood threatened by automation, flung their wooden shoes (called sabots) into the machines to stop them? Hence, the word "sabotage".

I groaned with the realization that I'd been lulled into a false sense of security. I'd made a concerted effort to figure out all (well, most….okay, at least the critical features) of the last version. What more could be asked of an icon-challenged kid who learned to read phonetically? I know that a new version of Office doesn't mean the end of the universe as we know it. It just seems that way when there's a whole new row of icons when I open a Word document! What will Excel, which I've never really mastered, be like? How many files can I mess up? Definitely not in my comfort zone, it never occurred to me that I should take the IT person at her word when she told me this is a vast improvement over previous versions. Have I grown old and inflexible? Have I outlived my usefulness? Am I becoming as obsolete as Windows 98?

Wait a minute!!! Is this a pity party here? Am I frightened by a challenge? Office is, after all, just a software program…just another undiscovered intellectual domain to explore and conquer! Is there a point to my ramblings? Oh, yeah….not everything has changed. It's a small comfort that I still have the same telephone number and e-mail address, just a new fax number to memorize! 202-283-2392.

Grace Robertson
Phone: 202-283-2516
Fax: ***202-283-2392***
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 22 ***September 2006***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

IRC §42: the Low-Income Housing Credit in Summary

by Grace Robertson, LIHC Program Analyst

I was recently asked if I could *please* summarize IRC §42 in 1,581 words or less. So here's a condensed, high-level explanation. In the absence of details, I've included references.

Intent

The credit was intended to provide an incentive for taxpayers to invest in affordable housing; i.e., the credit is a dollar-for-dollar reduction of the income tax liability.

Administration

IRC §42 is co-administered by the Internal Revenue Service and state housing agencies. The states receive a specific amount of credit each year (based on population). They determine which housing projects will receive credits, and how much. They are also responsible for monitoring the properties to ensure that the taxpayer remains compliant throughout the life of the project. Noncompliance is reported to the IRS. [*IRC §42(m) and Regulation 1.42-5*]

Commitment

The taxpayer agrees to provide affordable housing for at least thirty years.

> In exchange for the investment in affordable housing, the taxpayer will receive tax credits for each of ten years, which is known as the credit period. [*IRC §42(f)(1)*]
>
> To keep the credit, the taxpayer must provide affordable housing for fifteen years, which is known as the compliance period. [*IRC §42(i)(1)*]
>
> After IRS jurisdiction ends, the taxpayer must continue to provide affordable housing under the terms of the extended use agreement, which is referred to as the extended use period. The agreement is a contract entered into by the taxpayer and the state agency, recorded in the land records, and enforceable under state law. The state agency has sole jurisdiction. [*IRC §42(h)(6)*]

All three time periods begin on the same day; i.e., the first day of the tax year in which the buildings are placed in service, or if the taxpayer elects, the following year.

Types of Housing

The credit supports a variety of housing opportunities. The taxpayer can build new housing, or acquire and rehabilitate existing housing. The housing can be apartments, single-family housing, single-occupancy rooms, or even transitional housing for the homeless. The property may be mixed affordable and market rate rental units or a portion of the property may be for commercial use. However, the housing was intended for use on a nontransient basis, so the credit cannot be used, for example, to build hotels, hospitals, or nursing homes.

Financing

In combination with investment generating the Low-Income Housing credit, the taxpayer may also qualify for the Rehabilitation credit under IRC §47, but not the New Markets credit under IRC §45D. The project may also qualify for tax-exempt bonds under IRC §146, in which case the taxpayer is also subject to the rules under

IRC §142(d). The taxpayer may also use other federally-sourced loans and grants.

Credit Amount

The amount of credit the taxpayer can claim each year is determined as:

Eligible Basis
x Applicable Fraction
Qualified Basis

Qualified Basis
x Applicable Percentage
Credit Amount

Eligible Basis – IRC §§42(d) and 42(e)

The Eligible Basis is the total of allowable costs associated with the depreciable residential rental property. If the building is located in a high cost area, the Eligible Basis may be increased to 130% of the actual costs. Common errors include:

The cost cannot be documented,
The cost was not incurred before the end of the first year of the credit period,
The cost is associated with the land or a land improvement,
The cost is not allocated between the land, land improvements, and depreciable residential rental property.
The cost is associated with a commercial use, or
The cost was financed with a federal grant.

Applicable Fraction –IRC §§42(c) & 42(f)

The Applicable Fraction is the portion of rental units that are qualified low-income units; determined as the lesser of square footage or number of units. To qualify under IRC §42(i)(3), the unit must be:

Occupied by a qualifying household; i.e., the household has income less than a predetermined limit based on the number of individuals in the household, the taxpayer's election of a minimum set-aside, and the area's median gross income. Income is determined using HUD's rules for Section 8 housing, not taxable income under the Internal Revenue Code. [*IRC §§ 42(g)(4) and 142(d)(2)(B)*]

If any member of the household is a student, the unit is qualified only if an exception under IRC §42(i)(3)(D) is met. The most common errors include:

1. Failure to compute the Applicable Fraction for the first year of the credit period using the "averaging" formula under IRC §42(f)(2).

2. Failure to account for units first occupied by qualifying tenants after the end of the first year of the credit period under IRC §42(f)(3).

3. Failure to document, or adequately document, that the household has qualifying income. [*Regulation 1.42-5(b)(2)*]

The housing must be suitable for occupancy. Consideration is given to the site, building exterior, building systems, dwelling units, and common areas. All areas and components of the housing must be free of health and safety hazards. One of the most common problems is the inability to address routine maintenance and "wear and tear" over time. [*IRC § 42(i)(3)(B) and instructions for Form 8823*]

The rent must be restricted. The rent cannot exceed 30 percent of the imputed income limit. Problems include failure to include a utility allowance, or including unallowable fees in addition to the monthly rent; i.e., the fees are a condition of occupancy or nonrefundable. [*IRC § 42(g)(2)*]

Applicable Percentage – IRC §42(b)

The amount of credit, over the ten-year credit period, is equal to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing. The discount factor is known as the Applicable Percentage and is based on interest rates. The Applicable Percentage is fixed as of the month the building

is placed in service, or at the taxpayer's election, as of the month the taxpayer and state agency enter into a binding agreement regarding the building. The Applicable Percentage is published each month in the Internal Revenue Bulletin. Note, however, that state agencies have the authority to limit the amount of credit the taxpayer is allocated under IRC §42(m)(2). If the state agency decides to allocate less than the maximum allowable under IRC §42, the Applicable Percentage will be adjusted.

The Applicable Percentage is seldom an audit issue unless:

the taxpayer financed the building(s) with federally-sourced subsidies [*IRC §42(i)(2)*],

The taxpayer did not use the Applicable Percentage identified by the state agency on Form 8609, line 2.

Global Issues

The taxpayer is also subject to the following rules which may impact compliance on a unit-by-unit basis, at the building level, or the entire project.

Minimum Set-Aside – the housing project will not qualify for any credit unless it includes a minimum number of qualified low-income rental units. [*IRC §42(g)(1)*]

Available Unit Rule – If the income of an existing tenant rises above a specific limit, the next available comparable unit in the building must be rented to an income-qualified tenant. [*IRC §42(g)(2)(D) and Regulation 1.42-15*]

Vacant Unit Rule – If a low-income unit becomes vacant, the taxpayer must make reasonable attempts to rent the unit before renting any units to tenants who are not income-qualified. [*Regulation 1.42-5(c)(1)(ix)*]

General Public Use – the rental units must be available for use by the general public. In addition, units must be rented in a manner consistent with the Fair Housing Act; i.e., a determination that the taxpayer violated the Fair Housing Act may result in the loss of credit. [*Regulation 1.42-9*]

Material Participation of Qualified Nonprofit Organizations – If the taxpayer received an allocation under IRC §42(h)(6), the qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period.

Extended Use Agreement – No credit is allowable for a taxable year unless such an agreement is in effect as of the last day of such taxable year. [*IRC §42(h)(6)*]

Certifications and Annual Reports – Under IRC §42(l), a taxpayer completes a one-time certification and provides the IRS with annual reports:

1. Certification with respect to the 1st year of the credit period, which is a one-time filing of Form 8609. Part I is completed by the state agency and Part II is completed by the taxpayer.

2. The taxpayer files Form 8609-A with the tax return for each year of the 15-year compliance period to complete the annual report.

The taxpayer is required to certify at least annually to the state agency that the project met all the requirements. [*Regulation 1.42-5(c)*]

Inspections by State Agency – tenant records and the property are subject to physical inspection by the state agency. [*Regulation 1.42-5(c)(2)*]

Credit Disallowance and Recapture

The credit may be disallowed (in part or in whole) based on the results of an audit. Not only is the credit disallowed in the year under audit, but if the Qualified Basis (Eligible Basis x Applicable Fraction) is less than the Qualified Basis at the close of the preceding year, then the

taxpayer is subject to the credit recapture provisions. [*IRC §42(j)*]

The recapture amount is computed as a portion of the credit allowable in prior years plus interest beginning on the due date for filing the return for the prior taxable year involved.

No credit is allowable for the year in which a taxpayer disposes of a building (or interest therein). The recapture provisions are also applicable unless, under IRC §42(j)(6), it is reasonably expected that the new owner will continue to operate the building as a qualified low-income building for the remainder of the 15-year compliance period *and* the taxpayer timely furnishes the IRS a bond for a satisfactory amount and for the required time period. [*See Form 8693 and instructions*]

Conclusion

In the Bentley Court case, the judge said that IRC §42 is detailed and complex. I agree, and even though this summary isn't exactly "brief", it is 1,580 words! Hope it helps.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

All LIHC cases should include Project Code 670 and ERCS Tracking Code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♫Grace Notes♫

New Year's Eve, as the clock strikes twelve, we traditionally bid a fond farewell (or good riddance) to the ending year and usher a new year in with high expectations and a list of resolutions to accomplish. If you work for the Federal government, which has a fiscal year ending September 30th, the whole month is a time of reckoning!

And, as we complete another year, I would like to sum it all up by thanking all of you who have so steadfastly and enthusiastically engaged in the administration of IRC §42,

Thank You
And
Happy New (Fiscal) Year!

Grace Robertson
Phone: 202-283-2516
Fax: ***202-283-2392***
Grace.F.Robertson@irs.gov

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 23 ***December 2006***

The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

LIHC Partnership Returns & the Examination of Income

The examination of income is a required issue for all tax returns selected for audit and while LIHC partnerships are usually audited for specific IRC §42 issues, examiners must still complete the minimum income probes. While there is no required order in which these audit procedures and techniques for business returns must be performed, they are presented here as outlined in IRM 4.10.4.3.4.

Financial Status Analysis (IRM 4.10.4.3.3.1)

But first, while not required for partnership returns, a quick Financial Status Analysis (FSA) based on the rental schedule included with the return can be insightful. The FSA is really an evaluation of cash flows to estimate whether the taxpayer has sufficient funds to cover the known expenses. If possible, a three year analysis should be completed. The key questions are:

1. Is the rental activity generating a loss; i.e., there are more deductible expenses than income?

2. If generating a loss, is it a "tax" loss caused by depreciation or another noncash expense?

Note that a true negative cash flow can be anticipated because the rent for low-income units is restricted. In fact, under Reg. 1.42-4, the IRC §183 "hobby loss" rules do not apply to qualified low-income buildings for which the IRC §42 credit is allowable.

If the loss represents a true imbalance of cash flows, i.e., more expenses paid than income reported, then the examiner needs to determine the source of funds used to pay the bills and debt.

Balance Sheet Analysis

Analyzing accounts that have significantly changed and/or activity in the account may help explain how the taxpayer balances the cash flows. For example:

1. Increase in capital accounts,
2. Decrease in cash reserves or other assets,
3. Accrual of short term liabilities,
4. Postponement of existing debt, and
5. Increased or new debt.

For LIHC purposes, it is most important to consider the postponement of debt and increased debt. Key questions include:

1. If the terms of existing debt are so favorable that the taxpayer can postpone payment, then is it true debt? Is the debt owed to a related third party? Is the debt amount fixed? Are the interest rate and repayment periods fixed? Has the taxpayer made payments in the past? Can it be anticipated that the taxpayer will ever be able to repay the debt? Is the only payment on debt anticipated to be the proceeds from the building (when sold)?

2. Does the debt represent a developer's fee? If the payment is conditioned upon the on-going compliance of the LIHC project, then the fee is a management fee that should be expensed in the current period.

More than likely the debt described above supports costs included in the Eligible Basis used to compute the LIHC amount. If debt is not true debt, or is determined to be a current

period cost, then the Eligible Basis will be affected.

Also consider whether the debt is really a disguised federal grant; i.e., there is no expectation of repayment. If the debt is really a federal grant, the Eligible Basis must be reduced by the amount of the grant that is federally funded and used to construct or operate an LIHC building. See IRC §42(d)(5)(A). Note: Eligible Basis is not reduced if the proceeds of a federal grant are used as a rental assistance payment under Section 8 of the United States Housing Act of 1937 or any comparable rental assistance program.

Is debt federally sourced? If so, what are the terms? Federal subsidies include direct and indirect loans which are from a federal source and bear a below-market interest rate; i.e., less than the applicable Federal rate in effect under IRC §1274(d)(1) as of the date on which the loan is made. Under IRC §42(b)(2)(B)(ii), the Applicable Percentage is 30% of the qualified basis of qualified new buildings that are federally subsidized, resulting in an Applicable Percentage approximating 4% for each year in the 10-year credit period.

Reconcile Schedule M-1, M-2

For Schedule M-1, remember that entries are not part of the taxpayer's double-entry accounting system. Normal account controls do not exist and errors can be frequent. Look for items that are deducted from the books and then erroneously deducted again on the Schedule M-1, transpositions of numbers, and expenses on the books but not on the tax return.

For Schedule M-2, changes in capital accounts can indicate whether monies have been distributed to a partner and where those funds originated

Required Filing Checks

The partnership return and the partners' tax returns are considered related because the returns are for entities over which a partner (most likely the general partner) will have control and could possibly manipulate to divert funds or camouflage transactions. In addition to determining whether the partnership and related partners are filing returns, the analysis should include:

1. A review of the partnership agreement. This document will provide information regarding the rights, obligations and powers of the managing partner.

2. Since the general partner is frequently the entity that developed the property, review the terms of the development contract (fee) and any contracts for on-going management of the project.

3. Identify transactions between the taxpayer and any individual or group of partners. Loans to the partnership and the source of the funds loaned should be evaluated.

Interview the Taxpayer

Interviewing the taxpayer is one of the most important audit techniques an examiner can use to gather information. This section focuses on interviewing the taxpayer about income from the operation of a LIHC project. Please refer to LIHC Newsletter #12 for more information about interviewing the owner of an LIHC project.

Rents

The maximum rent that can be charged for an LIHC unit is based on location, the location's median gross income, and the number of bedrooms in the unit. Ask the owner how many units are in the project, what the vacancy rate is, and what the turnover rate is for both low-income and market rate units. Also ask how many bedrooms each low-income and market rate unit has. From this information, the maximum rental income can be estimated. See IRC §42(g)(2) for details

However, there are adjustments to the rent limit, which need to be addressed during the interview:

1. Has the taxpayer received payments under Section 8 of the United States Housing Act of 1937? The gross rent limit applies only to

payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through Section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, are not included in gross rent

2. Do tenants pay their own utilities? The gross rent must include an allowance for the cost of any utilities, other than telephone and cable, paid directly by the tenant.

3. Do tenant pay fees for supportive services? After 1989, gross rent does not include any fee for a supportive service paid to the owner by any governmental program or tax-exempt organization if the amounts paid for rent and assistance are not separable. Supportive services are discussed in Reg. §1.42-11.

4. Is rent based on Section 515 of the Housing Act of 1949? Beginning in 1991, gross rent does not include any Section 515 rental payment to the extent the owner pays an equivalent amount to the USDA Rural Housing Service. See IRC §42 (g)(2)(B)(iv).

Other Income Producing Activities

1. Are tenants paying any fees in addition to rent, and if so, what are the fees for?
2. Is the taxpayer receiving any rent subsidies from any federal, state, local or private source?
3. Is the property being used for a commercial purpose that generates income?

Other Sources of Funds

1. Did the taxpayer receive any federal grants or federal subsidies during the tax year under audit?
2. Have investors made additional contributions?
3. Did the taxpayer receive any loan proceeds during the tax year under audit?

Tour the Business Site

For purposes of the minimum income probes, touring the LIHC property site serves three fundamental purposes:
Taxpayer's Business Practices

Examiners can gain familiarity with the taxpayer's business practices. This is particularly important if a management company provides day-to-day oversight of the property. Observe the taxpayer's internal controls: how is rent collected, recorded and deposited? Trace the transactions through the books and records to evaluate the reliability of the taxpayer's recordkeeping; i.e., do the books and records reflect actual operation?

Also ask about other common rental fees and payments. The treatment of these additional fees as either included in gross rent, or as a fee in addition to gross rent, will determine whether the LIHC unit is correctly rent-restricted. If not properly rent restricted, the unit is not included in the numerator when computing the Applicable Fraction.

Any charges to low-income tenants for services that are not optional generally must be included in gross rent. (See Reg. §1.42-11). No separate fees should be charged for tenant facilities (i.e., pools, parking, recreational facilities) if the costs of the facilities are included in eligible basis.

Identify Potential Sources of Income

In addition to the rent collected from households occupying the LIHC units, consider other sources that are not tenant-specific, such as vending machines in a laundry room. Also look for commercial uses of the property, such as a radio or cell phone tower.

Confirm the Existence of Assets

It may seem obvious considering the frequent reviews and inspections by the state agencies, but make sure the property actually exists and is currently suitable for occupancy. A detailed explanation of the physical standards is included in the instructions to Form 8823.

Evaluate Internal Controls

Internal controls are the taxpayer's policies and procedures used to identify, measure, and safeguard business operations and avoid material misstatements of financial information.

As with all taxpayers, the evaluation must include gaining an understanding of the taxpayer's business practices and control features. Specific to the LIHC, examiners should determine how the taxpayer ensures that the LIHC units are occupied by qualified low-income households, the rents for LIHC units are correctly limited, and the units are physically maintained in a manner suitable for occupancy.

1. Separation of duties: who determines that households are income-qualified? What policies are in place to ensure that the housing is available to the general public? How are prospective tenants identified? Who collects rents? Who makes deposits? Who reconciles the bank accounts?

2. Who maintains the financial records? Equally important, who has custody of the tenant files?

3. Adequate supervision of employees: Is there an on-site property manager? Who decides when physical maintenance is needed?

4. Management oversight and review: Because of the complex compliance requirements and potentially significant financial loss should noncompliance occur, it is quite likely that the limited partners (investors) will have some mechanism for ensuring that their investment is not at risk. Ask the taxpayer if there have been any independent or internal audits. A review of the results can be helpful to identify issues and set both the scope and depth of the IRS audit.

Test Gross Receipts

Use judgment to determine the depth of the reconciliation of income per the books and records to the income reported on the tax return. Base the conclusion on the reliability of the internal controls

1. Ask the taxpayer how income was computed and duplicate the taxpayer's steps.

2. Reconcile the bank records. If loan proceeds or other non-rent deposits are identified, ask for verification of the source; e.g., loan documents.

3. Confirm that income from all assets observed during the tour of the business in included in income.

4. Trace specific transactions. Do the books account for each month that each unit was occupied? For tenants that pay by cash, how is cash handled and how timely is cash deposited?

5. Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income. Test weaknesses to determine whether income was actually diverted.

Business Ratio Analysis

The initial reconciliation of income per the books and records to the tax return provides an understanding of *how* the taxpayer determined gross receipts. The books and records can also be used to evaluate the accuracy and reasonableness of the reported amount of income by analyzing ratios.

Horizontal Analysis

The tax return under audit should be compared to the prior and subsequent year returns. Look for changes in key ratios or absolute numeric entries. Changes over time can be identified and may result in the identification of large, unusual, or questionable items that would not otherwise be apparent. For example, a significant decrease in the depreciation expense may indicate that an asset is no longer in service. If the cost of the asset was included in the Eligible Basis, the impact on the credit needs to be considered.

Vertical Analysis

The tax return should be analyzed to identify differences between this taxpayer's business and the industry's standards for the year under audit. The purpose is to evaluate the reasonableness of the gross rents and new profit reported on the tax return.

This is a great audit technique, but realistically, where would you easily find statistics specific to LIHC properties?

An alternative is needed and (thank goodness) there is an easy substitute. Under IRC §42(m), the following information is available from the state agency that allocated the credit:

1. A comprehensive market study of the housing needs of low-income individuals in the area to be served by the project. (IRC §42(m)(1)(A)(iii))

2. Sources and uses of funds, as well as the total financing planned for the project. (IRC §42(m)(2)(B)(i))

3. Developmental and operational costs of the project. (IRC §42(m)(2)(B)(iv))

The information listed above can help determine whether the property is performing as anticipated. Significant deviation of actual costs and rental income from the anticipated amounts should be explained. Please refer to Newsletter #7 for more information about state agencies and how to contact them.

Conclusion

An examination of income is conducted to determine whether taxable income has been accurately reported on the tax return. While a return may be selected specifically for an LIHC issue, the examination of income remains an audit requirement. Completion of the examination of income will also provide needed information for determining whether the owner is in compliance with the requirements of IRC §42 and if the credit was correctly computed.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

All LIHC cases should include Project Code 670 and ERCS Tracking Code 9812. If you expand an audit to include additional years or related taxpayers, please make sure the additional returns also carry the LIHC project code and tracking code designation. If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♫Grace Notes♫

I really enjoy living on the east coast. Having grown up in the Salt Lake valley, basically a desert and dry bed of the really big ancient Lake Bonneville, I truly appreciate the multitudes of green trees in the spring…the glades of sun-dappled green trees in the summer…and the brilliant splendor of flaming reds and oranges and yellows during the autumn months. I even (mostly) enjoy raking up the leaves, which is what I found myself doing most of Thanksgiving weekend.

So there I was, raking up a pile of leaves under the Oak tree, when a flurry of wind came rushing through, creating a little momentary tornado with me in the middle. It was an odd feeling and certainly a unique perspective as the leaves fluttered around me. The leaves were as individually shaped as snowflakes!

Later, dragging bags of leaves to the sidewalk, I noticed an oddly shaped leaf stuck to the brick façade of my house. My first thought was that the leaf was snagged in a cobweb. But when I looked closer, I discovered that it was really a brown Preying Mantis sunning on the warm bricks. "Cool", I thought, "I didn't know these beautiful creatures actually change colors so they can continue blending with the foliage!" (If your brother is an entomologist, all bugs are beautiful creatures.)

While we have always focused directly on LIHC issues, the feature article this month is also written from a new point of view. What if I changed the perspective and looked at how I would complete the mandatory examination of income for a LIHC tax return…and, since this is the LIHC Newsletter, how would the examination of income interrelate with the audit of the credit?

Looking at something from a different perspective brings understanding and appreciation. It's fun!

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #24, April 2007

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Guide for Completing Form 8823: an IRS Revenue Agent's Viewpoint

The new Guide for Completing Form 8823 was unveiled at the National Council of State Housing Agencies' January 2007 conference. The guide was written at the request of the state agencies and with their assistance, to promote the consistent application of IRC §42 requirements and reporting of noncompliance to the IRS via Form 8823.

While the guide was written specifically for state agencies and its scope is limited to the reporting of noncompliance and building dispositions, the guide is also a very useful audit tool for revenue agents.

Taxpayers are selected for audit based on the reported noncompliance. All the Forms 8823 and attached explanation are included in the case file. Reviewing the chapters for the categories of noncompliance reported by the state agency will help agents understand the issue and prepare for the audit.

The guide is the only comprehensive source of information for topics not detailed in the Code. Here are a few examples:

> Households need to be income-qualified in order for a rental unit to qualify for the credit. How is the income limit determined? How do you define a household? Income isn't taxable income, how is it determined and verified? What kind of documentation should be in the tenant file? See chapter 4.
>
> Under the Code, the low-income units must be suitable for occupancy. How is "suitable for occupancy" defined? If the property looks okay to you when you tour the property as part of your audit, is that good enough? See chapter 6.
>
> The rent charged for low-income rental units must be restricted. What if the taxpayer charges the tenant fees? Which fees are allowable? How do the fees affect the rent limit? Does it matter? See chapter 11.

The guide is well-documented within the text, in footnotes, and at the end of each chapter. These references will be helpful when citing the authority to sustain technical positions.

In total, there are 16 categories identifying specific noncompliance issues, plus an "other" category and the reporting of building dispositions, which trigger the application of the recapture rules (see Exhibit 24-1). Happy reading!

Editor's Note: The guide is available sending an e-mail to **Grace.F.Robertson@irs.gov**. The guide will not be available on the IRS web for a while due to technical problems.

IRC §42 Filing Requirements

It's *that* time of year…time to file federal tax returns. For owners of LIHC properties, this will include computing the credit amount on Form 8609-A, Annual Statement for Low-Income Housing Credit. A few reminders:

For Part 1: Compliance Information. The building identification number should be identified on Line A and answer <u>all</u> the questions. If the taxpayer answered "no" to item C, the credit is subject to disallowance.

For Part II, which is the actual computation of the credit, there are several common errors:

Eligible Basis

Eligible Basis is determined as of the close of the first taxable year of the credit period and is generally the same every year. See IRC §42(d) for all the requirements. Decreases in Eligible Basis will result in a decrease in Qualified Basis which will trigger the recapture provisions under IRC §42(j).

Applicable Fraction- First Year Computation

The Applicable Fraction is determined as of the last day of each tax year. For the first year of the credit period, the Applicable Fraction is the average fraction over the 12-month period. See IRC §42(f)(2).

Intuitively, the allowable credit for the first year should be proportionate to the maximum housing credit dollar amount on Form 8609, line 1b, and the proportion should be the "averaged" Applicable Fraction.

For example, a low-income building is 100% occupied by income-qualified households on the last day of the first taxable year of the credit period, but the "averaged" Applicable Fraction is 58.04%. The Eligible Basis is $2,000,000 and the Applicable Percentage is 8.1%.

For the first year of the credit period, the allowable credit is computed as:

Eligible Basis	$2,000,0000
x Applicable Fraction:	.5804
x Applicable %:	.081
Credit Amount:	$94,025

For years after the first year, the allowable credit is computed as:

Eligible Basis:	$2,000,0000
x Applicable Fraction:	1.0
x Applicable %:	.081
Credit Amount:	$162,000

$94,025/$162,000 is 58.04%. This is a good check on the math, but unfortunately is not a true statement if the state agency allocated less credit than the full amount of credit supported by the eligible basis. In our example, suppose the state agency limited the maximum annual credit amount allowable to $110,000 under IRC 42(m)(2)? The credit for years after the first year would be limited to the $110,000, but what about the first year?

The credit is computed just as before. Since $94,025 is less than the $110,000 maximum allowable credit, the full $94,025 can be claimed for the first year of the credit period.

Eligible Basis:	$2,000,0000
x Applicable Fraction:	.5804
x Applicable %:	.081
Credit Amount:	$94,025

For the 11th year of the credit period, the allowable credit is the portion of the credit not allowed in the first year. So, in our example, $110,000 - $94,025 = $15,975 for year 11. The taxpayer should keep documentation of the credit amount claimed for the first year of the credit period.

Applicable Percentage

If, as a result of renting additional low-income units after the end of the first year of the credit period, there is an increase in Qualified Basis, then the Applicable Percentage for the additional Qualified Basis is 2/3 of the Applicable Percentage identified on Form 8609, line 2.

Disposition of Building

If a low-income building or interest therein is sold or otherwise disposed, the Qualified Basis at the end of the taxable year is zero and no credit is allowable. The taxpayer is also subject to the recapture rules and must file Form 8611 with their tax return. If, however, the building continues to operate as a qualified low-income building, the taxpayer can avoid the recapture requirement by placing a bond with the IRS. The bond is filed with the Philadelphia Campus using Form 8693 within 60 days of the disposition. Form 8693 is not filed with the taxpayer's tax return.

Form 8609, Low-Income Housing Credit Allocation and Certification

Taxpayers are no longer required to file Form 8609 with their tax returns. Instead, taxpayers complete the IRC §42(l) certification by submitting the completed Form 8609 to the IRS just *one time.*

The certification must be made using the Form 8609 received from the state agency, with Part I completed, signed and dated.

Taxpayers must make the one time submission even if they filed Form 8609 with their tax return in a prior year (if the allocation was made using the November 2003 revision of the form, refer to the instructions for the December 2005 revision for additional information).

Taxpayers must complete the one time submission with Part II completed for qualified low-income buildings financed with tax-exempt bonds.

Taxpayers make elections by checking the "yes" or "no" boxes for lines 8b, 9a, 9b, 10a, and 10b. The four elections 10(a)-(d) are irrevocable.

If the taxpayer elects to treat the building as part of a multiple building project (line 8b), each building to be included in the project must be identified in an attachment to the Form 8609. Refer to the instructions for the December 2006 revision of Form 8609 for additional information.

LIHC and ESTG: Office of Examination Specialization and Technical Guidance (ESTG)

The LIHC program is managed by ESTG, a group within SBSE Exam Policy. There are 13 program analysts and technical advisors who are experts on a variety of technical issues, industries, and specific Code sections like IRC §42. The group is committed to the development of technical expertise through training and mentoring, and maintains a website that includes a page for the LIHC program. Reference material and technical information is available at: **http://sbse.web.irs.gov/TG/TGIndustryIssues.htm#LowIncome**.

Note: The webpage is part of the IRS' internal network and is not available to the general public.

IRS Guidance

1. Rev. Proc. 2007-20 – Transactions in which the refundable or contingent fee is related to the low-income housing credit under IRC §42(a) are not reportable transactions for purposes of the disclosure rules under Treas. Reg. 1.6011-4(b)(4). However, the transactions may be reportable under (b)(2), (b)(3), (b)(5), (b)(6) or (b)(7) of the same regulation.

2. Chief Counsel Notice CC-2007-010 – the IRS has provided limited relief for satisfying the requirement for making a carryover allocation of LIHC dollar amount under IRC §42(h)(1)(E) and (F) in the Gulf Opportunity Zone by the close of the 2006 calendar year. Given the unique nature of the problems in the GO ZONE and the administrative complexities associated with the initial allocation of credits from the Credit Cap, the Service will consider carryover allocations intended to be made from the 2006 Credit Cap that satisfy Treas. Reg. 1.42-6(d)(2)(i) through (x), but signed and dated by January 31, 2007, as having been made by the close of the 2006 calendar year.

LIHC Administrative Reminders

All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If you expand an audit to include additional years or related taxpayers, please make sure the additional returns also carry the LIHC project code and tracking code designation.

TEFRA Reminders

As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember that examiners are required to document actions taken and decisions made. Examiners must complete Form 12813, TEFRA Procedures Checksheet for every examination of a partnership or limited liability company (LLC) filing as a partnership. If the partnership or LLC is subject to the TEFRA procedures, three additional checksheets are required:

Form 13814, TEFRA Linkage Package Checksheet

Form 13828, Tax Matters Partner (TMP) Qualification Checksheet

Form 13827, Tax Matters Partner (TMP) Designation Checksheet

Surveying LIHC Tax Returns

If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

You might have noticed that the format of the newsletter changed ever so slightly this month. It's not that I rearrange the furniture on a whim, but with the release of the Guide for Completing Form 8823, it did seem appropriate to hit the "reset" button.

First of all, a really, really big thanks to everyone that assisted with the Form 8823 Guide – ideas and discussions, writing, providing references, feedback on drafts, editing….and well, everything else. It has been quite a journey.

My second thought is that we have been issuing the LIHC newsletter since October of 2000 and if you look back at those old newsletters…well, we've come a long way. If you find a conflict between the newsletter and the guide – the information in the guide is the most current and should be followed.

Change is a pain, but progress is excellent!

Grace Robertson
Phone: 202-283-2516
Fax: ***202-283-2485***
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #25, August 2007

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Eligible Basis: Audit Strategy

The low-income housing credit amount is based on certain costs associated with a building qualifying as residential rental property; i.e., the cost of acquiring and rehabilitating, or constructing, a building. The total qualifying costs are known as the *eligible basis.*

Step 1: Determine that the costs are for depreciable assets on a building-by-building basis. And, since there can be more than one allocation (Form 8609), the costs should be associated with an allocation. Since some costs are incurred on a project basis, it will be necessary to determine how the taxpayer allocated the costs between buildings.

Step 2: Determine whether the cost is associated with residential rental housing, including the costs of personal property for use by the households, such as appliances. It can also include the cost of amenities such as garages, swimming pools and parking lots, as long as the taxpayer does not charge a separate fee charged for the use of the amenity and the amenity is available to all households. A portion of the cost of a community service facility can also be included.

Step 3: Determine whether costs where incurred before the end of the first year of the credit period. Eligible basis is the building's adjusted basis as of the close of the 1st taxable year of the credit period.

Step 4: Determine how the costs were financed. Ensure that the eligible basis as been reduced for any federal grants.

Step 5: Determine whether the cost is associated with the substantial rehabilitation of an existing building. These projects are subject to additional rules, which are addressed in Newsletter #17

Step 6: Once the correct eligible basis is determined, compare the result to the amount indicated by the taxpayer on Form 8609, Part II, line 7, which should be the same as on Form 8609-A, line 1.

The following information and documents are needed to audit this issue:

1. Form 8609, as completed/signed by both the state agency and the taxpayer.
2. Date each building in the project was placed in service. The taxpayer should provide certificates of occupancy. The information from the certificates should match the information on Form 8609, Part I.
3. Determine when the 10-year credit period started. It will be the tax year the building was placed in service, or the subsequent tax year if the taxpayer elected to postpone the beginning of the credit period on Form 8609, Part II, line 10a.
4. The taxpayer's depreciation schedules. Also ask for original construction contracts and receipts to verify cost amounts.
5. The taxpayer's credit application and final cost certification should be secured from the state agency, as well as the state agency's final gap analysis. These documents will include descriptions of the property, including amenities, which the taxpayer intends to construct. The cost certification should not be relied upon, but is a starting point for reconciling the taxpayer's documentation of eligible basis. The state agency's gap analysis will disclose the taxpayer's financing resources.

Proposed Regulation Update for Utility Allowance Released for Public Comment

The IRS released proposed regulatory changes that would update Treas. Reg. 1.42-10, Utility Allowances. Most significantly, the proposed regulation provides for two new methods of computing a utility allowance:

1. An owner may obtain a utility estimate from the state agency that has jurisdiction over the building, provided the state agency agrees to provide the estimate. The estimate may be based on (1) the cost for units of similar size and construction located in the same geographical area, or (2) the actual utility company usage data and rates for the building.

2. The utility allowance can also be calculated using the HUD Utility Schedule Model, which is available on the Low-Income Housing Credits page at **www.huduser.org/datasets/lihtc.html**.

The proposed changes to the regulation were released for public comment in the Federal Register on June 19, 2007 (Volume 72, No.117). Comments are due by September 17th and a hearing is scheduled for October 9th, 2007.

Revenue Procedure 2007-54: Updated Relief Procedures

The IRS has released updated guidance for LIHC properties and state agencies located in areas declared major disasters by the President. The new revenue procedure supersedes (replaces) Rev. Proc. 95-28. Highlights include:

1. The date for meeting the 10% basis requirement is extended 6 months after the date the owner would otherwise be required to meet the requirement.

2. For carryover allocations, if the disaster occurs within the two year construction period, the IRS will treat the owner as having satisfied the placed in service requirement if the building is in service no later that December 31st of the year following the two year period.

3. For buildings in the first year of the credit period, the state agency has two choices: (1) treat the allocation as returned credit or (2) toll the beginning of the credit period, but not longer than 24 months after the end of the calendar year in which the disaster occurred. No credit can be claimed during the restoration period for such first-year buildings.

4. Buildings beyond the first year of the credit period will not be subject to recapture or loss of credit if the qualified basis is restored within a reasonable time. The state agency will determine how much time the owner needs, but in no case will the time be more than 24 months after the close of calendar year in which the disaster occurred.

5. State agencies, without prior IRS authorization, may permit owners to provide temporary emergency housing relief to displaced low-income individuals for up to 4 months beyond the date of the President's major disaster declaration.

Instruction for reporting the status of LIHC buildings damaged by disasters qualifying for relief under this revenue procedure will be included with the instructions for Form 8610.

Notice 2007-66: Relief for LIHC Projects in Gulf Opportunity Zone

For qualified low-income buildings located in the GO Zone and beyond the first year of the credit period, the IRS has extended the maximum time period considered reasonable under IRC §42(j)(4)(E) from 24 months to 48 months after the end of the 2005 calendar year. The actual time period is determined by the state agency on a building-by-building basis. To qualify, the owner must be engaged in the restoration of the buildings qualified basis, which means:

1. on-going physical repairs to the building,

2. having entered into binding, written contracts for the repair or restoration to be completed within the restoration period, or

3. active negotiation of contracts for the repair or restoration, including obtaining permits for construction.

If a building's qualified basis is restored within the period determined by the state agency, not to exceed 48 months, the building will not be subject to recapture and the building may continue to earn credit during that restoration period.

Changing Faces: Departing

Angie Kaminski, long time manager of the LIHC Compliance Unit at the Philadelphia Campus, has accepted a new assignment as an analyst with the Planning and Analysis Staff at the campus.

Kent Rinehart, program analyst on SBSE's Examination Specialization and Technical Guidance staff, is also leaving for a new assignment with the Penalties staff. Kent has worked with the LIHC as a revenue agent, field coordinator, and then as an analyst.

Both Angie and Kent will be genuinely missed for their enthusiastic support of the LIHC program, but we wish them well in their new assignments (really).

Changing Faces: Arriving

Steve Howard has joined the LIHC contingent as our Technical Guidance Coordinator in Appeals.

LIHC Administrative Reminders

Expanding Exam, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

Imagine that you are the captain of a navy ship on patrol when your ship is hit by a missile from an enemy ship and the missiles just keep on coming. In moments most of the crew is lying on the top deck, injured and dying, and the ship is severely damaged. The remaining uninjured crew can only do one thing at a time, so what should you do first? Take out the enemy ship with your superior missiles? Get the injured out of harm's way? Fix the hole in the ship? Retreat before you sink?

I suspect the few of us will ever command a Navy vessel in the middle of a battle. We will, however, spend our days doing "stuff"; tasks that just absolutely must be done, tasks requiring prioritization, tasks intended to serve a purpose. Unless you are the captain of the ship, it may be difficult to see the big picture and whether your assigned task actually contributes toward the goal.

For example, IRS examiners conduct audits of tax returns to determine whether a specific

taxpayer is compliant with the Internal Revenue Code. Most people will agree that the very risk of an audit, and the possible negative outcome, is sufficient motivation to stop most people (but not all) from participating in serious noncompliance. But have you every tried to measure or quantify the impact? Does an examiner, doing audit after audit, necessarily see that impact?

Similarly, state agencies are required to physically inspect LIHC properties and review tenant files at least once every three years. The very fact that LIHC properties are subject to review is an incentive for most owners to maintain the property in a manner suitable for occupancy and ensure tat the households occupying the units are income qualified. Findings of noncompliance have immediate consequences for the owner; the noncompliance is reported to the IRS, which may result in an IRS audit, and the taxpayer may be excluded from future allocations of credit for new projects. If you consider the ways the low-income housing industry is integrated with checks and balances, it is not difficult to see the most owners (but not all) are diligent in maintaining compliance and avoiding the consequences of noncompliance. But can we really measure or quantify the impact of the state agencies' reviews and inspections? Is that impact visible to the state agency employee sifting through tenant file after tenant file?

Like the captain of the navy ship, each of us must set priorities in order to accomplish the most important tasks assigned to us. Like members of the crew, we don't necessary see the big picture. When deciding which tasks are most important, we need to keep focused on our single objective: providing decent, safe, and secure affordable housing to individuals and families who are in need.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Have you thought about the captain's dilemma? What would you do? If you discuss the question in a group, you'll find a variety of answers and justifications; something to think about when setting your own priorities.

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #26, September 2007

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Documenting Household Income

The accurate determination of a household's income is a fundamental requirement of the IRC §42 Low-Income Housing Credit program. Not only is it necessary for identifying households most in need of the housing, but the determination must be adequately documented in order for the owner to claim the credit.

Under Treas. Reg. §1.42-5(b)(1)(vii), owners of LIHC properties must keep "documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation)." Taxpayers must retain these records for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year (15th) of the compliance period of the building.

Further, under section 6001 of the Code, *all taxpayers* are required to maintain records sufficiently detailed to prepare a proper tax return. This requires the maintenance of such permanent books and records sufficient to establish the amounts of gross income, deductions, *credits*, or other matters to be shown on the taxpayer's return. This requirement also applies to the preparation and maintenance of tenant files sufficiently documented to support household eligibility for purposes of claiming the low-income housing credit under IRC §42.

In some cases, a potential tenant may have self-employment income. Income from a sole proprietorship can be estimated by reviewing the individual's prior year tax return and Schedule C. But what if the potential tenant doesn't file a tax return? Now what should you do?

All income defined under IRC §61 is subject to taxation, and a tax return must be filed for all self-employed individuals who operate sole-proprietorship businesses or otherwise report income on Schedule C. It doesn't matter whether the taxpayer is reporting a profit or a loss.

If the person is not eligible to get an SSN, which is needed to file a tax return, an individual taxpayer identification number (ITIN) can be obtained using Form W-7.

Publications 501 and 519 may be helpful if more detailed information is needed.

Defining "Married" Students

Residential rental units comprised of full-time students (no one of whom is entitled to file a joint return) do not qualify as low-income units. However, there are exceptions. Under IRC §42(i)(3)(D)(ii)(II), a unit is still treated as a low-income unit when it is occupied entirely by full-time students if such students are married and file a joint return. As explained in the Guide for Completing Form 8823, a married couple that is entitled to file a joint return, but has not filed one, still satisfies the requirement.

So, who is entitled to file a "joint" tax return? A taxpayer can choose "married filed jointly" if married and both spouses agree to file a joint return.

For purposes of filing a married joint return, a couple is considered married for the whole taxable year if, on the last day of the tax year, the couple meets any one of the following tests.

1. The couple is married and living together as husband and wife,

2. The couple is living together in a common law marriage that is recognized in the state where they now live or in the state where the common law marriage began,

3. The couple is married and living apart, but not legally separated under a decree of divorce or separate maintenance, or

4. The couple is separated under an inter-locutory (not final) decree of divorce. For purposes of filing a joint tax return, the couple is not considered divorced.

For more information, refer to Publication 501.

Treating Buildings as Part of a Multiple Building Project

As part of the First-Year Certification required under IRC §42(l)(1) and documented on Form 8609, Low-income Housing Credit Allocation and Certification, a taxpayer can elect to treat the buildings as part of a multiple building project. To qualify for the election, the buildings must be:

1. located on the same tract of land (unless all the units in all the buildings are low-income units),

2. owned by the same person for tax purposes,

3. financed under a common plan, and

4. have similarly constructed residential units.

The taxpayer's election will effect how the property operates in at least four ways.

Minimum Set-Aside Requirement

Under IRC §42(g)(1), an LIHC property owner elects to provide housing to low-income households with income at specific levels when compared to the area's median gross income, as adjusted for family size. The taxpayer also agrees to provide housing to a minimum number of low-income households. The determination of whether the owner has met the minimum set-aside requirement is made at the *project* level.

Suppose an owner has two LIHC buildings with 100 units in each building, and elects the 40-60 minimum set-aside; i.e., 40% of the units in the project will be rented to households with income not exceeding 60% of the AMGI.

If the owner decided to treat the buildings as separate projects, then 40 units in each building must be rented to income-qualifying households, or 80 units in total.

If the owner decides to treat the buildings as a multiple building project, the owner will still need to provide 80 low-income units (40% x 200 = 80) but the units do not need to be distributed equally between the two buildings.

Transferring Tenants Between Buildings

Under Rev. Rul. 2004-82, Q&A #8, a low-income household can transfer to a low-income unit in a different building within the *project*. A cautionary note is needed here. Only households whose income is no greater than 140% of the income limit (or 170% for deep rent skewed projects) can move between buildings in a project because the Available Unit Rule under IRC §42(g)(2)(D)(ii) is applied at the *building* level.

Vacant Unit Rule

Under Treas. Reg. §1.42-5(c)(1)(ix), if a low-income unit *in the project* became vacant during the year, reasonable attempts must be made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the *project* were or will be rented to tenants not having a qualifying income.

Physical Inspections and Tenant File Reviews

State agencies are required to physically inspect at least 20% of an LIHC *project's* low-income units and review the low-income certifications (and documentation) for the households in those units at least once every three years.

Suppose an owner has two buildings with a hundred low-income units in each building. If each building is treated as a separate project, the state agency will review 20 units in each building, for a total of 40 units. If the taxpayer elects to treat the buildings as a multiple building project, 20% of the 200 units is also 40 units.

The answer is quite different if the owner's low-income property consists of 100 single family houses. If each house is treated as a separate project, the state agency will need to review all 100 homes and all the tenant files. If the owner elects to treat all the homes as a multiple building project, only 20 of the homes will need to be inspected along with the review of the tenant files for those units.

Impact of Noncompliance Reported to the IRS on Forms 8823

State agencies use Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, to notify the IRS of noncompliance with IRC §42 requirements.

The form may indicate that the owner was noncompliant, but the noncompliance was corrected before the Form 8823 was sent to the IRS. In cases where the noncompliance was not corrected before the end of the correct period, the Form 8823 will indicate that noncompliance previously reported on a different Form 8823 has now been corrected. In either case, these "back in compliance" Forms 8823 are processed without contacting the taxpayer.

Owners are notified, however, when the IRS receives Forms 8823 disclosing noncompliance which has not been corrected within the correction period. The notification letter identifies the noncompliance issues and explains that nonqualifying units should not be included when calculating the credit. The owner may be subject to the recapture provisions under IRC §42(j).

LIHC property owners are taxpayers who are expected to file accurate tax returns just like everyone else. So, if noncompliance occurs, taxpayers should account for the noncompliance regardless of whether the state agency identifies it, reports it to the IRS, or which letter (if any) is sent to the taxpayer by the IRS.

For example, a state agency reviews a project and finds that the owner is out of compliance. The owner is notified of the noncompliance and immediately corrects the problem. As a result, the owner is reported as "out and back in compliance" when the state agency files the Form 8823 with the IRS. Will the owner receive the notification letter? Are they expected to forego credits?

Example 1

The state reviewed a project and found that a unit was not suitable for occupancy on February 1, 2007. The owner was notified and immediately fixed the problem on March 30, 2007. Therefore this unit was "out and back in compliance" and an 8823 will be filed, but the taxpayer will not receive a notification letter.

Assuming the taxpayer's tax year ends December 31st, there is no tax impact. At the end of the tax year, when the Applicable Fraction is computed based on a "snapshot" measurement, the unit is in compliance.

Example 2

A state agency reviewed a project in December of 2006 and noted that water pipes had frozen and burst. The pipes could not be repaired until spring when the ground thawed. The state agency extended the correction period to the maximum six months and reported the owner out of compliance on December 15th, 2006 and back in compliance on April 15th, 2007 when the Form 8823 was filed.

Even though the taxpayer won't get a letter, and assuming the broken pipes affected all the units, the Applicable Fraction is zero on December 31, 2006, the last day of the taxable year. No credit would be allowable for the building in 2006 and the noncompliance would trigger a credit recapture event.

Credit Recapture Events

A taxpayer is required to recapture a portion of the credit allowed prior years if, for any year in the 15 year compliance period, the qualified basis at the end of the taxable year is less than the qualified basis at the end of the preceding taxable year. Since the qualified basis is equal to the eligible basis multiplied by the applicable fraction, any decrease in either the eligible basis or applicable fraction will trigger a recapture event.

Decreases in qualified basis can be caused by:

1. noncompliance at the low-income unit, building or project level,
2. disposition of the low-income building, or
3. disposition of an interest in a low-income building.

The "credit recapture amount" is defined in IRC §42(j)(2) and has two parts:

1. The amount of credit recaptured is based on the year in which the recapture event occurs. For years 2 through 11, the amount of credit to be recaptured is 33.3% of the credit allowed in previous years. The percentage recaptured decreased every year thereafter.
   - 26.7%. in year 12,
   - 20% in year 13,
   - 13.3% in year 14, and
   - 6.7% in year 15.

2. The amount of interest is determined for the recaptured credit at the overpayment rate for all prior taxable years involved starting on the due date for the filing of the tax return for the prior taxable years involved.

Refer to IRC §42(j)(4) for "special rules"; i.e., (1) the application of the tax benefit rule, (2) no recapture of credit claimed under IRC §42(f)(3), (4) decreases in qualified basis caused by casualty events, and (5) di minimis changes in floor space.

LIHC Administrative Reminders

Expanding Exam, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with TEFRA Coordinators that can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫ Grace Notes ♫

You're right. An LIHC newsletter was issued just a month ago, and while the newsletters are normally issued quarterly (more or less), I write the articles as I think of relevant topics or someone asks a question. In this case, four people asked really good questions. Voila! – a newsletter goes to print!

On the other hand, you might notice that the questions are totally unrelated and not entirely based on IRC §42 law. Just think of this newsletter as the far right category on the Jeopardy answer board titled "Odds and Ends."

Which, quite logically, reminds me that it's the end of summer. I hope your summer included some fun vacation time…or at least wasn't all work….and you are ready to begin the new year because……

…to be continued….

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

P.S. Don't you just love cliffhangers?

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #27, October 2007

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

LIHC Audit Expectations

The LIHC program may be only a small portion of the IRS' effort to encourage compliance with the tax law, but it does contribute to SBSE Examination's success when quality audits are conducted. In this article, nine expectations or strategies for completing qualify audits of LIHC tax returns in a timely manner are discussed.

Issue Identification and Case Building

Case files for LIHC audits will include information and documents needed to develop the LIHC issues, including:

Classification checksheets identifying the specific issues and the potential adjustment to the credit,

The reason for the audit will be identified. The audit may result from information submitted by a state agency on Form 8823, industry sources, public information, or IRS analyses.

Memoranda and technical guidance for specific issues, and

When appropriate, copies of prior year returns.

Most LIHC properties are owned by partnerships. Yk1 research will be provided as needed to help examiners understand the partnership structure.

Technical Assistance

When an audit is initiated (Status 12), the examiner will be contacted by the Headquarters analyst. The analyst will provide assistance as needed throughout the examination.

Customer Satisfaction

Examinations should be conducted expeditiously and the actions should be timely.

Keep taxpayers and their representatives informed of the case's status from the start of the examination through its resolution.

Provide taxpayers and their representatives with clear, complete and accurate explanations of the report, adjustments, and available options for resolving issues.

Minimum LIHC Audit Requirements

Determining the scope of an examination is the process through which examiners select issues warranting examination, so that (with reasonable certainty) all items necessary for a substantially correct determination of the tax liability have been considered. At a minimum, the following LIHC issues must be addressed:

Eligible Basis: Review the taxpayer's records to confirm that only allowable costs for depreciable residential rental property and amenities have been included in the computation.

Habitation Standards: Tour the property to ensure that the property is well maintained and suitable for occupancy.

Tenant Eligibility: Review the taxpayer's tenant files to ensure that tenants are income-qualified.

Rent Limits: Ensure that the restricted rent is correctly computed and allowances under IRC §42(g)(2), which reduce the gross rent amount, are properly applied.

In cases where the state agency has reported that the taxpayer is no longer participating in the program, the audit can be limited to consideration of the recapture provisions under IRC §42(j).

Investor returns are also identified for audit when the taxpayer has failed to correctly recapture the LIHC under IRC §42(j) and/or did not correctly and timely secure a surety bond or securities under IRC §42(j)(6).

Examination of Income

The examination of income is a required issue for all tax returns selected for audit and while LIHC partnerships are usually audited for specific IRC §42 issues, examiners must still complete the minimum income probes as outlined in IRM 4.10.4.3.4. In addition, the following two audit techniques should also be used

The financial status analysis described in IRM 4.10.4.3.3.1 is not required for partnership returns, but a quick review of the cash flows based on the rental schedule included with the return to estimate whether the taxpayer has sufficient funds to cover the operational expenses can be insightful. If the loss represents a true imbalance of cash flows, i.e., more expenses paid than income reported, then the source of funds used to pay operational costs and service debt should be identified.

Examiners should also review the taxpayer's website as part of the tour of the business. See IRM 4.10.4.3.6.2. While the taxpayer is probably not involved in e-commerce, the taxpayer may use the Internet to advertise available housing. The site may disclose rents, renting practices, and the availability of amenities.

Issue Development and Taxpayer Privacy

Examiners should complete the audit at the taxpayer's premises, conduct interviews and tour the business site whenever possible to ensure proper factual development.

The obligation to protect taxpayers' privacy and safeguard taxpayer information is a fundamental part of the IRS' mission to apply the tax law with integrity and fairness. Taxpayers have the right to expect that information they provide with be safeguarded and used only in accordance with the law.

> No information will be collected or used with respect to taxpayers that is not necessary and relevant for tax administration and other legally mandated or authorized purposes.
>
> Information will be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates. (See IRM 4.10.1.6.12 for procedures to be used when making third party contacts.)
>
> Information about taxpayers collected from third parties will be verified to the extent practicable, with the taxpayers themselves, before a determination is made using the information.

Required Filing Checks

Examiners are encouraged to expand an audit to include multiple years or related taxpayers in all cases when appropriate. See IRM 4.10.5.

Penalties

Transactions designed to defeat the tax system must be addressed. Consideration should be given to fraud (IRM 20.1.5.12), aiding and abetting penalties (IRM 20.1.6.6) and preparer penalties (IRM 20.1.6.3).

Case Monitoring and Quality Improvement

To ensure proper monitoring of LIHC cases, Project Code 0670 and Tracking Code 9812 are used to identify audits in process. Examiners will be asked to provide information about the case, issue development, and results. On occasion, closed cases will be reviewed. The information will be used to improve the quality of case work and administration of the program. The information will be not be used to evaluate employee performance.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should

also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

It's time to set goals for FY2008. I was once asked how I managed to get so much done, and other than being a bit too focused and intense at times, here's what I answered:

First, you need to decide what it is you want to accomplish; i.e., the *goal*. The IRS is responsible for administering the tax code with integrity and fairness for all. Part of the strategy for administering the tax code is conducting audits. So, for SBSE Examination, the goal is to efficiently conduct quality audits..

Second, you need to determine what must be done to accomplish the goal; i.e., *quality* audits *efficiently* completed. In this newsletter, I have outlined nine tasks or expectations that will contribute to the completion of efficiently conducted quality audits of taxpayers owning LIHC properties. The tasks and expectations I've identified are not new, nor are they particularly unique to the LIHC program. But they are the "tried and proved" methodology for completing quality audits in a timely manner.

Third, and this may seem obvious, but you need to actually complete the tasks identified in step two. What is not so obvious is that you must do *only* those tasks that actually move you closer to your goal. Distractions –all those fun things you *want* to do- can be your downfall!

And that brings us to the heart of the matter: how do you achieve your goals and have fun, too? After all, being focused and intense can give you a royal headache. And that reminds me of two of my favorite quips from my respected elders:

"Work isn't work if its fun."

"You have to do it til you like it."

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #27, December 2007

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

LIHC Property Owners Subject to State Agency Reviews

Under Treas. Reg. 1.42-5(c)(2), state agencies are required to review LIHC properties. The first review must be completed by the end of the second calendar year following the year the last building in the project is placed in service, and at least once every three years thereafter.

The reviews consist of an on-site physical inspection of all the buildings in the project, and at least 20 percent of the units to ensure the property is suitable for occupancy. In addition, for each unit selected for the physical inspection, the state agency must also review the tenant file to ensure that (1) the household occupying the unit is income qualified, and (2) the rents are correctly restricted.

An owner is in compliance when requests for a site inspection and tenant file reviews are honored without unreasonable postponements. An owner is out of compliance when requests are denied or unreasonably postponed. The IRS, in the Guide for Completing Form 8823, has advised the state agencies that valid reasons for postponing an inspection or tenant file review should be accommodated. However, similar to IRS policy for rescheduling audit appoints, the site visits and files reviews should not be delayed more than 45 days, except under unusual circumstances. In any event, owners should not be allowed to unreasonably delay or circumvent the required compliance monitoring reviews.

In the event the taxpayer fails to respond to a state agency's request to conduct the physical inspection of the property or review the tenant files, the taxpayer is out of compliance with the requirements of IRC §42.

Effectively, the state agency cannot determine whether the property is physically suitable for occupancy, whether any of the households occupying the units are income-qualified, or whether the rents are correctly restricted. And, since the noncompliance is global in nature, the project is considered *entirely* out of compliance.

Under IRC §42(c)(1)(A)(i), the applicable fraction is determined as of the close of the taxable year. If the noncompliance persists and is not corrected by the end of the taxpayer's taxable year, the Applicable Fraction is zero. If the Applicable Fraction is zero, then the Qualified Basis is zero and no credit is allowable for that year, or for any year until the physical inspection and tenant file review is completed. The taxpayer is also subject to the recapture provisions under IRC §42(j).

Multiple Building LIHC Projects: Clarification of Election

The LIHC Newsletter (#26) for September 2007 included an article about multiple building projects. The article stated that a taxpayer makes the election to treat a building as part of a multiple building project when completing Form 8609, Low-Income Housing Credit Allocation and Certification.

A clarification is needed. If the project meets the criteria, the election to treat the buildings as part of a multiple building project is valid only if:

> The "yes" box for Line 8b on all the Forms 8609 for all the buildings to be included in the project is checked. Remember, there may be more than one Form 8609 per building!

AND

> A statement is attached to the Form 8609 that includes (1) the name and address of the

project and each building in the project, (2) the Building Identification Number of each building to be included in the project, (3) the aggregate credit dollar amount for the project, and (4) the amount of credit allocated to each building in the project.

Remember, even if the "yes" box is checked, failure to attach the statement with the information described above will result in each building being considered a separate project.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I know I'm having a bad day when:

1. *I have to explain to my manager that I was late for work because my cat took my contact case (with contacts inside) off the night table during the night and it took a "few" minutes to find it. Dare I say the cat actually "stole" something?*

2. *I have to dial a telephone number THREE times because my fingers "automatically" follow the layout of the numbers on my computer keyboard even though I consciously know the layout on the telephone is in the opposite direction. Why did they do that?*

3. *I persist in using a password because I believe it is the right one (it must be a typo) and I don't want to look it up again. The account locks and I spend twenty minutes on hold waiting for the help desk to pick up the phone, which then transfers me to another help desk line, which puts on hold again. I promise, I promise!!! I'll never do it again!! Besides, there's so much computer klutziness I haven't tripped over yet! "Klutziness" is a real word?*

Sometimes, not often enough, we reflect upon the good things, and those thoughts always center around those we love.[1]

Joyous Holidays

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

[1] *A favorite line from the song "Sometimes", words by Felice Mancini and music by Henry Mancini.*

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #29, February 2008

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Congress Revises Student Rule for Single Parents

Congress, as part of the Mortgage Forgiveness Debt Relief Act of 2007, has revised IRC §42(i)(3)(D)(ii)(I), which addresses student households composed of a single parent and his or her children. The Code now reads:

> ….A unit shall not fail to be treated as a low-income unit merely because it is occupied…entirely by full-time students if such students are…single parents and their children and such parents are not dependents (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof of another individual and such children are not dependents (as so defined) of another individual other than a parent of such children.

While most changes to the Code are prospective, this change is applied *retroactively* as well as prospectively. The new rule applies to all LIHC allocations made before, on, or after the date of enactment and all buildings financed with tax-exempt bonds under IRC 42(h)(4) that are placed in service before, on, or after the date of enactment.

Filing Reminder: IRC §42(l) Report & Certification

Annual Report

Under IRC §42(l)(2), taxpayers are required to provide annual reports regarding their LIHC properties. This requirement is fulfilled when filing Form 8609-A, Annual Statement for Low-Income Housing Credit, is filed with the tax return. As well as computing the credit in Part II, taxpayers must complete Part I, Compliance Information. Question C asks whether the taxpayer has the original Form 8609 (or copy) that was signed and issued by the housing credit agency.

In order to claim the credit, taxpayers must have an original, signed Form 8609 (or copy) issued by a housing credit agency assigning a Building Identification Number to the building. This requirement applies even if no allocation of credit is required (as is the case of a building financed with tax-exempt bonds).

Any building owner claiming a credit without receiving a completed Form 8609 that is signed and dated by an authorized official of the housing credit agency is subject to having the credits disallowed.

Certification

Under IRC §42(l)(1), taxpayers are required to certify to the Secretary certain information regarding the operation of the LIHC property. The certification is completed by completing and signing Part II of the Form 8609 received from the housing credit agency and filing *just one time* with the Philadelphia Campus. (Be sure to keep copies of the completed form for your records.) The certification must be submitted to the IRS no later than the due date (including extensions) of the first tax return with which Form 8609-A is filed.

The completed Forms 8609 should be sent to:

Internal Revenue Service
P.O. Box 331
Attn: LIHC Unit, DP 607 South
Philadelphia Campus
Bensalem, PA 19020

Failure to make the certification timely, unless shown to be due to a reasonable cause and not willful negligence, will result in no credit being

allowable with respect to such building for any taxable year ending before the certification is made.

The one-time filing of Forms 8609 with the Philadelphia Campy is required even if the taxpayer previously filed the forms with its tax returns. So, even if a taxpayer has the Forms 8609 from the state and has been claimed the credit, the one-time certification must be completed.

Q&A From the Accountants' Corner

Q1: The 26th and 28th editions of the newsletter include articles about multi-building projects, but we're all standing around the coffee machine wondering about something you didn't address at all. On Form 8609, line 8b is used to designate which buildings are included in a multi-building project. Each building can stand alone as a separate project, and all the buildings can be included in the project, but can a taxpayer designate only some of the buildings as a project?

A1: Yes, a taxpayer can let each building stand on its own, or choose to include some or all of the buildings in the project. And just to recap from the prior newsletters:

> The buildings included in the project must meet specific criteria regarding proximity, ownership, financing, and comparability.
>
> The election is made by checking the "yes" box on all the Forms 8609 for all the buildings that will be included in the project and a statement is attached to the Forms 8609s with information about the buildings included in the project and the credit allocated to those buildings.
>
> At a minimum, the election will impact how the property is operated in at least four ways: (1) computation of the minimum set-aside, (2) ability to transfer tenants between buildings, (3) application of the Vacant Unit Rule, and (4) sampling used by the state agency when conducting tenant file reviews and physical inspections.

Q2: When completing the two Forms 8609 for an acquisition/rehabilitation project, and the acquisition placed-in-service date is in the year before the year the rehabilitation is completed, how do we complete question 10a, which asks whether the taxpayer is electing to begin the credit period the first year after the building is placed in service?

A2: Under IRC §42(f)(5), the credit period for the acquisition credit cannot begin before the first year of the credit period for the rehabilitation credit, so the idea is to match up the credit periods. For example, an owner places an acquired building in service on July 15, 2006 and completes the rehabilitation on June 9, 2007.

On the Form 8609 for the acquisition credit, the state agency reports that the placed in service date is July 15, 2006, on line 5 and the owner checks the line 10a box "yes" to elect to begin the *acquisition* credit period in the first year after the building is placed in service; i.e., 2007.

On the Form 8609 for the rehabilitation credit, the state agency reports that the placed in service date is June 9, 2007, on line 5 and the owner checks the line 10a box "no" to document that the owner is *not* electing to begin the *rehabilitation* credit period in the first year after the building is placed in service.

As a result, the credit period for both the acquisition and rehabilitation credit will begin at the same time; i.e., on the first day of the 2007 taxable year. If the owner is a calendar year taxpayer, both credit periods will start on January 1, 2007.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment

made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

It's February 13th, a cold and rainy day in the Washington area. It rained all night and the trees are covered with ice, which looks beautiful, but makes for treacherous driving around the beltway. I'm not complaining, though, as friends further north report blizzards and sub-zero temperatures before factoring in the wind chill. 'Course, this isn't exactly Texas, where the temperature is a balmy 70 degrees and the tulips are popping up. But…it's all relative, I tell myself.

"Well, not everything," myself answers back. For example, owners of LIHC property are required to maintain the LIHC property in a manner "suitable for occupancy." HUD has developed, and the IRS has adopted, the Uniform Physical Condition Standards, which rather precisely define by description just exactly what isn't acceptable. If you want to know more, there's a nice discussion in the Guide for Completing Form 8823, Chapter 6, and there's a relatively short summary included with the instructions for Form 8823.

The UPCS are equally applicable to all LIHC projects, regardless of location or type of housing. Owners know what is expected, inspectors can make objective evaluations of compliance, state agencies can accurately report noncompliance to the IRS, and, therefore, the IRS can administer tax law with integrity and fairness for all.

"See," I tell myself, "It is too all related!"

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #30, June 2008

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Chief Counsel Advisory 200812023

On March 21, 2008, the IRS released a Chief Counsel Advisory (CCA) providing guidance regarding IRC §42, the low-income housing credit. The issue involved the allocation of tax credits when special allocations in the partnership agreement result in the actual allocation of depreciation being different from the allocations provided for in the partnership agreement.

Chief Counsel Advisories are issued as requested by IRS' Examination functions. The following article, written by Kristina Thompson, provides an analysis of the legal issues presented in the CCA.

LIHC Partnerships and Credit Allocations under IRC §704 (b)

By Kristina Thompson, SBSE Revenue Agent

Generally when auditing LIHC issues, we are evaluating the taxpayer's compliance with the requirements of IRC §42. However, most owners of LIHC projects are partnership entities, so agents also need to review the taxpayer's compliance with partnership tax law.

Background

If you are new to LIHC issues, it may be helpful to understand why partnerships are generally set up as the ownership entity. The LIHC was set up under section 42 of the Internal Revenue Code to provide an incentive for taxpayers to invest in affordable housing by providing a tax credit. The credit is a dollar for dollar reduction of the investor's income tax liability. The taxpayer will generally invest in the affordable housing in exchange for a 10-year stream of tax credits and a 15-year stream of tax losses. The amount that any taxpayer is willing to invest in the project usually depends upon the rate of return generated by the future benefit of the tax credits and losses. Basically, investors are buying tax credits.

The entity of choice for these investors is the Limited Partnership or Limited Liability Company. Both entities offer limited liability for the investor, along with the flexible provisions of subchapter K which allow the taxpayer to allocate substantially all of the tax benefits associated with the project to the limited partners. The partnership agreements are often structured so that all of the gain, loss, and credits are allocated 99.9% to the limited partner and .01% to the general partner.

Under IRC §704 (a) the partnership is allowed to provide for the partners' distributive share of gain, loss or credits to be allocated based upon the partnership agreement. However IRC §704(b) provides that the partners distributive share of gain, loss, or credit shall be allocated in accordance with the partners interest in the partnership. If the allocation in the partnership agreement does not have substantial economic effect the allocation will not be allowed.

Overview of IRC §704(b)

Under IRC §704(b), an allocation of the partnership items will be respected if either of the following is satisfied: (i) the allocation has (or is deemed to have) substantial economic effect; or (ii) the allocation is (or is deemed to be) in accordance with the partners' respective interests in the partnership. In meeting these requirements, special rules apply in allocating deductions attributable to nonrecourse debt.

Substantial Economic Effect Test - Under the IRC §704(b) regulations, a two-part analysis is used to determine whether an allocation has ''substantial economic effect.'' First, the allocation must have economic effect, based on a mechanical analysis, and second, such economic effect must be substantial. This determination is made at the end of the partnership taxable year to which such allocation relates.

Economic Effect – The IRC §704(b) regulations provide, as a general rule, that allocations under a partnership agreement will be considered to have economic effect if the partnership agreement requires (i) the partners' capital accounts to be maintained in accordance with the IRC §704(b) regulations, (ii) liquidation proceeds to be distributed in accordance with positive capital accounts, taking into account all necessary adjustments to the partners' capital accounts for the taxable year of such liquidation, and (iii) ***partners to be unconditionally obligated to restore negative capital accounts upon the dissolution of the partnership by contributing cash or other property to the partnership.*** I recommend that you read your taxpayer's partnership agreement carefully. Many times, the limited partner is ***not*** required to restore any negative capital account balance upon the dissolution of the partnership.

The capital account requirements set forth in the IRC §704(b) regulations provide the fundamental rules for measuring each partner's equity investment and determining the economic relationships among the partners. A partner's capital account generally is increased by (i) the amount of money that the partner contributes to the partnership, (ii) the fair market value of property that the partner contributes (net of liabilities secured by the property and assumed by the partnership), and (iii) any allocations of partnership income or gain allocated to the partner. A partner's capital account is decreased by (i) the amount of money distributed to the partner by the partnership, (ii) the fair market value of property distributed to the partner (net of liabilities secured by the property and assumed by the partnership), and (iii) the amount of loss and deduction allocated to the partner. Thus, a partner's capital account reflects its economic interest in the transaction, based on the assumption that the value of the partnership property equals its IRC §704(b) book basis.

In the above discussion, note that tax credits do not have any effect on a partner's capital account. The provisions in the regulations under IRC §704 state that since the credit does not effect the capital account, any allocation of the credit must be in relation to the item that is effecting the capital account. In the case of the Low-Income Housing Credit, this would be depreciation since the basis in the building is what the dollar amount of the credit is based upon. Many partnership agreements will state that depreciation is allocated 99.9% to the limited partner, and as such, that partner would also be entitled to 99.9% of the credit. An issue arises if the limited partner ***does not have an unconditional obligation to restore the negative capital account upon the dissolution of the partnership and the partner is not allocated the overall total loss at the stated rate of 99.9% because the partner has a negative capital account.***

The regulations for IRC §704 are over 72 pages long and would require a great deal of discussion to thoroughly understand all the implications. However, for our purposes here, the result is that ***the LIHC should be reallocated based upon the amount of minimum gain that is required to be allocated to the limited partner.***

The minimum gain is actually the allocation of depreciation that is giving rise to the credit. Under the economic substance tests of IRC §704(b), the partnership is required to allocate at least a minimum gain to the limited partner based upon its share of the nonrecourse debt. This is required once the limited partners' original contribution is completely offset by the operating losses the property is generating.

To calculate the minimum gain, you are required to determine what the basis of the property is and the amount of debt associated with it. Since we are dealing with real estate, the debt is usually nonrecourse. If the nonrecourse debt is greater than the adjusted basis of the building, then the partnership will have minimum gain based upon a hypothetical sale of the asset for the amount of the associated nonrecourse debt.

For example, if the partnerships adjusted basis (purchase price less depreciation) in the building is $450,000 and the nonrecourse debt is $500,000, then the partnership would have $50,000 of minimum gain. Since the limited partner is allocated 99.9 % of the debt, 99.9% of that gain is also allocated to the limited partner.

Let's say that limited partner has a negative capital account and has no obligation to restore any negative capital account deficit. If the depreciation on the housing project is $50,000 for the year and the minimum gain allocation is only $5,000, the limited partner is not entitled to a credit allocation of 99.9% even though the partnership agreement calls for such. In this scenario the limited partner would only be allocated 10% of the credit and the general partner would be allocated the other 90%. Most of the time the general partner (e.g., a nonprofit entity) cannot use the credit to offset a tax liability and the credit is lost.

Summary: How to Identify the Issue

Generally, a LIHC project is owned by a partnership, with a limited partner (LP) and a general partner (GP). If you are auditing an LLC the member is usually a (LP) and the managing member is the (GP).

When a project is initially started the GP might contribute a small portion of capital and the LP will contribute a significantly larger portion of the total capital. In exchange for the contribution, the LP is allocated tax losses generally limited to the LP's initial contribution as well as the LIHC.

As the partnership operates and generates losses (due to depreciation of the building) the losses are allocated per the partnership agreement. At some point, the LP will offset all of its capital contribution by claiming the tax losses. The LP's do not want to have a negative capital account deficit for which additional contributions must be made, so the partnership agreement will limit the LP's obligation. Be sure that you read the partnership agreement and understand the LP's obligations.

Basically, when the LP has a negative capital account, the partnership computes the minimum gain and the LP must be allocated at least its percentage of the minimum gain amount. If any allocation of loss is in excess of this minimum gain, a reallocation of the losses and corresponding credit must occur. Issues have been identified where no reallocation of the credit is being done by the taxpayer.

If you are auditing a partnership claiming LIHC, check the K-1's for profit and loss percentages. Most of the time the LP is 99.9 % and the GP is 0.1%. Compare the total loss on the return to the allocated amount on the K-1 and then compare this to how the credit was allocated among the partners. If the losses and credit are not allocated in the same percentage, you may have the issue.
The key to identifying and developing this issue is reviewing the partnership agreement and understanding the limited partners' obligations.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

According to the dictionary, the word "thankful" mean to be conscious of benefits received, and "thank you" is an expression of gratitude. So, I'd like to express my gratitude to all the examiners who are so enthusiastically and diligently working LIHC issues. I know that IRC §42 is complex, with its own tongue-twisting terminology and requirements.

And I'd also like to thank all the managers for their patience and supplying the aspirin – and my manager, too. I'd also like to thank the Philadelphia LHC Compliance Unit for keeping all the paperwork straight…and Chief Counsel, who must translate all the tongue-twisting terminology into (relatively) plain English. I would be remiss if I didn't thank the state housing agencies, who are so diligently administer the program with a heart, the developers who have a vision and investors who provide the resources.. and I simply cannot forget the property managers who are the face of this affordable housing program for persons most in need of assistance.

I'd really like to thank everyone, but I don't want to overlook anyone, but the list is getting rather long. But, let's face it, it takes a village! So here goes:

I'm thankful that there is a village,
I'm thankful to be a part of the village, and
I thank you for your citizenship.
We serve together.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #31, July 2008

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Editor's Note: In the sixth issue of the newsletter, issued way back in June of 2002, I wrote an article about a technical issue that was then surfacing as part of our audit activities. It has come to my attention that taxpayers may be inappropriately relying on the contents of that newsletter – particularly since the article is now six years old and there have been changes to the filing requirements – so, in this issue, we will again discuss how issues involving the IRC §42(l)(1) certification should be developed during an IRS audit. I'd also like to bring your attention to the disclaimer above, which has been part of the header information above beginning with the 22nd newsletter issued in September of 2006.

IRC §42(l)(1): Owner's Certification with Respect to the First Year of the Credit Period

Under IRC 42(l)(1), a taxpayer must certify with respect to the first year of the credit period:

1. the taxable year and calendar year in which qualified low income buildings were placed in service,
2. the adjusted basis and eligible basis of such buildings as of the close of the first year of the credit period,
3. the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under IRC §42(h),
4. the election made under IRC §42(g) with respect to the qualified low income housing project of which such building is a part, and
5. other information as the Secretary may require.

The certification is made to the Secretary of the Treasury and must be made following the close of the first taxable year in the credit period for any qualified low income housing building. Unless it is shown that failure to certify the first year of the credit period is due to reasonable cause and not to willful neglect, no credit will be allowed with respect to such building for *any* year before such certification is made.

Making the IRC 42(l)(1) Certification

Part I of Form 8609, Low-Income Housing Credit Allocation and Certification, completed and signed by the state agency, documents approval of the finished low-income housing building and identifies the amount of the allowable annual low-income housing credit. Taxpayers must complete and sign Part II of the Form 8609 issued by the state agency and then file the form with the Philadelphia Campus to complete the IRC §42(l)(1) certification.

Reg. §1.42-1(h) addresses the filing of forms, stating that the requirements for completing and filing Form 8609 are addressed in the instructions to the form. The instructions read:

> Building owner. You must make a one-time submission of Form 8609 to the Low-Income Housing Credit (LIHC) Unit at the IRS Philadelphia campus. After making a copy of the completed original Form 8609, file the original of the form with the unit no later than the due date (including extensions) of your first tax return with which you are filing Form 8609-A, Annual Statement for Low-Income Housing Credit

Form 8609-A, Annual Statement for Low-Income Housing Credit, which is filed with the taxpayer's federal tax return for each year of the 15-year compliance period, is used to compute the allowable credit for that year. In Part I of the form, Question C asks whether the taxpayer has the original Form 8609 (or copy) signed and issued by the state agency. The instructions for this line read:

Item C. In order to claim the credit, you must have an original, signed Form 8609 (or copy thereof) issued by a housing credit agency assigning a BIN for the building. This applies even if no allocation is required (as in the case of a building financed with tax-exempt bonds). Check "Yes" to certify that you have the required Form 8609 in your records.

Caution: Any building owner claiming a credit without receiving a completed Form 8609 that is signed and dated by an authorized official of the housing credit agency is subject to having the credit disallowed.

To summarize, three important changes have been made since 2002:

1. The certification requirements apply to both low-income credits allocated under IRC §42 and buildings financed with tax-exempt bonds under IRC §142(d) and receiving credits associated with the volume cap under IRC §146.

2. The certification must be made no later than the due date (including extensions) of the first tax return with which the taxpayer files Form 8609-A, Annual Statement for Low-Income Housing Credit and claims credit.

3. Taxpayers make the certification *one time* by filing the Form 8609, Low-Income Housing Credit Allocation and Certification, with the IRS Philadelphia Campus.

Audit Activity

The IRS has identified tax returns where the taxpayer is claiming the low-income housing credit, but does not have Part I of the Form 8609, Low-Income Housing Credit Allocation Certification, from the allocating state agency. Taxpayers without the Forms 8609 may be claiming the credit amount identified in carryover allocation documents executed by a state agency under IRC §42(h)(1)(E) or (F). The credit computation is shown in Part II of Form 8609-A, Annual Statement for Low-Income Housing Credit. In Part I, for Question C, which asks whether the taxpayer has the Form 8609 signed and issued by the state agency, taxpayers are either answering "no" or are leaving the question unanswered.

In addition, taxpayers are filing Forms 8609 with only Part II completed to the Philadelphia Campus to complete the first year certification. The submission may include an explanation that the taxpayer has provided the state agency with all the information necessary for the state agency to make a final determination of the credit amount under IRC §42(m)(2)(C)(i)(III) and that the certification is being made in advance of the state agency's final approval of the taxpayer's building as a qualified low-income building.

Examination Requirements: Taxpayer Obtains Forms 8609 from State Agency

There is no prohibition against satisfying the certification requirements during the examination process (see Chief Counsel Advisory 200137044). The taxpayer should be given the opportunity to provide completed Forms 8609 (signed by the state agency) and Part II completed and signed by the taxpayer. If the taxpayer presents Forms 8609 signed by the state agency, then the following four issues must be addressed:

1. Determine whether the credit claimed by the taxpayers in years before the certification is more than the annual credit actually allocated by the state agency. The examination should be expanded to include prior years to disallow credit in excess of the credit amount allocated by the state agency. The recapture provisions under IRC §42(j) should be applied to prior year returns closed by statute.

2. Verify that the taxpayer's elections and past filings are consistent. For example, the taxpayer may have elected to begin the credit period the first year after the building was placed in service, but actually claimed credits for the year the building was placed in service. If this happens, the taxpayer has created documentation to support claiming the credit for eleven years rather than for the prescribed ten-year credit period under IRC §42(f)(1). The SBSE Headquarters analyst should be contacted if this issue is identified.

3. Verify the costs included in Eligible Basis, the computation of the Applicable Fraction

under IRC §42(f)(2), and the Minimum Set-Aside for the first year of the credit period to confirm that the credit has been correctly computed. Including costs incurred after the end of the first year of the credit period in Eligible Basis is of particular concern.

4. Determine whether the failure to timely complete the IRC §42(l) certification was due to reasonable cause or willful neglect. The taxpayer can claim the credit for tax years before the state agency provided the Form 8609 only if the taxpayer can demonstrate (1) a reasonable cause for not timely completing the IRC §42(l)(1) certification, *and* (2) that the failure to complete the IRC §42(l)(1) certification was not due to willful negligence.

Reasonable Cause

"Reasonable cause" means that the taxpayer exercised ordinary business care and prudence in determining its tax obligations but is unable to comply with those obligations. To establish reasonable cause, taxpayer must explain why they claimed the credit before completing the IRC 42(l)(1) certification. (See IRM 20.1.1.3.1)

Taxpayers commonly argue that the circumstances were beyond their control. The Forms 8609 were timely requested from the state agency after the end of the year in which the property is placed in service, but were not received before filing its tax return. Factors to consider:

1. When was the request for the Forms 8609 made? What follow-up efforts did the taxpayer make to secure the Forms 8609?

2. Why did the state agency fail to provide the Forms 8609 (Part I completed and signed)? State agencies generally attempt to provide the completed forms quickly. Failure to do so is indicative of problematic properties; i.e., the cost certifications may not be complete, the state may have determined that the property was built using sub-standard materials, or the property was not built according to the contract, etc. The state agency should be contacted to determine the cause of the delay. Most state agencies keep records of their contacts with property owners; determine if and why the taxpayer delayed in responded to the state agency's inquiries.

A determination of reasonable cause must be based on an evaluation of all the facts and circumstances on a case-by-case basis. Consider the following factors:

1. How long after the end of the first year of the credit period did the taxpayer receive the Forms 8609? How many years has the taxpayer claimed the credit without having the Forms 8609? How did the taxpayer answer question C on Form 8609-A?

2. Did the taxpayer encounter other difficulties while noncompliant with the IRC §42(l)(1) certification requirement, and how were the problems resolved?

3. What reason did the taxpayer give for the delay? To show reasonable cause, the dates and explanations should clearly reflect efforts to timely resolve noncompliance with IRC §42 and expeditiously obtained the Forms 8609 from the state agency.

4. Did the taxpayer know, or make reasonable attempts, to determine the IRC §42(l)(1) certification requirements? Is the general partner a professional specializing in the development and management of IRC §42 properties?

5. Did the taxpayer make a mistake? How long was it before the taxpayer corrected the mistake? Generally, errors do not provide a basis for reasonable cause, but additional facts and circumstances may support such a determination. Forgetfulness, oversight, or reliance upon another person does not support a determination of reasonable cause for failing to timely making a required filing.

6. Death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause. Consider the relationship of the responsible party to the taxpayer; the dates, duration of the illness or absence; how the event prevented compliance; whether other business obligations were impaired; and whether the noncompliance was remedied within a reasonable period after a death or absence.

Willful Negligence

As used by the Supreme Court in United States v. Boyle, Executor of the Estate of Boyle, 469 U.S. 241, the term "willful neglect" may be read as meaning a conscious, intentional failure or reckless indifference. Under Treas. Reg. 1.6662-3(b):

1. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.

2. A disregard of rules or regulations is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances that demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe.

3. A disregard of rules or regulations is intentional if the taxpayer knows of the rule or regulation that is disregarded. Taxpayers often include a statement with their return to the effect that the Forms 8609 have been requested but have not been received from the state agency.

See IRM 20.1.5.7 for additional discussion.

Examination Requirements: Taxpayer Does Not Obtain Forms 8609 from State Agency

If the taxpayer cannot complete the IRC §42(l)(1) certification during the audit, then:

1. The entire credit should be disallowed in all years open by statute. Under IRC §42(j), a portion of credit can be recaptured in years closed by statute or otherwise not examined.

2. Determine whether the on-going delay in completing the IRC 42(l)(1) certification is due to reasonable cause. If reasonable cause is established, the taxpayer should be cautioned that statutes should be extended (or protective claims for refunds filed) to ensure that the taxpayer can amend returns to claim the credits at a later date when the amount of allowable credit is determinable.

3. The examination should include verification of the Eligible Basis, the Applicable Fraction, and Minimum Set-Aside for the first year of the credit period, as the taxpayer may be able to claim the prior year credits at a later time or claim credits beginning with the taxable year in which the Forms 8609 are received from the state agency.

4. If the failure to complete the certification process is not due to a reasonable cause or is due to willful neglect, the entire credit should be disallowed in all years open by statute. Under IRC §42(j), a portion of credit can be recaptured in years closed by statute or otherwise not examined. No credit is allowable for any tax year before the IRC §42(l)(1) certification is completed.

Penalties

Penalties should be considered if the LIHC is disallowed and/or recaptured; i.e., the taxpayer has not completed the IRC §42(l)(1) certification and was either (a) found to be willfully negligent, or (2) was not able to establish a reasonable cause for the failure. Responsible parties, such as a general partner or TMP, should be identified and consideration given to the aiding and abetting penalty under IRC §6701. This penalty applies to persons who are directly involved in aiding or assisting in the preparation of a false or fraudulent document under the tax laws. See IRM 20.1.6.6 for full discussion and procedures.

Conclusion

The importance of the IRC §42(l)(1)certification cannot be overemphasized; it isn't simply "paperwork." First, there's always the possibility that a taxpayer is fraudulently claiming the credit; i.e., the taxpayer does not have an allocation or even a carry-over allocation of credit from a state housing agency. Further, even if the taxpayer has entered into a contract with the state agency, the IRS has no way of knowing that the state agency has approved the completed project, the amount of credit the taxpayer is entitled to claim, or the terms of the allocation until the taxpayer completes the IRC §42(l)(1) certification. If audited by the IRS, the credit will be disallowed and the recapture provisions will be applied simply because the amount of allowable credit is unknown.

Second, claiming the credit without completing the certification creates a very specific duty of consistency (see Bentley Court II, *T.C. Memo*

2006-11). For example, the amount of credit claimed by the taxpayer before receiving the Form 8609 from the state agency must be consistent with the amount of credit subsequently allocated by the state agency and the elections made on Form 8609 must be consistent with the taxpayer's behavior before completing the certification. Under IRC §6001, the taxpayer must provide adequate proof of consistent behavior, which can include providing prior year federal tax returns.

Finally, the taxpayer bears the burden of demonstrating that there was a reasonable cause for failing to complete the IRC §42(l)(1) certification before the due date (including extensions) of the first tax return on which the credit was claimed. Failure to provide a reasonable cause will result in the disallowance and/or recapture of IRC §42 credits.

Guide for Completing Form 8823: Updates Pending

In January of 2007, the IRS released a new Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. The IRS is now drafting revisions to update the guide. Revisions will be made to include HUD's changes to Handbook 4350.3 (used to determine whether households are income-qualified), a new exception for student households, and changes to Regulation 1.42-10, Utility Allowances, which we anticipate will be finalized in the very near future. There will be clarification and more examples…and we'll deal with those pesky typos!

New LIHC Audit Technique Guide: Request for HELP!

The IRS is now drafting a new audit technique guide (ATG) for IRC §42. The existing ATG, written in 1999, is very outdated and is no longer available for use. ATGs are written for examiners, but are also made available to the public to help taxpayer comply with the requirements of the Internal Revenue Code. We hope to have the first draft ready for Chief Counsel review by December 31, 2008. When ready, a draft will be released for public comment

To help get the project started, I would like to invite anyone (within the IRS or beyond) with ideas for content, format, etc., to send me an e-mail at **Grace.F.Robertson@irs.gov** before September 1, 2008.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed without charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I recently met with the state housing agencies with which the IRS shares administration of the program; I'm always impressed and uplifted by their enthusiasm for the program. I shared some information about our audit activities with them, and thought others would be interested as well.

There are a sufficient number of LIHC examinations in process; 64% of the audits were initiated based on information provided by the state agencies on Form 8823. By the way, since the release of the Guide in January of 2007, there's been a marked change in the both the quantity of forms submitted and the quality of the filings. There are fewer filings but the states are providing more accurate and complete filings. However, the state agencies' reports are not the only source of audit work; e.g., LIHC issues have been identified through the partnership classification process and on returns selected for training purposes. And we don't audit just the partnership owning the LIHC property; we are also auditing developers, nonprofit entities, and investors.

31% of our audits right now were originally identified because the owner had not completed the IRC §42(l)(1) certification – which is one reason why I decided to provide an updated article on the issue. 20% are selected for technical issues and another 19% because the owner didn't correctly report the disposition of the LIHC property. 15% of our audits involve properties that are not physically maintained and are not suitable for occupancy. Another 8% are audits of owners who still own the property but who are no longer participating in the program. Finally, about 7% of our audits involve tenant and rent related issues, remember, the households are eligible to live in LIHC housing based on their income and the rents must be restricted – simple to say, more difficult to accomplish (and document).

So, that's how our examinations begin. The middles and ends of our audits are much harder to predict or quantify because the issues surfaced during the examination can be very different from what we anticipated.

What I do know, however, is that we've just past the middle point of the summer…and it is predictably and quantifiably hot and humid here in Northern Virginia. It's early on a Monday morning and I'm writing this at the kitchen table. To the left, I can look out a bay window onto the pleasant, tree-lined suburban street where I live…just a few early commuters have passed by. Normally, I would see kids on the corner and hear their chattering while they wait for the school bus, but they're sleeping in. I remember way back when I did that, too.

To my right, I can look through the sliding doors onto the deck where a rather plump chipmunk is sitting in a ray of early morning sunlight and washing his face. I'm thinking that his motions are not much different than those my cats would make, which isn't much of an intuitive leap since both cats are laying by the door drooling. The chipmunk is a frequent visitor and seems very comfortable, so I'm pretty sure he knows he's driving them crazy.

It is a peaceable moment before what I know will be a long and hectic day. I hope you have such a quiet moment once in a while, too.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #32,,October 2008

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Annual Income Recertifications Not Relevant for 100% LIHC Projects

As part of the Housing Assistance Tax Act of 2008, Congress amended IRC §142(d)(3)(A) to read (new language is italicized):

> "…The determination of whether the income of a resident of a unit in a project exceeds the applicable income limit shall be made at least annually on the basis of the current income of the resident. *The preceding sentence shall not apply with respect to any project for any year if during such year no residential unit in the project is occupied by a new resident whose income exceeds the applicable income limit."*

The amendment is effective for years ending after July 30, 2008. Under IRC §42(g)(4), the new exception is made applicable to IRC §42 properties. As a result, owners of §42 projects, where all the residential units are low-income units, can immediately stop completing the annual tenant income recertifications.

Background

The new exception sounds wonderful until you start thinking about the implications. So, to understand how the new exception fits into the "big picture," we need to understand the basic premise upon which the exception is based.

Under IRC §42(i)(3), a low-income unit is defined as a residential rental unit that is rent restricted, occupied by a household that meets the income limitation requirements, and suitable for occupancy.

Under IRC §42(g)(2)(D), if the income of an initially income-qualified household rises above the income limit, the unit is still considered a low-income unit as long as the rent continues to be restricted. If the household's income rises above 140% of the income limit (or 170% in deep rent skewed developments), then the unit continues to be considered a low-income unit as long as the next available unit of comparable size or smaller is rented to an income-qualified household.

Congress has concluded that the annual income recertifications are not "relevant" to 100% LIHC projects because the next available unit is *always* rented to an income-qualified household. However, Congress did not specifically except 100% LIHC projects from the application of the Available Unit Rule under IRC §42(g)(2)(D).

And that's where Congress' theoretical conclusion meets reality. What happens when an owner unintentionally rents a unit to a nonqualified household? How is the Available Unit Rule applied if an owner does not know which units are over-income units?

Applying the Available Unit Rule to 100% LIHC Projects

If an owner rents a unit to a nonqualified household, the unit ceases to be a low-income unit and does not qualify for the credit. The error is accounted for when determining the Applicable Fraction at the end of the taxable year.

For purposes of applying the Available Unit Rule *only*, the IRS will treat all households documented as initially income-qualified households as income-qualified as long as the owner *demonstrates due diligence* when completing the initial income certification. Therefore, the owner does not violate the Available Unit Rule when a unit is unintentionally rented to a nonqualified household.

Compliance

The key to compliance with the Available Unit Rule when an owner unintentionally rents a unit to a nonqualified household is demonstrating to the IRS that "ordinary business care and prudence" was exercised when income qualifying new tenants. Specifically, initial tenant income certifications should be timely, accurate, and complete. Here are some basic questions an IRS examiner might ask when considering whether the owner's tenants are income-qualified.

1. Have all the potential sources of income been identified?
2. Was income verified with third parties?
3. Are the methods for estimating income reasonable based on the facts?
4. Was the correct income limit used?
5. Was the computation correct?
6. Is the documentation sufficient?

Examiners routinely evaluate a taxpayer's internal controls; i.e., the procedures the taxpayer has in place to safeguard business operations. A taxpayer's due diligence is considered as part of that evaluation. Here are some of the questions an IRS examiner might ask.

1. What *oversight* does an owner provide a property manager? Is the property manager trained?
2. Are *written* procedures are in place for qualifying households? Who makes sure the procedures are followed? Is there a review process?
3. Does the owner use standardized forms?
4. Does the owner conduct independent internal audits?
5. What happens if noncompliance occurs?
6. Are households monitored for changes in family size?
7. How are the files maintained?

Here are three examples of fact patterns that *may* be challenged during an IRS audit.

1. Renting units larger than required for the household's size. By itself, this is not noncompliance, but is of particular concern when the household size increases soon after the initial move in and the combined income of the new household is over the income limit.

2. The household has insufficient income to pay the rent. Why would an owner rent a unit to someone who cannot pay the rent? Is there a source of income that hasn't been disclosed?

3. Renting units to household with income from a sole proprietorship, but the household does not file tax returns. Keep in mind that tax returns *can* be used to document income, but is not required. However, if an individual is operating a business that should be reported on Schedule C, the taxpayer *must* file a tax return even if the business activity does not generate a tax liability.

4. Household has less income when reapplying for housing. The income limits are a bright line test for determining whether a household is income-qualified. If a household has been denied housing because the anticipated income is just a little more than the limit, the household may try to manipulate that determination by slightly altering the facts – fewer overtime hours, for example. Although the income limits can seem arbitrary and the stories sympathetic, owners need to carefully consider the underlying facts before renting a low-income unit to a household under these circumstances.

Noncompliance by 100% LIHC Projects

The Available Unit Rule is violated when an owner fails to rent a unit to an income-qualified household *and* cannot demonstrate due diligence when making that determination. The Available Unit Rule is also violated if an owner of a 100% LHC project deliberately rents a unit as a market-rate rent. In such cases of egregious noncompliance, the IRS concludes that the owner disregarded the Available Unit Rule and that the building's qualified basis is to zero; i.e., the building is not part of a qualified low-income project *at all times* during the 15-year compliance period under IRC §42(c)(2). No credit is allowable until such time as the owner can establishes compliance with the Available Unit Rule. This may seem particularly harsh, but here's the logic.

First, the status of the other supposed low-income units is unknown; i.e., how many units are over-income units?

Second, if an owner cannot demonstrate due diligence, it is our experience that the noncompliance is not limited to just one unit.

Third, the owner must establish continuous compliance. IRS audits may be conducted as long as four years after the close of the tax year. The IRS allows taxpayer to reconstruct records, but completing tenant income recertifications so long after the fact is neither practical nor reliable.

Example 1

An owner of a 100% LIHC project can demonstrate due diligence and the tenant file provides sufficient documentation, but it is later determined during an IRS audit that one household was *not income*-qualified at the time the household moved into the unit.

The Applicable Fraction will be recomputed and the allowable credit for the year will be less. The taxpayer is also subject to the credit recapture rules under IRC 42(j). However, the IRS will not make a determination that the taxpayer violated the Available Unit Rule.

Example 2

An owner of a 100% LIHC project failed to rent a vacant unit as a rent-restricted unit; i.e., a unit is rented as a market rate unit.

The unit ceases being a low-income unit and since the owner disregarded the Available Unit Rule, the building's qualified basis is reduced to zero unless the owner can document *continuous* compliance with the Available Unit Rule. The taxpayer is also subject to the credit recapture rules under IRC §42(j).

Questions and Answers

Q1: Is the new law optional? No, the new rule automatically applies to all 100% LIHC projects.

Q2: How do you identify a project? Each low-income building is a separate project unless the owner, on Form 8609 line 8b, elected to treat the building as part of a multi-building project.

Q3: Does the new law apply to tax-exempt bond projects? Yes, but only if the project also has IRC §42 credits under IRC §42(h)(4).

Q4: Can a household transfer between buildings within the same 100% LIHC project? Yes, since the owner does not know which, if any of the units are over-income, the IRS will allow a household to transfer between LIHC buildings.

Q5: If an owner discovers that a household had income in excess of the limit at move-in, what should an owner do? Owner should continue to address the problem as they have in the past.

Q6: Can a 100% LIHC project switch to a mixed-use project? Yes, but to avoid noncompliance with the Available Unit Rule, the owner must first determine which units are over-income units and apply the Available Unit Rule as needed. Reducing the number of low-income units in a building will reduce the allowable credit and is a credit recapture event under IRC §42(j). For more information, see LIHC Newsletter #20.

Q7: Can a mixed-use project switch to a 100% LIHC project? For some taxpayers, the savings associated with the income recertification exception are far greater than the additional rent generated by the market-rate units.

Yes, but the amount of allowable credit does not increase based on the increase in Applicable Fraction. The maximum allowable credit was fixed at the time of allocation.

Q8: Are owners who received a waiver of the annual income recertifications under IRC §42(g)(8)(B) still subject to the terms of the waiver? Well…..technically yes. Congress did not repeal this particular paragraph. However, for all practical purposes, the new exception under IRC §142(d)(2) has subsumed the IRC §42(g)(8)(B) waiver. However, state agencies do not need to technically revoke the waivers.

Q9: Does the exception apply for other federal programs?

The exception is only applicable for IRC §42 purposes only. An owner will continue to be subject to the requirements for other programs. However, owners will no longer need to "merge" two sets of potentially contradictory requirements. Also, the recertifications

completed for other programs will be disregarded for IRC §42 purposes. All owners of 100% LIHC projects will be treated equally. However, the records may be sufficient if documentation must be reconstructed.

State Housing Credit Agency Requirements

State housing credit agencies have authority to impose additional requirements upon IRC §42 projects. For example, a state agency may require a one-time income recertification after the first year of occupancy. In my discussions with the state agencies considering placing such restrictions on a project owner, the state agencies (1) have little confidence that owners can consistently identify income-qualified households without frequent technical errors, or (2) that owners are willing to be provide sufficient due diligence. This is a perception that owners will need to address individually and collectively. In other cases, the state agency is also providing financing and, as part of their own internal controls and due diligence, wants to ensure that the state's funds are used for the purposes intended.

However, like other state-imposed requirements, failure to comply with a state agency's requirement is not a reportable noncompliance event on Form 8823.

Student Status

A unit occupied by a household composed entire of full-time students does not qualify as a low-income unit unless that household meets on of the exceptions under IRC §42(i)(3)(D). Up until now, the annual tenant income recertification also included consideration of the household's student status.

There is no separate student status certification requirement under the Code or regulations, but the student status impact units' status as "low-income" unit. Further, owners must demonstrate "continual" compliance with IRC §42 requirements. For the moment, owners should follow their state agency's requirements or use procedures similar to those used for the annual tenant income recertification to determine the unit's student status until the IRS can provide instructions in the Guide for Completing Form 8823. Self-certification is sufficient; third-party verification is not required and is at the owner's discretion.

Conclusion

While the new exception may seem like a radical change, the IRS focus has *always* been on the initially income certification. For more information, please refer to Newsletters #20, 21 and 26.

Military Basic Housing Allowances

As a general rule, military basic housing allowances are included in the computation of a household's income. However, under section 3005(a) of the Housing Assistance Act of 2008, IRC §142(d)(2(B)(ii) has been amended to *exclude* military basic housing allowances from the computation if the low-income building is located in any county, or adjacent county, in which a *qualified* military installation is located. The new rule applies to certifications completed after July 30, 2008 and before January 1, 2012.

The IRS has released, in Notice 2008-79, a list of qualifying military bases:

1. Colorado – U.S. Air Force Academy
2. Hawaii – Fort Shafter
3. Kansas – Fort Riley
4. Maryland – Annapolis Naval Station (including U.S. Naval Academy)
5. South Carolina – Fort Jackson
6. Texas – Fort Jackson and Fort Hood
7. Virginia – Dam Neck Training Center Atlantic
8. Washington – Naval Station Bremerton

The list is not meant to be all inclusive and any qualified military installation which satisfies the requirements of IRC §142(d)(2)(B)(iii)(1) is eligible to receive similar treatment regardless of its failure to be included in Notice 2008-79 or any subsequent updates. The owner is responsible for documenting that the exception under §142(d)(2)(B)(ii) is applicable.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 46 through 47 identify the type of credit and the extent of any adjustment made. See IRM 4.4.12.4(58) and (59) for instructions.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

♫Grace Notes♫

There's a bricked in flower box about 10 feet long and 4 feet high by the front door of my home. This year I planted Marigolds, which have round flowers in harvest shades of yellow and orange. I call my favorite the "turtle" Marigold because each orange petal is trimmed around the edges in a deep burnt brownish-orange, and when I look straight down at the flower, the layered petals remind me of a turtle's shell.

Marigolds are easy to care for -just water on a frequent and regular basis, and take off the spent blossoms. I particularly like doing this because the smell brings back pleasant memories of my mother's garden and, if you snap it off just right between the steam and base of the flower, you hear a crisp little snap as the flower cleanly breaks off. The process is called "dead-heading,"

Deadheading takes a little practice and a careful consideration of each individual flower. There will be some flowers that are obviously dried and shriveled, but you also want to snap off the flowers that still look pretty good, but are wilting a little so that the plant won't waste more energy on a flower that is dying off anyway. It just takes a little patience.

Deadheading not only keeps the flower bed looking nice, but has a most interesting consequence. The more you deadhead the old flowers, the more the plant works at creating new buds. By the end of the summer, the tiny little Marigolds I planted last spring with plenty of space in between are an interwoven mass of brilliant gorgeousness. The most pleasant part of the drive home around the beltway is parking in the driveway for a moment to enjoy the colors reflected in the late afternoon sun.

I must admit, however, that reading through the new law for the first time wasn't nearly as relaxing. Yellow highlighter and red pen in hand, I pondered the implementation dates, twisted my brain around the double negatives, and carefully counted all the zeros with my fingers….then I got to section 3003(g), the title of which is "Repeal of Deadwood" and just smiled, took a deep breath….Congress is just "deadheading" IRC §42. Well, that's how I've come to think about the new law.

Since its original enactment way back in 1986, IRC §42 as been amended and tweaked several times, but this time, Congress has carefully considered each individual requirement. There are some requirements that have obviously outlived their usefulness, and there are other rules, given how the program has evolved over the last 22 year, that are no longer relevant. And getting rid of the deadwood has also given Congress room to adapt the program to meet current needs.

The challenge for us will be to cleanly break off the deadwood and seamlessly weave the new requirements into the program.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #33, December2008

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

It's time to make some lists and check them twice (at least)….

Notices:

The IRS has issued notices suspending certain requirements under IRC §42 to provide emergency housing relief on a temporary basis for displaced individuals as a result of devastations inmajor disaster areas.

1. Notice 2008-56: IRC §42 Relief, Indiana
2. Notice 2008-58: IRC §42 Relief, Iowa
3. Notice 2008-61: IRC §42 Relief, Wisconsin
4. Notice 2008-66: IRC §42 Relief, Missouri

Notice 2008-109 provides guidance for implementing provisions of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which includes relief measures under IRC §1400N for the Hurricane Ike disaster areas in Louisiana and Texas, and the Midwestern Disaster Area, which includes counties in Arkansas, Illinois, Indiana, Iowa, Missouri, Nebraska, and Wisconsin.

On July 30, 2008, Congress enacted the Housing Assistance Tax Act of 2008. Since that time, the IRS has issued two implementing notices.

1. Notice 2008-79 provides information for an amendment to IRC §142(d) excluding military basic allowance payments from income with determining if a household is income-qualified

2. Notice 2008-106 clarifies that the 9% Applicable Percentage floor for non-Federally subsidized new buildings that are placed in service after July 30, 2008, and before December 31, 2013, applies notwith-standing an irrevocable election by the taxpayer under former IRC §42(b)(2)(A)(ii) made on or before July 30, 2008.

Revenue Procedures:

Rev. Proc. 2008-60 provides procedures for taxpayers maintaining disposition bonds (or Treasury Direct Accounts) to elect to be subject to the reporting requirements under IRC §42(j)(6) as amended by the Housing Assistance Tax Act of 2008 for disposition of IRC §42 projects (or interests therein) after July 30, 2008.

The Housing and Economic Recovery Act of 2008 provides a temporary increase in the state housing credit ceiling for 2008 and 2009. As identified in Rev. Proc. 2008-66, the amount used to calculate the State housing credit ceiling is the greater of (1) $2.30 multiplied by the State's population, or (2) $2,665,000.

Revenue Rulings:

In Rev. Rul. 2008-6, the IRS determined that rental assistance payments made to an owner of IRC §42 property on behalf of a tenant under the Indian Housing Block Grant Program authorized by the Native American Housing Assistance and Self-Determination Act of 1996 are not grants for purposes of IRC §42(d)(5)

Chief Counsel Advice Memos:

Chief Counsel Advisory 200812023 provides guidance for issues involving the allocation of tax credits when special allocations in the partnership agreement result in the actual allocation of depreciation being different from the allocations provided for in the partnership agreement. See Newsletter #30 for detailed discussion.

SBSE* Memorandum:

The IRS made an IRS memorandum for examiners auditing LIHC issues available to the public. The memorandum was distributed at the National

Council of State Housing Agencies' Miami conference in June 2008.

The memo provides guidance regarding the treatment of taxpayers who fail to comply with IRC §42 requirements at all times during the 15-year compliance period. The memo, titled "Low-Income Housing Credit (LIHC) – Noncompliance Resulting from Conflicting Program," is dated August 20, 2007 and signed by Glenn DeLoriea, Program Manager for Examination Specialization and Technical Assistance.

* Small Business/Self-Employed is an operating division within the IRS.

Newsletters:

Four LIHC Newsletters were issued this year (five if you include this one).

1. Issue #29, February - includes a summary of a change to the student exceptions under IRC §42(i)(3)(D)(ii)(I) for single parents and their children that was made as part of the Mortgage Forgiveness Debt Relief Act of 2007.

2. Issue #30, June – the lead (and only) article is about CCA 200812023 and the application of IRC §704(b); i.e., the allocation of credit among a partnership's partners.

3. Issue #31, July – another single topic edition of the newsletter, this time focusing on the First Year Certification under IRC §42(l)(1) and updating information provided in the 6th edition of the newsletter issued in June of 2002.

4. Issue #32, October – provides guidance for implementing of an amendment to IRC §142(d)(3)(A) that is applicable to 100% LIHC projects under IRC §42(g)(4). As part of the Housing Assistance Tax Act of 2008, owners of IRC §42 project, where all the residential units are low-income units, can immediately stop completing the annual tenant income recertification otherwise required.

The Thrice Checked List:

In the last newsletter, when answering questions about the amendment to IRC §142(d)(3), I stated that the exemption from the annual tenant income certification applied to tax-exempt bond projects only if the project also had IRC §42 credits under IRC §42(h)(4).

I was mistaken and should have checked my answer one more time. The new exemption applies to IRC §42 projects, and IRC §142 housing projects, *regardless* of whether the project has credits under IRC §42(h)(4).

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

It's early morning and I'm again sitting at the kitchen table, looking out the doors to the deck. I can tell that its going to be another rainy, icy cold winter day that's only slightly less gloomy than last night's evening news. I've been listening to a Barry Manilow CD of holiday music and the words of the last song keep drumming through my brain….

When I'm worried and I can't sleep,
I count my blessings instead of sheep,
And I fall asleep counting my blessings.

And I remember something that happened to me a long time ago…I was in a car pool with a man who wasn't, well….exactly a morning person, and on one particularly cold wintry morning when I greeted him with a slightly too enthusiastic "good morning!," he barked back at me, "So what's so good about it?"

I had no problem listing the most obvious reasons, starting with the fact he woke up that morning….I think he was sorry he asked!

I've grown old enough to embrace the "holidays" and the plurality of traditions and celebrations that the term is intended to acknowledge. And, in a moment of insight, appreciate that the commonality of the "holidays" is the expression of our grateful hearts. So, as I commute around the Washington beltway, I count my blessing, including insulated cups, seat warmers, Star Trek CDs….and the convergences of fortuitous coincidences.

Happy Holidays

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

P.S. The song is called "Count Your Blessings" and written by Irving Berlin.

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #34, March 2009

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Examiners Q&A

Q1: During an examination of a taxpayer owning IRC §42 property, I reviewed a sample of tenant files. For some of the tenants, the owner secured tax returns to document that the household was income-qualified. What should I do if I find tax issues? For example, a married person claiming "head of household" status and the Earned Income Credit (EIC) for children that were not listed on the lease.

A1: Information about a tenant's possible non-compliance with federal income tax laws discovered during an IRS audit should be submitted for evaluation and possible enforcement action using Form 5346, Examination Information Report. See IRM 4.10.8.14 for detailed instructions;

Note: Form 5346 is for use by IRS employees *only*.

Q2: What is a building identification number?

A2: A Building Identification Numbers (BIN) is assigned by a state housing agency to every building in a qualified low-income housing project that includes low-income residential housing units. The BIN consists of the two character state postal abbreviation followed by a two digit designation representing the year the credit is allocated, and a five digit numbering designation the state agency uses to identify the projects and buildings within the project.

For example, the identification number for one of 25 buildings allocated a credit by the Connecticut Housing Finance Authority might read CT-01-01023 to designate that the credit was allocated in 2001 to the 23rd building in project #1.

The building's BIN remains the same from that point forward and is used to identify the building for IRC §42 purposes; e.g., Forms 8809, 8609-A, and 8823.

Q3: What's the difference between a low-income unit and a single-room occupancy (SRO) unit under IRC §42(i)(3)(B)(i)?

A3: Eligible Basis includes the adjusted basis of depreciable property subject to IRC §168 and the property qualifies as residential rental property under §103. Under Treas. Reg. 1.103-8(b)(8)(i), the term "unit" means any accommodation containing *separate* and *complete* facilities for living, sleeping, eating, cooking, and sanitation. Such accommodations may be served by centrally located equipment, such as air conditioning or heating. For example, an apartment containing a living area, a sleeping area, bathing and sanitation facilities, and cooking facilities equipped with a cooking range, refrigerator, and sink, all of which are separate and distinct from other apartments, would constitute a unit.

As explained in the legislative history, SRO units can qualify for the IRC §42 credit even though kitchen, bathroom, and dining facilities are shared.

The significance for IRC §42 purposes is that while tenants in low-income units are expected to sign leases of at least 6 months to establish the non-transient nature of the tenancy, occupants of SRO units can enter into month-by-month agreements.

State Housing Agencies Q&A

Q1: Every year we file Form 8610, Annual Low-Income Housing Credit Agencies Report, with the IRS to reconcile our credit allocations and remaining credit ceiling. We are also required to certify that we are compliant with the compliance monitoring and notification requirements under Treas. Reg. 1.42-5. What is the legal authority for the requirement and are we required to report monitoring activities for IRC §42 projects that have completed their 15-year compliance period?

A1: The legal authority is IRC §42(l)(3), which requires state housing credit agencies to annual report: (1) the amount of credit allocated during the year to individual buildings, (2) sufficiently identify the taxpayer owning the building, and (3) other information as the Secretary (IRS) may require. Some reminders:

> Forms 8610 were due March 2nd this year. State housing agencies are subject to a failure to file penalty under IRC §6652 if not filed timely. Timeliness is determined based on the date and time stamped by the Post Office on the envelope, the same as for the filing of tax returns.
>
> Only one Form 8610 per state. If a state has authorized more than one housing agency to allocate IRC §42 credits, the agencies must coordinate and file one combined Form 8610.

Lines 14, 15, and 16 provide for a reconciliation of compliance monitoring requirement on a three year cycle based on the year the last building in the project was placed in service. State agencies are not required to include projects if:

1. The buildings are no longer subject to compliance monitoring because the buildings are no longer participating in the IRC §42 low-income housing credit program.
2. The 15-year compliance period ended more than three years before the beginning of the reporting period. For example, if the compliance period ended December 31, 2005, the project would not be included in the reconciliation on line 14 of Form 8610 for 2008.

Note: the 10-year credit period under IRC §42(f)(1) and the 15-year compliance period under IRC §42(i)(1) begin on the *first* day of the tax year in which the buildings are placed in service, or if the taxpayer elects, the following year. The 15-year compliance period ends on the *last* day of the tax year, which is December 31st of the 15th year for calendar year taxpayers.

Q2: The credit allocated to states this year is the greater of $2.20 multiplied by the state's population or $2,555,000. How did the IRS calculate the $2,555,000?

A2: IRC §42(h)(3)(C)(ii)(II) provides a minimum credit ceiling for states with small populations. For 2008 and 2009 only, under IRC §42(h)(3)(I)(ii), the minimum credit ceiling is increased by an amount equal to 10% of the minimum credit ceiling after the cost-of-living adjustment and rounded to the next *lowest* multiple of $5,000.

Rev. Proc. 2008-66 provides that, for calendar year 2008, the state minimum amount is $2,325,000. So, $2,325,000 plus $230,000 ($232,500 rounded down the next lowest $5,000) equals $2,555,000.

Q3: How do I know if someone claiming to be an IRS revenue agent and conducting an audit of one of our owners really works for the IRS?

A3: At the time initial contact is made, the revenue agent should provide you with contact information, including name, telephone number and employee ID or badge number. In addition, revenue agents use pocket commissions to present proof of authority to perform his or her official duties. (See IRM 4.2.4.2.1.)

Taxpayer Q&A

Q1: Now that the Forms 8609 are no longer filed with my tax return, should I file my certification every year with the LIHC Compliance Unit in the Philadelphia Campus?

A1: No. It is a one-time filing to satisfy the IRC §42(1)(1) certification with respect to the first year of the credit period. Keep in mind:

1. In order to claim the credit, you must have an original, signed Form 8609 (or copy thereof) issued by a housing credit agency assigning a identification number for the building (BIN), even if no allocation is required; e.g., certain buildings financed with tax-exempt bonds. Any owner claiming credit without receiving a completed Form 8609 that is signed and dated by an authorized official of the state housing agency is subject to having the credit disallowed.
2. The most common error when filing Form 8609, Part II is failing to identify the first year of the credit period on the line to the right of where the taxpayer's name is printed.

3. Remember to make copies of the completed Forms 8609 for your records before submitting the originals to the IRS.

Taxpayers are also required to submit an information report to the IRS under IRC §42(l)(2), which is included on Form 8609-A, Part I, and filed annually with the taxpayer's tax return for each year in the 15-year compliance period. There are five questions (A-E).

Tax Return Preparers Q&A

Q1: There have been some changes to Form 8586 and Form 3800. Why?

A1: Under §3022(b) of the Housing Assistance Tax Act of 2008, IRC §38(c)(4)(B) was amended to allow IRC §42 credit against Alternative Minimum Tax (AMT) if the credit is attributable to buildings placed in service after December 31, 2007.

So, Form 8586, Low-Income Housing Credit, has been revised and now includes two parts:

Part I is for buildings placed in service before January 1, 2008, and is subject to the same AMT rules as in prior years.

Part II is new and is used to identified the IRC §42 credit associated with buildings placed in service after December 31, 2007.

Form 3800, General Business Credit, has also been revised to account for credits that are allowed against AMT. Credits attributable to buildings placed in service before January 1, 2008 are included are line 1d and credits attributable to buildings placed in service after January 31, 2007 are accounted for on line 29d.

Other reminders:

General business credits reported on Form 3800 are treated as used on a first-in, first-out basis by offsetting the earliest-earned credits first. Therefore, the order in which the credits are used in any tax year is:

1. Carryforwards to that year, the earliest ones first,
2. The general business credit in that year, and
3. the carryback to that year.

If the general business credit includes more than one kind of credit, then the ordering rules under IRC §38(d) dictate that credits are used as listed in IRC §38(b), which just happens to be the same order the credits are lists on Form 3800, line 1(a)-(z).

For recordkeeping purposes, a taxpayer usually documents the allowable IRC §42 credit using the Schedules K-1.

1. Any credit coded A or B is attributable to buildings placed in service before January 1, 2008.
2. Any credit coded C or D is attributable to buildings placed in service after December 31, 2007.

Taxpayer should also keep a separate record of the amount of credit from different sources so that the 10-year credit period can be correctly identified and any credit recapture can be correctly computed.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

http://tefra.web.irs.gov/m1/1a_home.asp

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

March 2nd: I'm working at home today and sitting at the kitchen table again. There's a blizzard raging outside, the wind is ferocious and I can't see to the end of the driveway. March is making a grand entrance like a roaring lion, but it feels more like February is an unwelcome guest who has already stayed way too long and has just announced it having so much fun that is has decided to stay another week. Is February really the shortest month of the year?

March 4th: For only the second time this year, I had to shovel iced footprints and snow off the sidewalks, but the kids and dogs must have had a wonderful time playing in the powder snow. I'm not complaining.

March 6th: Before leaving for work at 5:30 am, I roll the garbage can out to the curb. It's so warm that I decided to leave the scarf and gloves at home and wore a light rain coat instead of my heavy winter coat with the hood. I drive east in the morning and at certain times of the year, like now, there's a hint of light at the horizon peeking though the bare tree skeletons. It's like a personal "good morning" from the universe. I'm a little disappointed when reminded to set all my clocks an hour ahead on Saturday night.

March 9th, 7:00 am: I'm working at home again. It's early and I'm preparing for a day away from the office. I have company at the kitchen table this morning, as both Hannah and Olivia (my cats) are comfortably perched together on their shelf in the window. While that may sound quite ordinary and cozy, I know these two cats do not like to actually "touch" and they've been snuggled together for quite a while now without a territorial dispute. What's more, I realize that their ears are all a twitter. I look up from my computer to see them sitting at attention, heads and tails moving from left to right and back again like synchronized swimmers. I look out the window, too, and find they are drooling over a robin; a really big, red-breasted robin. He's chirping away and bouncing around the yard and, when he moves out of sight, Olivia hurries to another window to continue her vigil. Hannah stays put and stretches out on the self. I realize there are more than a single bird out there…it's beginning to sound like a whole a cappella choir!

So, since March roared in like a lion, I look forward to it departing as gently as a lamb without freezer burning my Hyacinths and Daffodils any worse than February's agonizing finale. I'm pretty sure I will again be greeted by beautiful sunrises in another few weeks, and I expect to hear the Canadian geese honking overhead as they pass by on their trek home for the summer. I'm so hopeful that I've started saving coupons for discounts at the garden center!

March 9th, 9:30 am: The wind is picking up and Hannah is twisting her head around and around to watch the dead leaves I didn't rake up last fall dance around with the dust in the yard like miniature tornados. Olivia is too busy watching the beautiful black and white big-as-a-horse greyhound passing by with his head leaning into the wind, pulling against his leash, and shivering just a little. Guess I'll keep the winter coat out just a little longer.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #35, May 2009

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

New Income Limits for 2009: *Really* New Income Limits

As usual, HUD has released the 2009 income limits, with a March 19, 2009, effective date. Owners of IRC §42 and IRC §142(d) housing projects have until May 3, 2009 (45 days), to implement the new limits and rents. However, the new income limits are particularly important this year as they reflect changes in law enacted way back in July of 2008.

New Law Incorporates "Hold Harmless" Policy

Section 3009 of the Housing Assistance Tax Act (HATA) amended IRC §142(d)(2) to add a new subparagraph E, which reads:

(E) Hold harmless for reductions in area median gross income.

(i) In general. Any determination of area median gross income under subparagraph (B) with respect to any project for any calendar year after 2008 shall not be less than the area median gross income determined under such subparagraph with respect to such project for the calendar year preceding the calendar year for which such determination is made.

(ii) Special rule for certain census changes. In the case of a HUD hold harmless impacted project, the area median gross income with respect to such project for any calendar year after 2008 (hereafter in this clause referred to as the current calendar year) shall be the greater of the amount determined without regard to this clause or the sum of--

(I) the area median gross income determined under the HUD hold harmless policy with respect to such project for calendar year 2008, plus

(II) any increase in the area median gross income determined under subparagraph (B) (determined without regard to the HUD hold harmless policy and this subparagraph) with respect to such project for the current calendar year over the area median gross income (as so determined) with respect to such project for calendar year 2008.

(iii) HUD hold harmless policy. The term "HUD hold harmless policy" means the regulations under which a policy similar to the rules of clause (i) applied to prevent a change in the method of determining area median gross income from resulting in a reduction in the area median gross income determined with respect to certain projects in calendar years 2007 and 2008.

(iv) HUD hold harmless impacted project. The term "HUD hold harmless impacted project" means any project with respect to which area median gross income was determined under subparagraph (B) for calendar year 2007 or 2008 if such determination would have been less but for the HUD hold harmless policy.

Keep in mind that IRC §142(d)(2) is cross referenced in IRC §42(g)(4) and is equally applicable to qualified low-income projects under IRC §42.

The General "Hold Harmless" Rule

IRC §142(d)(2)(E)(i) provides the general rule:

> Any determination of area median gross income (AMGI) under subparagraph (B),
>
> For any calendar year after 2008
>
> Not less than the AMGI for the preceding calendar year.

Applying the "hold harmless" policy seems straightforward. For both qualified residential rental properties under IRC §142 and low-income housing under IRC §42, an initial AMGI is determined with respect to a project and the AMGI for any given year going forward from the date of initial determination will never be less than the AMGI for the year before. As a result, Congress has providing owners with some stability and

predictability when forecasting (1) the income limits used to determine whether a household is income-qualified, and (2) the maximum rents that can be charged for low-income units.

Implementing the Hold-Harmless Provision

In 2007 and 2008, HUD modified the methodology used to calculate AMGI to include additional data sources. In some areas, the change in methodology resulted in a significant decrease in the area's median gross income. As a result, HUD used a "hold harmless" policy to keep the AMGI at the existing level (the "HUD hold harmless policy"). This is the hold harmless policy referred to in IRC §142(d)(2)(E)(iii) and projects for which the AMGI was not decreased in 2007 or 2008 because of this policy are "HUD hold harmless impacted projects" under IRC §142(d)(2)(E)(iv).

For "HUD hold harmless impacted projects," the AMGI is the greater of:

1. AMGI determined using the general rule in IRC §142(d)(2)(E)(i) or,

2. the sum of the AMGI under the HUD hold harmless policy for 2008 plus any increase in AMGI after 2008.

Practical Application

Up until now, Rev. Rul. 89-24 provided guidance for computing the income limits and we relied upon HUD's determination of AMGI as the starting point. HUD annually provided updated tables that identified very low-income (50% of AMGI) adjusted for family size, which was used for the 20-50 minimum set-aside requirement. By multiplying the 50% AMGI by 120%, the 60% AMGI could be calculated for the 40-60 minimum set-aside requirement.

From now on, HUD is providing two tables, one for Section 8 and other HUD programs and one for IRC §§ 42 and 142(d) housing projects as described below.

Section 8 and Other HUD Housing Programs

HUD will continue providing the AMGI as it has in the past for purposes of Section 8 and other HUD programs. Significantly, beginning with income limits in 2010, HUD will no longer apply a hold harmless policy and the limits will fluctuate up and down over time with changing economic conditions in the area.

Multifamily Tax Subsidy Projects

HUD now refers to qualified residential rental projects under IRC §142(d) and qualified low-income housing projects under IRC §42 collectively as "Multifamily Tax Subsidy Projects" (MTSP). Starting this year, HUD is providing a separate table with income limits specifically calculated for MTSPs. For 2009, the income limits for MTSPs are based on the Section 8 limits that incorporate the HUD hold harmless policy.

The tables are in the same format that has always been used. The column down the left-hand side identifies the state and area within each state. From left to right, the columns identify the income limits based on household size (1 to 8 persons).

The tables are different in three respects:

1. The tables identify the income limits at the 50% and 60% AMGI levels needed to satisfy the minimum set-aside requirements under IRC §142(d)(1) or IRC §42(g)(1). As a result, the instructions in Rev. Rul. 89-24 to compute 60% AMGI are no longer needed.

2. The table for 2009 includes the hold harmless requirement under IRC §142(d)(2)(E)(i).

3. In those areas where the income limits did not decrease in 2007 and 2008 because of HUD's hold harmless policy, the tables include a second set of income limits identified as "HERA Special 50%" and "HERA Special 60%." FYI: The IRS refers to tax act of July 2008 as the Housing Assistance Tax Act of 2008 (HATA) and HUD refers to it as the "Housing and Economic Recovery Act of 2008 (HERA).

Desperately Asked Questions (DAQs)

Q1: I own an IRC §42 project. How do I know if the project is a "HUD hold harmless impacted project?"

A1: You must meet two requirements:

1. You relied on the income limits provided by HUD to determine the income limits applicable to your project and determined whether households were income qualified based on those income limits (adjusted for family size). If your project was in service, or placed in service during 2007 or 2008, you relied on the income limits provided by HUD. Conversely,

if your project was not placed in service until after December 31, 2008, you could not have relied on the income limits provided by HUD in 2007 or 2008.

2. The MTSP tables for 2009 indicate whether the area in which your project is located is an area affected by HUD's hold harmless policy in 2007 or 2008; i.e., the HERA Special 50% and 60% income limits are identified in the table for your project's location.

Q2: The Hold Harmless rule is applied at the project level. How do I identify my project?

A2: Under IRC §42(g)(3)(D), every low-income building is a separate project unless the owner elects to include the building in a multi-building project. The election is documented on Form 8609, line 8b. In addition to checking the appropriate box, the owner must also provide a statement identifying all the buildings in the project when submitting the Form 8609 to the IRS to complete the First Year Certification under IRC 42(l)(1).

As a practical matter, if your project was placed in service in 2007 or 2008, you might not yet have completed the First Year Certification. You can still treat all the buildings as part of a multi-building project but be sure to complete the First Year Certification as soon as possible with elections that reflect your actions prior to the certification.

Q3: My project is located in an area impacted by HUD's hold harmless policy, but what if some of the low-income buildings in my project were placed in service in 2008 and some will be placed in service in 2009?

A3: If at least one building in the project was placed in service during 2007 or 2008, then all the buildings in the project are subject to the HERA Special 50% and 60% income limits. As a result, the income limits used to determine whether a household is income-qualified and calculate the maximum gross rent will be the same for all the buildings in the project.

Q4: I bought an existing building in 2008 with tenants in place which I am rehabilitating. I plan to place the rehabilitation in service during 2009. I relied upon the Rev. Proc. 2003-82 safe harbor to rent low-income units to income-qualified tenants in 2008, before the beginning of the credit period. The HUD tables indicate that the building is located in an area impacted by the HUD hold harmless policy in 2008, but my rehabilitation wasn't placed in service until 2009. Is the project subject to the HERA special income limits?

A4: Yes. Even though the 10-year credit period had not yet begun, you relied upon the HUD income limits in 2008 to determine the income limits and whether households were income-qualified.

Q5: My project is subject to IRC §1400N(c)(4) because the IRC §42 project was placed in service during 2007, is located in the Gulf Opportunity Zone, and is in a nonmetropolitan area (as defined in IRC §42(d)(5)(B)(iv)(IV)). As a result, I have been using the National Nonmetropolitan Median Gross Income (NNMGI) to determine income limits. Is my project subject to the HERA special income limits?

A5: No, you will continue to use the NNMGI to determine the income limits.

Q6: My IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949) and has been in service since 2004. Under IRC §42(i)(8), for determinations made after July 30, 2008, the income limit is the greater of the AMGI or the NNMGI. The new HUD tables for 2009 indicate that the area was impacted by HUD's hold harmless policy. What should I do?

A6: Since you relied upon the HUD income limits in 2007 and 2008, you will now use the greater of the HERA special income limits or the NNMGI. CAUTION: IRC §42(i)(8) is not applicable to projects that do not have an allocation of credit under IRC §42(h)(1), but instead are financed with tax-exempt private activity bonds and credits associated with the §146 volume cap.

Q7: I placed my IRC §42 project in service in 2008, but did not begin the 10-year credit period until 2009. The project is located in an area impacted by the HUD hold harmless policy. Should I use the HERA special income limits?

A7: Yes, because you placed the building in service no later than 2008 and the income limits for the building were determined in 2008. Notice 88-116 explains that the placed-in-service date for a new or existing building used as residential rental property is the date on which the building is ready and available for its specifically assigned function, i.e., the date on which the first unit in the building is certified as

being suitable for occupancy in accordance with state or local law. Presumably, if the building and units are ready and available for occupancy in 2008, you would rely on HUD's income limits for 2008 to determine whether households are income-qualified and could rely upon the Rev. Proc. 2003-82 safe harbor to rent low-income units to income-qualified tenants before the beginning of the credit.

Q8: My low-income housing development was built in three phases; the first phase was placed in service in 2007, the second phase in 2008, and the third phase will be placed in service in September of 2009. Technically, each phase is identified as a separate project on the Forms 8609, but physically the development is seamless; the buildings in all three projects are identical and you can move freely among all the buildings. So, the first two phases are subject to the HERA special income limits, and I will use the regular MTSP income limits for the third project?

A8: You are correct. CAUTION: Be sure you document when the buildings were placed in service and keep the documentation secured.

Q9: As part of my credit allocation, I agreed to provide a specific number of units for households with income at or below 30% of the AMGI. My project is located in an area impacted by HUD's hold harmless policy in 2007 and 2008. How do I compute the 30% AMGI income limit?

A9: The state housing agencies have authority to impose addition restrictions upon an IRC §42 credit allocation. These restrictions or requirements are recorded as part of the extended use agreement and are enforceable by state housing agencies under state law. The state housing agency should provide you with instructions.

Q10: Has there been any change in the way we compute the maximum gross rent?

A10: No, under IRC §42(g)(2)(C) the gross rent is based on imputed income limits which would apply if the number of individuals occupying the unit were 1.5 individuals for each separate bedroom.

For example, to compute the rent for a 1-bedroom unit you would add the one person income limit and the two-person income limit together and divide by two, multiply by 30% and then divide by 12 to identify the monthly maximum gross rent.

Q11: My 100% LIHC project was placed in service in 2006 and is financed with a federally-subsidized loan from HUD. To receive the higher 70-percent credit, I am renting at least 40% of the units to households with income at or below 50% AMGI. I understand that I continue to be subject to this rule, but which income limits do I use to determine the 50% AMGI income limit? Do I use HUD income limits for Section 8 or the "HERA Special" MTSP income limits?

A11: The MTSP income limits should be used to determine the 50% AMGI used for the 40-50 rule under former IRC §42(i)(2)(E). Since you relied upon HUD's income limits in 2007 and 2008, you should the HERA Special Income Limits.

Q12: 2007 was the 15th year of the compliance period for my low-income building and I am now operating under the terms of the extended use agreement (IRC §42(h)(6)). Am I subject to the MTSP income limits?

A12: Yes, the MTSP "HERA Special" income limits are applicable to your project, even after the end of the 15-year compliance period during which you are subject to credit recapture. However, if you (or a subsequent owner) receive a new allocation of credit and begin a new credit period sometime in the future, you would use the normal MTSP income limits since you did not rely upon HUD's income limits in either 2007 or 2008.

Conclusion (Editor's Note)

Whenever I've worked my way through one of these entangled IRC §42 requirements, I think of Judge Joel Gerber, who ruled in the Tax Court case Bentley Court v. Commissioner. In his written decision, he referred to IRC §42 as "detailed and complex." Yeah, right…I don't know whether to laugh or cry.

IRC §42 Low-Income Buildings Damaged by Casualty Events: Chief Counsel Advisory 200912012

Chief Counsel has provided guidance for three issues related to IRC §42 properties damaged by casualty events. The Chief Counsel Advisory (CCA) was issued February 20, 2009.

Legal Authority

IRC 42(j)(4)(E) only provides relief from the recapture provisions, and then only to the extent that the building is restored by reconstruction or

replacement within a reasonable time, which is generally two years. It does not provide authority for claiming the credit during the time that a low-income building is being restored.

This has been a bit of a confusing point because under Rev. Proc. 2007-54, which addresses casualty events in areas declared major disasters under the Stafford Act, a taxpayer can continue to claim the credit during the construction period. The authority for this determination is Treas. Reg. 1.42-13(a)

Failure to Restore Building

If an owner tries, but fails to restore a low-income building within a reasonable period of time, which year is the recapture year?

The CCA explains that the year of recapture is the year of the casualty event. Further, if the casualty event is in an area designated a federal disaster, the credits claimed for the year the disaster occurred and during the subsequent reconstruction period are disallowed.

If the statute of limitation is closed for the recapture year, then the taxpayer's first open taxable year in the 15-year compliance period is treated as the year of the taxpayer's reduction in qualified basis. See Bentley Court II Limited Partnership v. Commissioner, T.C. Memo. 2006-113 (2006), which was discussed in Newsletter #21.

Casualty Event & Restoration in the Same Year

If a building is damaged by a casualty event and fully restored within the same taxable year, then there is no recapture or loss of credits *if* the units were restored within a reasonable period *and*:

1. Each unit is occupied by low-income tenants by December 31st of the year, *or*
2. The owner initiated continual and verifiable measures to rent restored vacant units to low-income tenants immediately upon restoration of the building. See Q&A #9, Rev. Rul. 2004-82, 2004-2 C.B. 350, for discussion of reasonable attempts to rent vacant units.

Generally, the credit is determined at the close of the taxable year under IRC §42(c)(1). Credit is determined on a monthly basis only for the first year of the credit period under IRC §42(f)(2)(A), and for additions to qualified basis under IRC S42(f)(3)(B). Otherwise, there is no authority for disallowing credits on a monthly basis.

Filing Requirement: State Agency's Annual Report under IRC §42(l)(3)

Each state housing agency that allocates IRC §42 housing credit to any building for any calendar year submits an annual report to the IRS. The report must specify the amount of credit allocated to each building for each year, and include sufficient information to identify each such building and the taxpayer owning the building. Under the Code, state agencies must also submit other information as the IRS requires. This requirement is satisfied when a state agency files Form 8610, Annual Low-Income Housing Credit Agencies Report, with supporting attachments:

> Forms 8609, Low-Income Housing Credit Allocation and Certification, with Part I completed, signed and dated;
>
> Schedule A (Form 8610), Carryover Allocation of Low-income Housing Credit; and
>
> If applicable, information about buildings receiving disaster relief under Rev. Proc 2007-54 or Rev. Proc 95-28.

The information on these forms provide the means for each agency and the IRS to reconcile the allocation of credit for each building with the aggregate amount of credit available for allocation under the state's housing credit ceiling. A housing agency must not allocate more credit than it is authorized to allocate during the calendar year.

Form 8610 also requires a state agency to certify under penalties of perjury that, for the reporting year,

> the state's qualified allocation plan was in effect,
>
> the state agency was in compliance with the compliance monitoring requirements, and
>
> the state agency fulfilled its noncompliance notification responsibilities.

The due date for filing of the annual certification (Form 8610 and attachments) is February 28th after the close of the calendar year in which IRC §42 credit was allocation to a qualified low-income

building. In states with multiple agencies allocating credit (including states with constitutional home rule cities), the agencies must coordinate and file a single completed Form 8610.

The penalty under IRC §6652(j) is applicable if a state agency fails to timely submit its annual report unless it is shown that the failure was due to reasonable cause and not willful neglect. The amount of the penalty is $100. The penalty may be applied regardless of the fact that an annual report was submitted if it is inaccurate or incomplete; e.g., missing required forms that make up the report.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 46 through 47 identify the type of credit and the extent of any adjustment made. See IRM 4.4.12.4(58) and (59) for instructions.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I reported last time that March made its entrance like a roaring lion, but I am perplexed as to how I should report its exit. March 31st was a balmy spring day; the sun was shining, the skies crispy blue, and daffodils blooming everywhere. Even the air smelled fresh and clean. But early the next morning, I found myself driving in drizzly rain and fog so thick the traffic around the beltway actually slowed to a mere 45 mph. So, my dilemma is this: did March exit like a lamb at 11:59 and a smidge past 59 seconds pm on March 31st, or did April boot March into history just a smidge after 00:00 am on April 1st?

April lived up to its reputation for showers, but the tulips and daffodils sprouted, bloomed and wilted well before the expected arrival date for May's flowers. It is still raining as I finish this newsletter on May 1st, and the weatherman is predicting a steady drizzle for the next week. I suppose May will officially start if and when any new flowers show up…I'm betting on the irises!

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Examination Specialization and Technical Guidance's

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #36, July 2009

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Notice 2009-44, Clarification of Treasury Regulation 1.42-10

On May 5, 2009, the IRS released Notice 2009-44 to clarify that utility costs paid by a tenant based on actual consumption in a sub-metered rent-restricted unit are treated as paid directly by the tenant for purposes of IRC §42(g)(2)(B)(ii), which requires that the rent for low-income units include a utility allowance if the tenant pays the utilities.

A sub-metering system typically includes a master meter, which is owned or controlled by the utility provider, with overall utility consumption billed to the building owner. The owner then uses unit-based meters to measure utility consumption and prepares a bill for each residential unit based on consumption.

For purposes of computing the utility allowance when a building is sub-metered as described above:

1. For RHS-assisted buildings, buildings with RHS tenant assistance, HUD regulated buildings and rent-restricted units in other buildings occupied by tenants receiving HUD rental assistance, the applicable RHS or HUD rules apply.

2. For all other rent-restricted units in other buildings:

    a. The utility rates charged to tenants in each sub-metered rent-restricted unit must be limited to the utility company rates incurred by the building owners.

    b. If building owners (or their agents) charge tenants a reasonable fee for the administrative costs of sub-metering, then the fee will not be considered gross rent under IRC §42(g)(2). The fee must not exceed an aggregate amount per unit of $5 per month unless State law provides otherwise.

    c. If the costs for sewerage are based on the tenants' actual water consumption determined with a sub-metering system and the sewerage costs are on a combined water and sewerage bill, then the tenants' sewerage costs are treated as paid directly by the tenants for purposes of the utility allowances regulation.

Tax Consequences

1. Any fees collected are reportable as taxable income on the owner's federal tax return.

2. Any reimbursements of utility costs received by the owner from the tenants must be accounted for as taxable income. The income, however, will be offset by the utility expense claimed by the owner.

Documentation

The utility allowance regulations in Treas. Reg. §1.42-10 include options for computing utility allowances based on data collected or prepared by the owner. Any consumption estimates and supporting data must be retained as part of the *taxpayer's* records for purposes of Treas. Reg. 1.6001-1(a); i.e., taxpayers are required to keep such permanent books of account or records as are sufficient to establish the amount of gross income, deductions, *credits*, or *other matters required to be shown* by such person.

Effective Date

Owners may rely on this notice for any utility allowances effective no earlier than the first day of

the building owner's taxable year beginning on or after July 29, 2008.

Request for Comments

The utility allowance regulations will be amended to incorporate the guidance provided in the notice. Treasury and the IRS invite taxpayers to submit written comments on issues related to the notice or any other issue regarding utility allowances. Methods for submitted comments are included in the notice.

PLR 200916007: Treatment of Off-Site Improvements as Eligible Basis

In Private Letter Ruling 200912007, the IRS addresses the treatment of infrastructure improvements constructed by a taxpayer and then dedicated to the local government. The issue is whether the costs should be included in the eligible basis of qualified low-income residential rental buildings for purposes of computing the allowable IRC §42 credit.

Facts

A taxpayer intends to construct a new IRC §42 project on seven acres of unimproved farmland. As part of the development of unimproved land without access to arterial streets and infrastructure, the local government requires the taxpayer to construct streets, curbs, sidewalks, storm water drainage and domestic water in-flow according to the City's specifications. In addition, the taxpayer must purchase and install steel casings within the streets through which utilities run gas lines, electrical wiring, cable, and phone wires.

If the taxpayer decides not to construct the project as planned, the City will modify the scope of improvements, expecting more improvements if the project size is expanded and less if the project size is constricted.

When completed, the improvements are dedicated for public use and ownership transfers to the City, which then releases the taxpayer's certificates of occupancy necessary for operating the completed project. The City will maintain the streets and steel casings and each utility provider will own and maintain its respective connective pipes and wires

Conclusion

Chief Counsel determined that:

> The costs incurred to construct the infrastructure improvements are indirect costs, within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) for purposes of IRC §263A, and are capitalized into the bases of the project's residential rental buildings because the buildings directly benefited, or were incurred by reason of, the construction of the project. The cost is to be allocated among the residential rental buildings using a reasonable method of allocation.
>
> Assuming that the project's residential rental buildings will be depreciated as residential rental property under IRC §168, the eligible basis of the project's residential rental buildings under IRC §42(d)(1) includes the cost of the infrastructure improvements.

The same conclusion was determined based on the same legal arguments in Rev. Rul. 2002-9 regarding impact fees imposed by a state or local government against new development or expansion of existing development. The fees are used to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. Rev. Rul. 2002-9 was silent, however, regarding the costs of improvements constructed by a taxpayer and then dedicated to the state or local government in lieu of paying an impact fee.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

The TV ads proclaim that kids lose an incredible amount of knowledge over summer vacation…and as we approach the mid-summer holiday, I wouldn't want anyone to lose even an itsy-bitsy iota of IRC §42 vocabulary.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Across

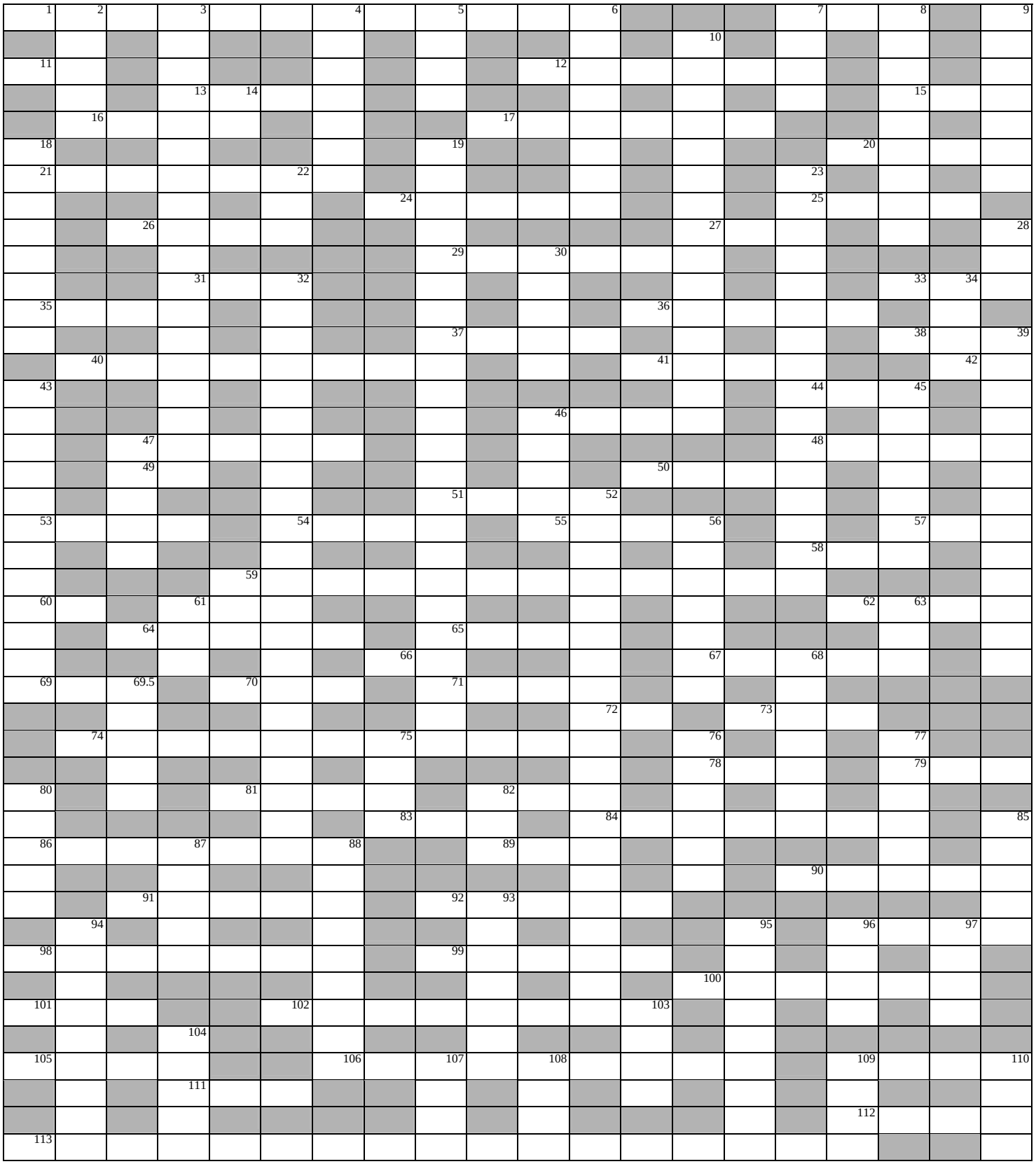
1-Fail to impose consequences
7-Building Identification Number
11-Not out
12-Persons who are learning something
13-Documentation of household eligibility
15-Start business use
16-Real Estate Investment Trust
17-Reduces tax liability dollar for dollar
20-Attach or permanently affix
21-Obtain possession
24-Imposed to support government activities
25-Forget to include
26-To remain in the same place
27-The results of addition
29-Gross Receipts minus all expenses
31-Not on the table
33-Cleopatra's snake
35-Constructed with yellow bricks
36-Depreciable, Eligible, or Qualified
37-Slippery, snake-like fish
38-Chief Counsel's assistance during an audit
40-What investors did
41-Claim upon the property of another
42-Mr. Kettle's spouse
44-Baseball hat
46-Willingly relinquish
47-Drilled a hole
48-To investigate thoroughly
49-If you go here, you must come down
50-Combustion reaction
51-Applied fairly, equitably, & with integrity by the IRS
53-A juvenile male equine
54-A type of unconsciousness
55-An egress for departure
57-An adult feline
58-Consequence of three strikes
59-Ten years
60-A toddler's favorite word
61-Warmer than warm
62-A location's median income before adjustments
64-IRS examination
65-Require for survival
66-Same as 49 across
67-Unacceptable attitude-"ism" (acronym)
69-Comfortable location for 57 across
70-Suitable for intended use

71-Non-depreciable asset
72-The objective case of "we"
73-Minimum number of low-income units in a qualified IRC §42 project
74-Incremental parts of the Applicable Fraction
78-Slang for received or taken
79-To apply or put to work
81-IRS acronym for IRC §42
82-Chief Counsel's advice for the IRS when no specific audit is in progress
83- Caribbean or Mediterranean
84-Nonspecific
86-"H" in FHA
89-Revenue Agent's Report
90-Cactus-like plant in the Mojave Desert, or a small town in western Arizona
91-Jargon or a five-letter word game
92-Frequently
96-one hundredth of a dollar
98-Required in mixed-use projects
99-Subsequently,
100-Parts of Louisiana, Mississippi, and Alabama
101-To weaken or deplete
102-40 and 60, 20 and 50, and 70, 30, or 140.
105-Replaced 62 across for 2009
106-Less than six months
109-A metropolitan area
111-Internal Revenue Code
112-In the distance
113-Always rented in 100% LIHC projects

Down

2-Taxpayer possessing IRC §42 project
3-Type of location for which increased eligible basis is allowable.
4-Procedures and Rulings
5-IRS organization for large and mid-sized businesses
6-A teacher's audience
7-Occupied, like a bee
8-10% of credit ceiling set aside for these entities
9-Assistance to fill a gap
10-The smallest percentage of low-income units required to be a qualified low-income project
14-The Addams family's cousin
18-Members of a partnership
19-Contains a state housing agency's criteria for determining housing priorities
22-Smallest unit of sunshine
23-Fifteen years
28-a spindle toy
30-should, would and _____
32-Form 8609, Part II
34-Unwanted e-mail
39-Used to assess locations' housing needs
43-Interprets law; writes Treasury regulations
45-One or more qualified low-income buildings, as elected by the owner
46-To rank in priority order, or assess quality
47-Contruct
52-A 30-year contract
56-Neptune's pitchfork
59-A type of North Atlantic white fish
61-Administers Section 8 Housing Program
63-Between April and June
68-To watch, a state housing agent responsibility
69.5-Prepares for occupancy
75-Standards against suitability for occupancy is evaluated
76-Ability to choose or state-level organization that allocates IRC §42 credit
77-Not private, for everyone
80-Refurbish
82-Vehicle for transportation
85-Reduces eligible basis if federally sourced
87-A county in England
88-30%, before adjustments
93-Years taxpayers are subject to recapture
94-Accelerated credit is subject to this
95-Noncompliance
96-A big black avian animal with feathers and wings
97-Food, clothing and shelter
103-Contains an embryo plant
104-To divide, as in atoms
107-Not where you should be; missing
108-Crust of dried blood over a wound
109-A friendly, informal conversation
110-A tall tale

The Mostly LIHC Crossword Puzzle



Examination Specialization and Technical Guidance's

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #37, October 2009

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Correction for Rev. Ruls. Providing Monthly Applicable Percentages

IRC 42(b)(2) is incorrectly cited in revenue rulings providing the month applicable percentage. Rev. Ruls. 2009-22, 2009-29, and 2009-33 are affected. The note for Table 4 should read:

> "Under Section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after ***July 30, 2008***, and before December 31, 2013, shall not be less than 9%."

We are working on correcting the note for future revenue rulings and "thanks" to the Missouri Housing Development Commission for bringing the "oops" to our attention.

Filing Tax Returns for LIHC Property Owners

It's October! And if you think the IRS is busy in April…I'm pretty sure October is a bumper month for accountants preparing tax return "on extensions"…so just a few reminders about claiming the IRC §42 credit.

Form 8609-A

Form 8609-A is filed by the taxpayer owning the low-income building. A separate Form 8609-A is required for each allocation, so there is a one-to-one match of Forms 8609 and Forms 8609-A.

Part I, Compliance Information

Part I includes 5 questions (A-E) which, if answered, satisfy the annual certification requirement under IRC §42(l)(2). Just keep in mind that when the Tax Matters Person signs the tax return, the "under penalties of perjury" clause includes all the accompanying schedules and statements. Perjury penalties under IRC §7206 include fines (no more than $10,000, $50,000 for a corporation) or imprisoned (no more than 1 year)…or both.

Part II, Computation of Credit

Form 8609-A, Part II, is the computation of the allowable credit for the tax year. The computation involves a number of steps needed to account for various types of low-income housing and circumstances. It is not necessary to analyze the whole equation here, but note the following:

1. The eligible basis entered on line 1 should be the same as disclosed on Form 8609, line 7.

2. The applicable fraction entered on line 2 is determined based on the number of qualifying low-income units *at the end of the taxable year* under IRC §42(c)(1)(B), except for the first year of the credit period, when the applicable fraction is computed as an average of the monthly applicable fractions under IRC §42(f)(2).

   A common mistake is to treat a residential unit as a low-income unit beginning with the month in which it (or the building) was *placed in service*, rather than the first full month the building was placed in service *and* the unit was first occupied by a qualifying household (with restricted rent) as of the last day of the month. If households are moving between units in a building or between low-income buildings in the project, the "swapping rules" described in Treas. Reg. 1.42-15(d) and Rev. Rul. 2004-82, Q&A #8 apply, respectively.

   Another mistake is relying on the percentage of low-income units to determine the applicable fractions rather than using the *smaller* of the unit fraction or floor space fraction. If using the floor space fraction, use only the square footage of the residential rental units…do not include

the hallways, common areas, other amenities used by tenants, or facilities necessary for the operation of the project.

3. The applicable percentage on line 5 should be the same as disclosed on Form 8609, line 2.

4. If residential units first qualify as low-income units after the end of the first year of the credit period, there will be an increase, or "excess" in qualified basis. The applicable percentage applied to the excess qualified basis is 2/3 of the applicable percentage on line 5, and is commonly referred to as the "2/3 Credit" under IRC §42(f)(3). The 2/3 Credit is accounted for on lines 7 and 9, and 10 and is actually a subtraction of the 1/3 portion of the credit that is not allowable. There's also a monthly averaging for the first year the unit is a low-income unit account for on line 11.

   Rather than use the form, taxpayers sometimes compute the allowable credit manually and then plug numbers into key lines of the form to show the allowable credit on Line 15. However, taxpayers invariably skip the lines for the 2/3 credit adjustment. This can become an onerously troublesome short-cut if there's ever a credit recapture amount under IRC §42(j).

   Under IRC §42(j)(4)(C), the 2/3 credit is not subject to the recapture provisions. So, years after the original computation, that has been transferred from tax return to tax return, year after year by accountant after accountant, someone will have to go through some really dusty old records to figure out how much 2/3 credit was claimed each year (building by building) in order to enter the correct amount on line 2 of Form 8611, Recapture of Low-Income Housing Credit.

   If a taxpayer is audited and a recapture of credit under IRC §42(j) results, the starting point for computing the recapture amount will be the credit claimed on Form 8609-A. If the 2/3 credit is not identified, the IRS applies the "duty of consistency doctrine" to conclude that what's on the return is accurate and that the entire credit claimed in each prior year is subject to recapture. While the taxpayer can establish the amount of 2/3 credit during the audit, providing the necessary documentation for all the prior years can be particularly difficult.

   Note: See "Tenant Income Issues: A Tax Court Case" in LIHC Newsletter #21 for a discussion of the duty of consistency doctrine and its application in Bentley Court II L.P., T.C. Memo 2006-113.

5. Line 15 is the allowable credit, but can never be higher than the amount of credit identified on Form 8609, line 1b.

6. Line 17 reflects credit allowable under IRC §42(f)(2)(B), which is the credit disallowed in the first year of the credit period and is allowable in the 11th year of the 15-year compliance period.

A word to the wise: *please* read the instructions for Form 8609-A before filling it out. I've touched on the basic reconciliations and fundamental aspects of the computation, but there are so many variations of credit allocations and fact patterns that I really couldn't begin to discuss them all. The instructions are available on the IRS website, www.irs.gov. (Note: the form and instructions are no longer together as one e-file.)

Form 8586, Low-Income Housing Credit

Form 8586 summarizes key information from the Forms 8609-A. What's new? Taxpayers will forever need to keep track of when the buildings were placed in service because the portion of the low-income housing credit attributable to buildings placed in service after 2007 is not limited by the tentative minimum tax.

Which just begs the question, what do you do if you received an allocation of credit for the acquisition and rehabilitation of an existing building and the existing building was placed in service as residential rental property in 2007, but the rehabilitation wasn't placed in service until 2008?

The credit associated with the acquisition will be reflected in Part I used for buildings placed in service before January 1, 2008, and the credit associated with the rehabilitation will be reflected in Part II for buildings placed in service after December 31, 2007. Want some aspirin for that splitting headache?

Form 4562, Depreciation

One last consideration is whether depreciable basis is reduced for the amount of the credit claimed. Eligible basis under IRC §42(d)(1) and (2) is the adjusted basis as of the close of the first taxable year

of the credit period. Under IRC §42(d)(4), special rules relating to determination of adjusted basis, paragraph (D) states that there is no reduction of the adjusted basis for depreciation when determining the eligible basis. So, the answer is "no."

IRC §42(l)(1) Certification for the First Year of the Credit Period

It's time to file tax returns on "extension", and those taxpayers may have requested an extension to file while waiting for the Forms 8609, Part I, from the state agencies. Keep in mind that taxpayers need to complete the IRC §42(l)(1) First Year Certification. There a complete discussion in Newsletter #31. Just remember:

The certification is made using Part II of the Form 8609 with Part I completed/signed be the state housing agency.

The "tax year" on the line to the left of where you print your name, is the first year of the credit period.

It's a *one* time filing with the Philadelphia Campus; you do *not* file them every year.

The certification is not complete unless you sign and date *all* the Forms 8609. Just because you have an acquisition/rehab project with 100 buildings and 200 Forms 8609, it doesn't mean you can just sign one on behalf of all of them.

The certification must be completed after the end of the first year of the credit period. No due date is specified and no requests for extensions of time to file the Forms 8609 are required or need be requested.

Do not file tax returns with the LIHC Compliance Unit along with the Forms 8609; the unit does not process tax returns.

Keep a copy of the completed certification for your records…*please*.

Form 8877 Obsoleted

Form 8877, Request for Waiver of Annual Income Recertification Requirement for the Low-Income Housing Credit, has been obsoleted and is no longer available for use.

Forms 8877 submitted by LIHC project owners to the IRS requesting the waiver will be rejected and sent back to the owner.

Existing waivers are now void, but state agencies do not need to technically revoke the waivers.

Explanation

As part of the Housing Assistance Tax Act of 2008, Congress amended IRC §142(d)(3)(A) to read (new language is italicized):

"…The determination of whether the income of a resident of a unit in a project exceeds the applicable income limit shall be made at least annually on the basis of the current income of the resident. *The preceding sentence shall not apply with respect to any project for any year if during such year no residential unit in the project is occupied by a new resident whose income exceeds the applicable income limit."*

The amendment is effective for tax years ending after July 30, 2008, and under IRC §42(g)(4), the new exception is made applicable to IRC §42 properties. As a result, owners of §42 projects, where all the residential units are low-income units, can stop completing the annual tenant income recertifications.

However, Congress did not repeal IRC §42(g)(8)(B), which reads,

"…On application by the taxpayer, the Secretary [IRS] may waive….any annual recertification of tenant income for purposes of this subsection, if the entire building is occupied by low-income tenants.

Keep in mind, the IRS extended the rule to apply to qualified low-income housing *projects* that consist entirely of 100%percent low-income buildings in Revenue Procedures 94-64 and 2004-38.

So, now we have overlapping authorities relieving owners of 100% LIHC projects of the requirement to conduct annual tenant income recertifications. For all practical purposes, the new exception under IRC §142(d)(2) subsumed the IRC §42(g)(8)(B) waiver and there's no need to continue providing annual income recertification waivers. Therefore, no need for the form!

IRS Releases Updated Guide for Completing Form 8823

On September 25, 2009, the IRS released an updated revision of the Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. The guide was distributed directly to the state housing agencies, which use the guide in conjunction with their compliance monitoring activities. The guide was also made available to the public using the LIHC Newsletter distribution list. The guide is now available on industry websites and from the IRS by sending a request to **Grace.F.Robertson@irs.gov**.

Scope

The guide provides state housing agencies with a single accumulative reference of current legal authorities needed for determining whether Form(s) 8823 need to be filed with the IRS, along with guidelines and examples of the law's application to specific fact patterns. Generally, the guide does not address the tax consequences of noncompliance. Taxpayers are responsible for evaluating the tax consequences of noncompliance with IRC §42.

Authority

The guide is not a legal authority and should not be used or cited as authority for setting or sustaining a technical position. Instead, the Internal Revenue Code and formal IRS guidance, as referenced extensively in the text and footnotes, should be cited as authority.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I love October. The summer heat has cooled, the tourists have gone home, and it's the beginning of a new fiscal year for the IRS. I spent the last days of September finishing projects, writing reports and otherwise accounting for my where-abouts during FY 2009….and I even had time to clean (literally) a couple of stacks of paperwork off my desk! It's been a pretty good year, all things considered…like Congress passing the Housing Assistance Tax Act in July of 2008.

Technically…that was FY2007, but implementing new law takes a little time. Someone has to figure out how the new law impacts current operations, what needs to be done and how it should be done, and who should do it and when. And then, when we all more or less agree, we make an action plan. The plan lists all the things that need to be done, who is responsible, and when the action items are to be completed. Did I mention someone is keeping a list and checks it *every* month? Oh yeah…the *really* fun job! And that brings my back to the top of the list and the "someone" interpreting the new law, which isn't nearly as clear as Congress might have hoped. That "someone" is not a single person, of course, but Chief Counsel and it's been a particularly busy year for them. So…….

My thanks and appreciation to the attorneys in Chief Counsel working with IRC §§42 and 142, for their on-going assistance and support.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Answers for the Mostly LIHC Crossword Puzzle

H [1]	O [2]	L	D [3]	H	A	R [4]	M	L [5]	E	S	S [6]				B [7]	I	N [8]		S [9]
	W		I			E		M			T		M[10]		U		O		U
I [11]	N		F			V		S		P [12]	U	P	I	L	S		N		B
	E		F [13]	I [14]	L	E		B			D		N		Y		P [15]	I	S
	R[16]	E	I	T		N			C[17]	R	E	D	I	T			R		I
P [18]			C			U		Q [19]			N		M			B [20]	O	N	D
A [21]	C	Q	U	I	R[22]	E		U			T		U		C [23]		F		Y
R			L		A		T[24]	A	X	E	S		M		O[25]	M	I	T	
T		S[26]	T	A	Y			L					S [27]	U	M		T		T [28]
N			T					I [29]	N	C[30]	O	M	E		P				O
E			O[31]	F	F [32]			F		O			T		L		A[33]	S[34]	P
R [35]	O	A	D		I			I		U		B[36]	A	S	I	S		P	
S			E		R			E[37]	E	L	S		S		A		T[38]	A	M[39]
	I [40]	N	V	E	S	T	E	D		D		L [41]	I	E	N			M[42]	A
C [43]			E		T			A					D		C[44]	A	P[45]		R
H			L		Y			L		G[46]	I	V	E		E		R		K
I		B[47]	O	R	E	D		L		R					P[48]	R	O	B	E
E		U[49]	P		A			O		A		F[50]	I	R	E		J		T
F		I			R			C[51]	O	D	E[52]				R		E		S
C [53]	O	L	T		C[54]	O	M	A		E[55]	X	I	T[56]		I		C[57]	A	T
O		D			E			T			T		R		O[58]	U	T		U
U				C[59]	R	E	D	I	T	P	E	R	I	O	D				D
N[60]	O		H[61]	O	T			O			N		D			A [62]	M[63]	G	I
S		A[64]	U	D	I	T		N[65]	E	E	D		E				A		E
E			D		F		U[66]	P			E		N[67]	I	M[68]	B	Y		S
L[69]	A	P[69.5]		F[70]	I	T		L[71]	A	N	D		T		O				
		R			C			A			U[72]	S		O[73]	N	E			
	R[74]	E	N	T	A	L	U[75]	N	I	T	S		A[76]		I		P[77]		
		P			T		P				E		G[78]	O	T		U[79]	S	E
R[80]		S		L[81]	I	H	C		C[82]	C	A		E		O		B		
E					O		S[83]	E	A		G[84]	E	N	E	R	A	L		G[85]
H[86]	O	U	S[87]	I	N	G[88]			R[89]	A	R		C				I		R
A			H			R					E		Y		Y[90]	U	C	C	A
B		L[91]	I	N	G	O		O[92]	F[93]	T	E	N							N
	R[94]		R			S			I		M			V[95]		C[96]	E	N[97]	T
R[98]	E	C	E	R	T	S		A[99]	F	T	E	R		I		R		E	
	C					R			T		N		G[100]	O	Z	O	N	E	
S[101]	A	P			P[102]	E	R	C	E	N	T	S[103]		L		W		D	
	P		S[104]			N			E			E		A					
M[105]	T	S	P			T[106]	R	A[107]	N	S[108]	I	E	N	T		C[109]	I	T	Y[110]
	U		L[111]	A	W			W		C		D		I		H			A
	R		I					O		A				O		A[112]	F	A	R
N[113]	E	X	T	A	V	A	I	L	A	B	L	E	U	N	I	T			N

Examination Specialization and Technical Guidance's

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #38, December 2009

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Requesting Information: Preparing Information Document Requests

In the last newsletter, we discussed the forms used by taxpayers owning LIHC projects to claim the credit on their tax returns and how the information on the forms can be reconciled, as well as some of the common errors.

The same information is used by IRS examiners, along with other internal information, to analyze tax returns and prepare for an audit before a taxpayer is contacted. Once the analysis is completed, the examiner will formally notify the taxpayer by mail that an audit is to be conducted. The letter will include a request for information and documents to be made available for the audit. This list of items is provided on a Form 4564, Information Document Request, or in IRS jargon, the "IDR."

Since it's that time of year when lists are made and checked twice, here's what you might expect to see on the first IDR for the audit of a taxpayer owning IRC §42 property, which is almost always a partnership.

General Information

1. Partnership Agreement.
2. Prospectus/Offering Memorandum related to the organization or syndication of the partnership.
3. Documentation for the partners' capital contributions and current balance.
4. Credit Allocation Application.
5. Market Study.
6. Credit Allocation Award or Carryover Allocation.
7. Extended Use Agreement.
8. All Forms 8609 issued to the taxpayer.
9. Internal audit reports.

Tax Returns

1. Copies of tax returns for the tax year prior to the earliest year under audit, and all tax returns for years subsequent to the tax years under audit.
2. Trial balance and any workpapers used to prepare the tax return under audit.
3. Depreciation schedules.

Eligible Basis

1. Final cost certification submitted to the state agency with supporting documentation.
2. Documentation of all financing sources.
3. Development contracts or agreements.
4. Documentation of cost allocations between land, nonqualifying land improvements and depreciable residential rental property included in eligible basis.

Low-Income Households

1. For the years under audit, rent rolls identifying the households and family size for each low-income unit.
2. Documentation of internal controls in place to ensure that income-qualified households occupy the low-income units.

1st and 11th Year of the Compliance Period

If the first year of the compliance period is audited, the special rule for computing the Applicable Fraction under IRC §42(f)(2) is used. The taxpayer should provide:

1. Certificates of Occupancy,
2. A schedule indicating when each low-income unit was first occupied by an income-qualified household.
3. Computation of First Year Applicable Fraction, including the computation of the Applicable Fraction on a monthly basis.

If the eleventh year of the compliance period is audited and the taxpayer has claimed credit, the taxpayer should provide the information identified above as well as a copy of the tax return for the first year of the credit period.

Additions to Qualified Basis

1. Provide a list of units first occupied by qualifying tenants after the end of the first year of the credit

period and identify when a qualifying household first occupied the unit, or
2. Confirm that all units were occupied by qualifying household by the end of the first year of the credit period.

Rents & Other Sources of Income or Funds

1. Description of residential rental units, including total number of units, total number of low-income units, size (bedrooms) and rents charged for low-income and market units.
2. Documentation that rents are correctly restricted.
3. Sources of rent subsidies.
4. Documentation for computation of any utility allowances.
5. Fees for services provided to tenants in addition to housing.
6. Other income from related activities; i.e., vending machines, laundry facilities, etc.
7. Other income from sources such as commercial use of a portion of the property.
8. Documentation of funds received from other sources; e.g., federal grants or subsidies received during the year, additional capital contributions, or loan proceeds.

Noncompliance

If the audit resulted from the filing of Forms 8823 by the state agency, the taxpayer should provide documentation for corrective actions taken to restore the project to compliance.

Dispositions

If the property was sold, documentation regarding the sale should be requested. Particularly, the sales contract and settlement documents, computation of the capital gain/loss, how the gain/loss was distributed among the partners, and whether the sale required the new owner to operate property as a qualified low-income project for the remainder of the 15-year compliance period.

Conclusion: Recordkeeping and Record Retention

Take a deep breath….this is the all-inclusive, master wish list for the *first* IDR. Examiners will tailor the request to fit the facts of the case, but also remember that there may be follow-up IDRs later on.

Can't remember where you stashed this stuff? No excuses! In addition to the general recordkeeping requirements under IRC §6001, owners of IRC §42 projects are subject to specific recordkeeping (it's another long list) and record retention requirements under Treas. Reg. 1.42-5(b). These records must be retained for at least six years after the due date (with extensions) for filing the federal income tax return for that year AND the records for the first year of the credit period must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the 15-year compliance period of the building.

Administrative Reminders

It's a holiday…we'll just skip this particular list this time….but just this once!

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I just want to wish everyone the warmest of holiday seasons and the very best for the coming year, but I'm getting hung up on "wishing" and "warmest," and honestly, is there something any better than best? And do years actual come and go, or do we move through them? Okay, way too much Star Trek here.

My dilemma is rooted in a long ago experience when I was once a member of committee tasked with writing a document describing various IRS procedures. Doesn't sound particularly tough to do, except that many of the procedures we were trying to describe were excruciatingly similar in nature and difficult to differentiate. It didn't take long to realize that adjectives needed to be used cautiously and including "very" this and "really" that just wasn't going to satisfy our need to precision and clarity. To be honest, I can't write "complex" or "complicated" without remembering the agonizing two hour discussion of the subtle differences in their meanings and whether either, or which, of the two we should use. I fear I have no more patience now than I had then, so…..

In this complex and complicated world,
Whether you celebrate the season in solitude,
Within a circle of loved ones or with strangers,
Wherever you are, I hope you will find peace.

Grace

Low-Income Housing Credit Newsletter

Internal Revenue Service #39, April, 2010

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Reminder: Filing Season

It's April, that time of year when tulips bloom and tax returns are due. Just a reminder that next Thursday is April 15th and for most taxpayers, your tax returns are due to the IRS. If you are an owner of IRC §42 property, there are four additional "filings" to consider.

1. If you have just completed the first year of the credit period, you can now make a final determination of costs includable in Eligible Basis. Your final cost certification should be submitted to your state housing agency according to their requirements.

2. If you have received the signed Forms 8609 from your state housing agency during the last year, and you haven't filed the Part II with the IRS, you might want to double check. Remember to complete the form completely and sign and date!

3. Your annual compliance certification to your state housing agency is probably due. Most of the agencies set filing dates soon after the end of the calendar year.

4. If, like a lot of IRC §42 project owners, you need more time to prepare you federal tax return, you can file a request for an extension of time to file.

Auditing Eligible Basis

The IRC §42 credit allowable each taxable year is *generally, and without considering all the details*, equal to:

Eligible Basis x Applicable Fraction x Applicable Percentage

Eligible Basis is a term unique to IRC §42 and has a specific definition, which is the topic of this article. In addition, basic audit issues and helpful audit techniques are discussed.

Defining Eligible Basis

Eligible Basis is, by definition, the cost of residential rental property as defined in IRC §103 that is depreciable property under IRC §168. The buildings may be:

1. New buildings, for which original use begins with the taxpayer (IRC §42(i)(4)),
2. Existing buildings, which means any building which is not a new building (IRC §42(i)(5)), and
3. Rehabilitated buildings, the expenditures connected with rehabilitating the building are treated as a separate new building and do not include the cost of acquiring the building (IRC §42(e)(1) and (2)).

IRC §263A generally requires direct costs and an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer to be capitalized to the property produced. IRC §263A(g)(1) defines produce as including constructing, building, installing, manufacturing, developing, or improving. Indirect cost subject to IRC § 263A capitalization are defined in Treas. Reg. § 1.263A-1(e)(3)(i) as "…all costs other than direct material costs and direct labor costs (in the case of property produced)….Indirect costs are properly allocable to property produced…when the costs directly benefit or are incurred by reason of the performance of production…"

Qualifying Assets

Eligible Basis includes the adjusted basis of:

1. Residential rental units, as defined in Treas. Reg. §1.103(b)(8)(i). In addition, IRC §42(i)(3)(B)(iv) provides that certain single-room occupancy units also qualify as residential rental units even though such housing may provide eating, cooking and sanitation facilities on a shared basis.

2. Under IRC §42(d)(4)(B), common areas and amenities provided to all the residential units.

3. Under IRC §42(d)(4)(C), any building used to provide services for certain nontenants. A "community service facility" means any facility located in a qualified census tract (as defined in IRC §42(d)(5)(C)), designed to serve primarily individuals whose income is 60 percent or less of area median income (within the meaning of IRC §42(g)(1)(B)), and used throughout the taxable year as a community service facility.

4. Under IRC §42(c)(1)(E), the portion of the building used to provide supportive services designed to assist tenants in locating and retaining permanent housing if the taxpayer is providing transitional housing for the homeless under IRC 42(i)(3)(iii).

5. Under Treas. Reg. §1.103-8(b)(4), functionally related facilities that are subordinate to residential rental units, such as swimming pools and similar recreational facilities, parking areas, and other facilities reasonably required for the project.

6. As explained in Rev. Rul. 74-265, land preparation costs (such as landscaping) may be subject to a depreciation allowance if such costs are so closely associated with a depreciable asset so that it is possible to establish a determinable period over which the preparation will be useful. A useful life for land preparation is established if it will be replaced contemporaneously with the related depreciable asset. Whether land preparation will be replaced contemporaneously with the related depreciable asset is necessarily a question of fact, but if the replacement of the depreciable asset will require the physical destruction of the land preparation, the test is considered satisfied.

Date of Determination

For a new building, under IRC §42(d)(1), the eligible basis is its adjusted basis as of the close of the first taxable year of the credit period. Under IRC §42(d)(2), the same rule applies for acquired buildings, but additional requirements must also be met. Finally, under IRC §42(h)(3)(C), if an existing building has been rehabilitated, then the determination is made as of the close of the first taxable year in the credit period for such expenditures, but only if criteria for minimum expenditure amounts have been met.

Identification of Large, Unusual, or Questionable Items

Reconciliation of Form 8609 and Form 8609-A

The eligible basis reported on Form 8609, line 7, and on line 1 of the Form 8609-A filed with the tax return should match. Any differences should be explained by the taxpayer.

Reconciliation of Final Cost Certification

Under IRC §42(m)(2), the credit allocated by a state agency is not to exceed amount necessary to assure project feasibility and viability as a qualified low-income housing project throughout the credit period. To make sure only the credit necessary is allocated, the state agencies perform evaluations of the sources and uses of funds at three critical points of the development process, including when the building(s) are placed in service.

This final evaluation for when a building is placed in service must be made no later than the date the state agency issues the Form(s) 8609. As described in Treas. Reg. §1.42-17(a)(5), the taxpayer must submit a schedule of project costs. This schedule is commonly referred to as the final cost certification because it is to be prepared on the method of accounting used by the taxpayer for federal income tax purposes, and must detail the project's total costs as well as those costs that qualify for inclusion in eligible basis under IRC §42(d).

The final cost certification should be secured from the taxpayer, or if not available, from the state agency. The eligible basis reported on this final cost certification should be compared to the eligible basis reported on Form 8609 and Form 8609-A, and any differences reconciled.

Setting the Scope

Finally, based on the review of the final cost certification, the audit scope for examining eligible basis can be determined. Specific costs should be identified as large, usual, or questionable items. (See IRM 4.10.2.3.1.) Consider the following:

1. Inherent character of the cost. Categories of costs that by character are not includable in eligible basis can be eliminated from further consideration if the taxpayer did not include the costs in eligible basis. For example, the costs associated with the acquisition of land.

2. Beneficial effects of how an item is reported; it is to the taxpayer's advantage to include as much cost as possible in eligible basis. For example, a taxpayer may purchase land with an existing building that was then rehabilitated and now qualifies as low-income housing. In this case, there should be an allocation of the purchase price between the land and the acquired building.

3. Consider costs that should be identified in the final cost certification, but are missing. For example, costs that were most probably incurred, but are not includable in eligible basis include partnership organizational costs, rent-up and marketing costs, and syndication fees.

4. Consider line items on the cost certification that are an accumulation of a larger number of separate costs. At a minimum, the taxpayer should be asked to provide an explanation of the underlying costs.

From the analysis, it may be possible to exclude costs the taxpayer did not include in eligible basis because the cost is not, by characterization, includable. For the remaining categories identified on the cost certification, two additional criteria can be used to identify large, unusual, or questionable items for audit consideration.

1. Consider the comparative size of the cost to total eligible basis. Small dollar values for line items that appear to be includable in eligible basis by character may not need further examination.

2. Consider the absolute size of the cost, even if comparably small, if the dollar value does not appear commensurate with the character of the cost.

At this point, the analysis should identify those costs that the taxpayer has included in eligible basis which are:

1. Clearly not includable in eligible basis,

2. Allocable costs for which the method of allocation should be reviewed,

3. Costs not clearly identified in the cost certification and which may not be includable in eligible basis,

4. An accumulation of costs, for which any one of the underlying individual costs may not be includable in eligible basis,

5. Individual line items selected because of its comparative or absolute size. Generally, these costs are expected to be the hard costs of constructing new residential rental property or rehabilitating existing property.

Audit Issues

The first issue is whether the asset, by character, is residential rental property qualifying for the credit. To summarize:

1. IRC §§ 103, 168, and 263A are *the primary* references for the definition of residential rental property.

2. Under IRC §42, eligible basis includes not only the cost of residential rental units, but also includes common areas, community service facilities, supportive services for the homeless, and functionally related facilities.

3. Eligible basis *may* include the cost of some land improvements and landscaping, but is generally limited to assets so closely associated with a depreciable asset includable in eligible basis so that it is possible to establish a determinable period over which the preparation will be useful.

If assistance is needed to determine the treatment of a specific cost, a series of technical advice memorandums (TAM) issued by the IRS provide helpful explanations and citations for the controlling legal authority. See TAMs 200021509, 200021510, 200043015, 200043017, 200044004, and 2000044005. TAM 200043016 is also helpful, but the treatment of local impact fees has been updated since the TAM was released; see Rev. Rul. 2002-09 and PLR 200916007.

The second issue is verification of the cost. Development of this issue tends to taxpayer-specific, but generally includes the review of contracts, receipts, etc. Owners of IRC §42 projects are subject to the same substantiation requirements as all other taxpayers under IRC §6001 and the associated regulations.

The third issue is determining when the cost was incurred, since only those qualifying costs incurred before the end of the first year of the credit period are includable in eligible basis.

1. Notice 1988-116 explains that construction, reconstruction, or rehabilitation costs are incurred for purposes of IRC §42 on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer incurring the costs with respect to other items of income and expense; i.e., the amount must be fixed and determinable.

2. Under IRC §42(d)(1), the eligible basis is the building's adjusted basis as of the close of the first taxable year of the ten-year credit period. Under IRC §42(f)(1), the credit period starts with the taxable year in which the building is placed in service, or at the election of the taxpayer, the succeeding taxable year. The election is documented on Form 8609, line 10a.

3. Notice 1988-116 also explains that for purposes of IRC §42, the term "placed in service" has two definitions.

   The placed-in-service date for a new or existing building used as residential rental property is the date on which the building is ready and available for its specifically assigned function.

   The placed-in-service date under IRC §42(e)(4)(A) for rehabilitation expenditures that are treated as a separate new building is the close of any 24-month period, over which the taxpayer has aggregated expenses for purposes of determining whether the minimum costs have been incurred to qualify for the credit (see IRC §42(e)(3)(A)). This calculated placed-in-service date applies even if the building is occupied during the rehabilitation period. See Newsletter #17. At this point, the taxpayer should document compliance with the requirement for the selected 24-month period to establish when the rehabilitation costs were placed in service.

4. Generally, Certificates of Occupancy issued by a local government agency after physically inspecting the buildings are used to document when a building has been placed in service. The documented placed-in-service date should match the date identified on Form 8609, line 5.

The fourth issue is whether the costs have been reasonably allocated among the assets. The following cost allocations should be reviewed.

1. The allocation of the purchase price between the land and any acquired buildings.

2. The allocation of costs between the acquisition of a building and its subsequent rehabilitation.

3. The allocation of costs between multiple low-income buildings. Consider:

   Costs for individual low-income residential rental buildings, particularly if not comparably constructed,

   Common areas and facilities not directly associated with a specific low-income building,

Land improvements and landscaping, and

Indirect costs capitalized under IRC §263A.

4. Mixed low-income housing and commercial property. None of the costs associated with commercial property is includable in eligible basis.

5. The developer fee should also be allocated based on associating the services provided with an asset includable in eligible basis. Examples of services likely to be performed by the developer, which are not includable in eligible basis include (*but are not limited to):*

   Securing undeveloped land,
   Forming the partnership or syndicating the partnership to investors,, and
   Securing the credit allocation.

Conclusion

In this article, the fundamental definition of Eligible Basis has been discussed and specific audit issues identified. Basically, examiners should determine whether costs are includable in Eligible Basis based on character, dollar value, when incurred, and reasonableness of allocations. Once the dollar value of Eligible Basis associated with each building is verified, other tests and requirements can be considered.

Multiple Allocations of Credit

Last September, the IRS released an updated Guide for Completing Form 8823 ("Guide"). One of the new issues we addressed is the treatment of households who were initially income-qualified and then continue to reside in the low-income unit after the end of the 15-year compliance period. As explained in the Guide, page 4-27, concurrent to qualifying the unit for IRC §42 purposes, the household also qualifies the unit for purposes of the +30-year extended use agreement, even after the end of the 15-year compliance period, based on the initial income certification at move in.

The second issue is the treatment of originally income-qualified households if, after the end of the 15-year credit period, the buildings receive a second allocation of credit. Basically, any household determined to be income qualified at the time of move-in for purpose of the extended use agreement is a qualified low-income household for any subsequent allocation of IRC §42 credit.

The Guide provides two examples. The first example considered the allocation of additional credit to the *same* owner who received the first allocation.

> An owner received IRC §42 credits to construct new low-income housing. The owner placed the buildings in service in 1991 and started claiming credits the same year. The 15-year compliance period ended December 31, 2005. In 2007, the owner applied for and received an allocation of credit to rehabilitate the existing low-income buildings. The rehabilitation is completed and the owner starts claiming the credit in 2009.
>
> On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit project. John and Mary timely complete their income recertification each year 2005 through 2008. The unit has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period.
>
> The unit is a low-income unit on January 1, 2009, when the owner (a calendar year taxpayer) begins claiming the credit. If the unit was determined to be an over-income unit under IRC §42(g)(2)(D) at the time of the household's last income recertification in January of 2008, then the owner is subject to the Available Unit Rule.
>
> NOTE: Similarly, vacant units previously occupied by income-qualified households continue to qualify as low-income units if the units are suitable for occupancy. However, the owner is subject to the Vacant Unit Rule.

The second example addresses the situation where a new owner acquires and rehabilitates the low-income buildings. How is a "new" owner identified? If the owner qualified for the acquisition credit, then the owner is a *new* owner. Here's the example:

> Owner ABC received IRC §42 credits to construct new low-income housing. ABC placed the buildings in service in 1991 and started claiming credits the same year. The 15-year compliance period ended December 31, 2005. In 2006, ABC sold the project to XYZ, who simultaneously received an allocation of acquisition and rehabilitation credit. The rehabilitation was completed and XYZ started claiming the credit in 2008. From the time of acquisition until a new extended use agreement is recorded, XYZ is subject to the extended use agreement between ABC and the state agency.
>
> On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit project. John and Mary timely complete their income recertification each year 2005 through 2007. The unit has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period.
>
> Based on the 2007 annual income recertification, the unit is a low-income unit at the beginning of XYZ's credit period on January 1, 2008, when XYZ (a calendar year taxpayer) begins claiming the credit. XYZ should follow the procedures under Rev. Proc. 2003-82 to test income at the beginning of the credit period as described above.
>
> NOTE: Vacant units previously occupied by income-qualified households are not low-income units on January 1, 2008. The owner must apply IRC §42(f)(2).

So, to summarize:

1. In either case, originally income-qualified households are protected by the extended use agreement and qualify as low-income households for purposes of the second allocation.

2. The Available Unit Rule (AUR) is applied differently.

    a. For a second credit allocation to the same owner, the AUR is applied based on the household's last annual income recertification.

    b. For a new owner, income is tested at the beginning of the credit period and the AUR applied accordingly. However, the household is not required to complete a new income (re)certification within 120 days of the acquisition; the existing certification is fine.

3. Vacant units are also treated differently.

    a. For a second credit allocation to the same owner, vacant low-income units continue to qualify as low-income units if the units are suitable for occupancy.

    b. For a second allocation to a new owner, units previously occupied by income-qualified households, but are vacant at the beginning of the 10-year credit period are *not* low-income units.

Form 8823: New Revision Released

A new revision of Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, was released in November 2009. State agencies monitor IRC §42 projects throughout the 15-year compliance period and when noncompliance is identified or the state agency becomes aware of a building disposition, this form is filed to report the event to the IRS.

Only one minor change was made to the form itself. Line 11p has been revised to read, "*Building* is no longer in compliance……." rather than "Project is no longer in compliance…" It's just a minor change in the description, but needed because noncompliance is reported on a building basis. A low-income project can consist of more than one low-income building and it is possible that only one low-income building in a multi-building project needs to be reported as no longer participating in the program.

Changes were also made to the instructions for completing the form.

1. For line 11c, Violations of the UPCS or local inspection standards, the website address where you can find the Dictionary of Deficiency Definitions has been update to **www.hud.gov/reac** under Library, Physical Inspection, Training Materials.

2. For line 11e, Changes in Eligible Basis or the Applicable Fraction, the instructions now reflect an amendment made to IRC §42(d)(5)(A) as part of the Housing and Economic Recovery Act of 2008, regarding the treatment of federal grants. For buildings placed in service before July 31, 2008, state agencies report any federal grant made with respect to any building or the operation thereof during any tax year in the 15-year compliance period. For buildings placed in service after July 30, 2008, state agencies report any federal grant used to finance any eligible basis costs of any project. However, IRC §42(i)(9)(B), provides that the basis of a qualified building shall not be reduced by the amount of any grant described in IRC §42(i)(A) See Notice 2010-18 for complete discussion.

    The instructions also include a change in the treatment of below market federal loans. For buildings placed in service before July 31, 2008, state agencies will need to report and below market rate federal loan that is or was used (directly or indirectly) with respect to the building or its operation during the compliance period and which was not taken into account when determining eligible basis at the close of the first year of the credit period. For buildings placed in service after July 30, 2008, below market rate federal loans are no longer considered federal subsidies.

3. The instructions for line 11h, Project not available to the general public, now include a reference to IRC §42(i)(9) which clarifies that a qualified low-income project does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants (1) with special needs, (2) who are members of a specified group under a Federal program or State program or policy that supports housing for such a specified group, or (3) who are involved in artistic or literary activities.

And last of all, the average estimated time for recordkeeping has been updated from 7 hours and 39 minutes to 11 hours and 43 minutes; that's an increase of 4 hours and 4 minutes.

Nit Picking Time

Nit #1: Chapter 4 of the Guide includes a new footnote #40, relating to completing income certifications for existing tenants-in-place before acquiring an existing building. It reads,

> "...if the new owner has access to the property before the acquisition date, tenant income certifications may be completed before the acquisition using the current income limits. The effective date is the date of acquisition."

So, how far in advance of the acquisition can a new owner complete income certifications? No time limit is stated, but for practical purposes, the limit is 120 days since the income certification's effective date is the acquisition date and the

substantiation and documentation can be no older than 120 days.

Nit #2: Define "project." The term has a specific definition under IRC §42, and generally, each low-income building is considered a separate low-income project (see IRC §42(g)(3)(D).) However, a taxpayer may elect to include low-income buildings as part of a multiple-building project (see IRC §42(h)(1)(F)(ii)) but only if the low-income buildings meet specific criteria. The election is identified as part of the owner's first year certification, on line 8b of Form 8609, and by attaching the statement described in the instructions for line 8b. See the instructions for Form 8609, line 8b, for more information. There are two nits to pick:

First, IRC §42 requirements are applied at either the building or the project level. So knowing each building's designation, as well as how the rules are applied, is critical to the long-term success of the project. Keep in mind that no matter how an owner elects to define the "projects," the building-based rules are still applied at the building level.

Second, "project" has a precise meaning within IRC §42 and should be used precisely when discussing IRC §42 issues, which can pose interesting dilemmas. What if an owner of 10 low-income buildings actually designates two 5-building projects? What if the project designations are unknown? As a practical matter, terms such as "property" and "development" have crept into the vernacular, but a "property" or "development" is not necessarily "the project" under IRC §42.

Nit #3: What's the difference between a "tax" year and a "calendar" year? And why is the distinction important?

A "calendar" year is the 12-month time period beginning on January 1st and ending on December 31st for a given year. A "tax" year is also (generally) a 12-month time period and (generally) "tax" years match calendar years, but not necessarily so. "Tax" years may coincide with a taxpayer's business cycle (for example, July 1st to June 30th) and may be less than 12 months (short years); e.g., the first or last year of operation.

The distinction is particularly important because IRC §42 rules are based on both "calendar" and "tax" years. For example, the Applicable Fraction is determined as of the end of the *tax* year, but a taxpayer must review utility allowances at least once during each *calendar* year. In one instance, "calendar" and "tax" years are combined! A full-time student is defined (in part) as an individual, who during each of 5 calendar months during the *calendar* year in which the *taxable* year of the taxpayer begins. And the five calendar months need not be consecutive.

The cautionary note is that while almost all owners of IRC §42 projects are taxpayers with "tax" years that are "calendar" years…it isn't always so.

Nit #4: When "generally" is included in an explanation it means: (1) there is at least one exception to the rule (which is, hopefully, also explained), or (2) the writer is unwilling to conclude, without equivocation, that there are no exceptions.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I have a theory. I call it the "Theory of Random Inconvenience" and I think it explains the bothersome little distractions we encounter. I emphasize the "randomness" of these events because, although there must be a cause (another theory), there is no intent to annoy. Things just happen…minor occurrences that if you added them all up, don't fill a bucket labeled iota! I'm most aware of these uncomfortable inconveniences when I

travel and perhaps two examples from a recent trip will help explain.

Dulles Airport just completed a new underground rail system between most of the terminals. As I went through security, the guard notes my gate and comments that while most passengers can now use the subway, I will need to use the above-ground bus. "Sorry," he says, "for the inconvenience." Not a problem….I've been on the bus countless times and one more time isn't going to make one bit of difference. As we ride along, I'm looking forward to a cup of hot chocolate and a scone from the little bakery conveniently located right where I'll be getting off, and reminding myself to buy a book at the bookstore conveniently located next door, before walking down the corridor to my gate. So, I get off the bus to find that my gate is right there! How convenient! But when I turn around to buy my hot chocolate and scone, I find that the bakery is boarded up! There's a note directing me way down the corridor to their new location right by the exit for the new subway. It's too far away and I don't have time anyway. How inconvenient for me, I thought, as I purchased a cellophane-wrapped sandwich.

Then, it's not a long flight and I arrive at my destination in the mid-afternoon. The shuttle ride to the hotel is equally uneventful and I check in with only a minor paperwork problem. I get to my room and find that it is near the elevators rather than at the far end of the hall. How convenient…except, the last night of my trip, when guests were reveling a little too loudly in the hallway while walking to their rooms (at the far end of the hall of course) at 2 in the morning. How inconvenient, I thought, as I tugs my blankets around me and went back to sleep.

I also have two corollaries. First, random inconvenience should not be confused nits that need to be picked. Inconvenience may make you uncomfortable, but there's no point obsessing about it. Nits, on the other hand, are the tediously little details of our lives that, like bugs that bite you, have consequence.

My second corollary is best explained by another example from the same trip. On my flight home, I found myself seated at the back of a fully-booked flight. Getting on went smoothly, since I was in one of the first groups on board. Conversely, I was one of the last to get off and by then everyone was getting a bit impatient as, row-by-row, passengers ahead of us grabbed their bags from under their seats and pulled suitcases down from the overhead, and then moved slowly up the aisle.

Being almost height-challenged, I was on my toes reaching up a bit awkwardly for my own bag, when a man put down his own luggage and simply reached above my head and grabbed it for me. "Thanks," I said as he turned away. My point? Acts of kindness may be inconvenient, but they are never random.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #40, August 2010

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition:

Auditing the Applicable Fraction for the First Year of the Credit Period
Documentation & Record Retention
Quiz Time
Administrative Reminders
Subscribing to the LIHC Newsletter
♫ Grace Notes ♫

Auditing the Applicable Fraction for the First Year of the Credit Period

Taxpayers participating in the IRC §42 program are required to file Form 8609-A, Annual Statement for Low-Income Housing Credit, for each taxable year of the 15-year compliance period. Part II shows the computation of the year's allowable credit. The Applicable Fraction is identified on line 2 and is always a fraction carried out to at least four places. Basically, after accounting for specific fact patterns, the allowable credit is computed as:

Eligible Basis
x Applicable Fraction
Qualified Basis
x Applicable Percentage
Allowable Credit

Law

Under IRC §42(c)(1)(B), (C), and (D), the Applicable Fraction (determined as of the close of the taxable year) is the smaller of the unit fraction or the floor space fraction. The term "unit fraction" means the fraction, the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units (whether or not occupied) in the building. The term "floor space fraction" means the fraction, the numerator of which is the total floor space of the low-income units in the building, and the denominator of which is the total floor space of the residential rental units (whether or not occupied) in the building.

Under IRC §42(f)(2)(A), there is a special rule for the first year of the credit period. The numerator is the sum of the Applicable Fractions determined as of the close of each full month of the taxable year that the building was placed in service, and the denominator is 12. The result is an "averaged" Applicable Fraction that accounts for the period of time during the taxable year that the units were not available for occupancy.

Pursuant to IRC §42(f)(2)(B), any reduction in allowable credit for the first year of the credit period under IRC §42(f)(2)(A) is allowable in the eleventh year of the compliance period and is accounted for on Form 8609-A, line 17.

In the case of buildings that were acquired and then rehabilitated, there are two credit allocations and two Forms 8609-A will be filed with the tax return; one for the acquisition credit and another for the rehabilitation credit. However, the taxpayer is not required to determine two Applicable Fractions. Under IRC §42(e)(4)(B), the Applicable Fraction for the substantial rehabilitation credit will be the same as the Applicable Fraction for the acquisition credit.

Example1: New Construction

A taxpayer constructed a new IRC §42 building with 10 identical units; i.e., the floor space of all the units is the same. The building was place in service on June 15, 2009, and 2009 is the first year of the credit period. The first schedule at the end of the newsletters identifies with an "X" which months during 2009 that the units were occupied by qualifying low-income tenants and the units were otherwise qualifying low-income units (rents restricted and suitable for occupancy).

The Applicable Fraction for January through June is zero. Even though a tenant lived in a unit during June, the unit was not placed in service the entire month. The Applicable Faction for 2009 is 0.4333, computed as:

$$(0+0+0+0+0+0+.50+.80+.90+1.00+1.00+1.00) \div 12$$

Example 2: Acquisition and Rehabilitation

A taxpayer acquired and rehabilitated a building qualifying for both the acquisition and rehabilitation credit under IRC §42. The building has 10 identical units (same floor space) which were all occupied at the time the building was

purchased. The building was place in service on May 15, 2008, the acquisition date, and the taxpayer elected to begin the credit period the following year, 2009. The second schedule at the end of the newsletters identifies with an "X" which months during 2009 that the units were occupied by qualifying low-income tenants and the units were otherwise qualifying low-income units (rents restricted and suitable for occupancy). Typically, gaps occur at the beginning of the year because the units are not occupied by qualifying tenants and during the year when the units are being rehabilitated. The Applicable Faction for 2009 is 0.7250, computed as follows:

(.40+.80+.90+.90+.60+.30+.80+1.00+1.00+1.00+1.00) ÷ 12

Audit Techniques

1. Determine when the building was placed in service. Certificates of occupancy issued by a state or local government inspector will provide the information.

2. Review how the taxpayer calculated the Applicable Fraction, including which units were included each month, and the calculation for both the unit fraction and floor space fraction.

3. Review the rent roles. Based on this analysis, a sample of tenant files can be selected and requested from the taxpayer.

4. Review the tenant files to ensure that the tenant is income-qualified. (This is a complex analysis beyond the scope of this article.) If significant errors are identified, expand the sample or review all the files if feasible.

5. Compute the Applicable Fraction based on the results of the analysis using both the unit fraction and the floor space fraction. The correct Applicable Fraction is the lesser of the two results. Compare to the Applicable Fraction reported by the taxpayer.

Common Errors

1. The taxpayer computed the Applicable Fraction based on the month the building was placed in service. For example, the building was placed in service in April, so the Applicable Fraction is reported to be 0.7500, computed as 9 month ÷ 12 months.

2. The taxpayer included the month the unit was placed in service if the unit was occupied the same month, even though the unit was not in service the entire month. To include the unit in the Applicable Fraction, the unit must be in service the entire month and occupied at least one day.

3. The taxpayer does not compute both the unit fraction and floor space fraction to determine the lesser fraction allowable.

4. The taxpayer cannot document that the tenants are income qualified. Treas. Reg. 1.42-5(b)(2) requires taxpayers to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the 15-year compliance period of the building; i.e., approximately 22 years.

Initial Request for Information

When auditing the first year of the credit period, the taxpayer should provide:

1. Certificates of occupancy

2. Rent roles, maintained unit-by-unit, and indicating when each low-income unit was first occupied and by whom.

3. Documentation for the taxpayer's computation of the Applicable Fraction, including the computation of the Applicable Fraction on a monthly basis, and using both methods (unit fraction and floor space fraction).

4. The income limits used to determine whether a tenant was income-qualified and how the income limit was determined.

Documentation & Record Retention

IRC §6001 reads:

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title…."

Treas. Reg. S1.6001-1(a) clarifies that, generally, "…any person subject to tax under Subtitle A of the Code…or any person required to file a return of information with respect to income, shall keep such *permanent* books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, *credits*, or other matters required to be shown by such person in any return of such tax or information." Paragraph (c) further explains that the taxpayer's books and records shall be:

1. Kept at all times available for inspection by authorized internal revenue officers or employees, and

2. Retained so long as the contents thereof may become material in the administration of any internal revenue law.

The IRS has also provided guideline for retaining records specific to claiming IRC §42 credit in Treas. Reg. 1.42-5(b)(1). Specifically, the owner of a low-income housing project must be required to keep records for *each qualified low-income building in the project that* show for each year in the *15-year compliance period*:

(i) The total number of residential rental units in the building (including the number of bedrooms and the size in square feet of each residential rental unit);

(ii) The percentage of residential rental units in the building that are low-income units;

(iii) The rent charged on each residential rental unit in the building (including any utility allowances);

(iv) The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under section 42(g)(2) (as in effect before the amendments made by the Omnibus Budget Reconciliation Act of 1989);

(v) The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;

(vi) The annual income certification of each low-income tenant per unit. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low- income building) *[Editor's Note: For tax year ending before July 31, 2008, an owner may have received a waiver from this requirement under Rev. Proc. 2004-38 or Rev. Proc. 94-64, but only if the low-income housing project consisted entirely of 100% low-income buildings. For tax years ending after July 30, 2008, owners are not required to complete annual tenant income recertifications if all the low-income buildings in the project are 100% low-income buildings.]*

(vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation). For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building). *[Editor's Note: See Editor's Note for (vi) above.]* Tenant income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937 ("Section 8"), not in accordance with the determination of gross income for federal income tax liability. In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement of this paragraph (b)(1)(vii) is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under section 42(g);

(viii) The eligible basis and qualified basis of the building at the end of the first year of the credit period; and

(ix) The character and use of the nonresidential portion of the building included in the building's eligible basis under section 42(d) (e.g., tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project).

Treas. Reg. 1.42-5(b)(2) is the record retention provision under which the owner of a low-income housing project must be required to retain the records described above for *at least 6 years* after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for *at least 6 years* beyond the due date (with extensions) for filing the federal income tax return for the *last* year of the compliance period of the building.

Under Treas. Reg. 1.42-5(b)(3), the taxpayer is subject to an *inspection* record retention provision. The owner of a low-income housing project must be required to retain the original local health, safety, or building code violation reports or notices that were issued by the State or local government unit for the Agency's inspection. Retention of the original violation reports or notices is not required once the Agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

And finally, specific to the computation of utilities allowance, Treas. Reg. 1.42-10(d) explains that owners must retain any utility consumption estimates and supporting data as part of the taxpayer's records for purposes of Treas. Reg. §1.6001-1(a).

<u>Storing Records Electronically</u>

The IRS has also addressed the feasibility of using electronic storage options. In Rev. Rul. 2004-82, Q&A #11, the IRS provided guidance on recordkeeping and record retention requirements for purpose of IRC §6001 and the associated regulations.

Q-11: May a taxpayer comply with the recordkeeping and record retention provisions under §1.42-5(b) by using an electronic storage system instead of maintaining hardcopy (paper) books and records?

A-11: Yes, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97-22, 1997-1 C.B. 652. This revenue procedure provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optical disk. Rev. Proc. 97-22 provides that records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of §6001.

However, *and this is important*, complying with the Service's recordkeeping and record retention requirements does not exempt an owner from having to satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the state agency. For example, the housing credit agency may require the taxpayer to maintain hardcopy books and records. For the basic requirements of maintaining records in an automated data processing system, including electronic storage systems, see Rev. Proc. 98-25, 1998-1 C.B. 689.

Purpose

A taxpayer's books and records are the primary source of information needed to prepare an accurate tax return. If audited, the books and records will be used by the examiner to determine whether the tax return actually discloses the amount of gross income, deductions, *credits*, or other matters required to be shown. In addition to the basic requirements under IRC §6001, the Service has, by regulation, identified specific information needed to demonstrate compliance with IRC §42. Why was this necessary? Consider:

1. Needed information is not created as part of the taxpayer's normal operation of a residential rental property. For example, a taxpayer does not usually require a potential tenant to submit to an intense income certification process to determine whether the household is a qualified low-income household.

2. IRC §42 requires unique computations "outside" the books and records. Eligible Basis, for instance, is (more or less) depreciable residential rental property, but not *all* depreciable residential rental property is includable in Eligible Basis. As a result, Eligible Basis will be comparable to, but not exactly the same as, the asset's adjusted basis identified in the depreciation schedules.

3. Compliance requires unique recordkeeping. Consider compliance with the Available Unit Rule, where a taxpayer needs to know, building by building and on a continuous basis, which low-income units are over-income and which units are subsequently rented to qualified low-income households. The method of recordkeeping must reflect current occupancy so the taxpayer can continuously comply with the requirement and at the same time create an audit trail so that compliance can be evaluated later.

4. The 15-year compliance period creates a particularly long retention period, at least 21 years for the some of the records.

5. The recapture provisions under IRC §42(j) can be financially devastating. Suppose a taxpayer is allocated an annual low-income credit of $30,000 and claims the entire credit each year for 10 years, 1997 through 2006. The taxpayer's 2007 tax return is audited. The taxpayer cannot establish that the minimum set-aside was met that year, the 11th year of the compliance period, resulting in the recapture of the accelerated portion of the credit ($10,000) and interest associated with each prior year. The total liability is just a little less than $147,000.

Standard of Sufficiency

IRC §6001 requires taxpayers to maintain books and records that are *sufficient* to show whether or not the taxpayer is liable for tax, or in the case of IRC §42, that the taxpayer is entitled to claim the credit. As defined in the dictionary, "sufficient" means adequate, much as is needed, or enough.

Specific to IRS audits, examiners review a taxpayer's books and records to gather facts needed to correctly determine a taxpayer's tax liability. Therefore, a taxpayer's books and records are sufficient when an IRS examiner can make a reasonable determination of the correct tax liability.

Alternative Sources of Information

The best source of information is the taxpayer's own written books and records, preferably created concurrent to when the transaction occurred. But realistically, taxpayers can rarely maintain books and records in such pristine condition and there's always a certain amount of digging through old shoe boxes. And, there are times, due to unusual circumstances, when the taxpayer's books and records simply are not complete or available, or may no longer exist. In such cases, an examiner may consider alternative sources of information, accept credible oral testimony, or rely on documentation from third parties. But the examiner will always be evaluating whether the source of the information is credible, as well as whether the facts and information gathered from alternative sources makes sense and is really sufficient.

For audits of IRC §42 issues, there is one credit-specific source of information which an examiner may, under very limited circumstances, want to considered. Under IRC §42(m)(2)(C)(i)(III), the state agency performs a final evaluation of the sources and uses of funds when the low-income building(s) are placed in service. As described in Treas. Reg. §1.42-17(a)(5), the taxpayer must submit a schedule of project costs. This final cost certification details the project's total costs as well as those costs that qualify as eligible basis.

Treas. Reg. §1.42-17(a)(5) also requires that for projects with more than 10 units, the schedule of project costs must be accompanied by a Certified Public Accountant's audit report on the schedule. For projects with less than 11 units, the

state agency may require an audited schedule of project costs. If a certified audit was performed, the accountant's audit workpapers may provide additional information needed to resolve tax issues involving the eligible basis. On the other hand, the accountant's workpapers may be unavailable or simply not include information about the issue at hand.

Nor should the accountant's audit workpapers be considered sufficient for all purposes. For example, the workpapers will describe the accountant's audit procedures and may include a summary of the verified construction costs which the examiner determines to be sufficient. On the other hand, the audit workpapers will probably not be sufficient to resolve issues involving a developer fee; i.e., what services were provided, when were they provided, and are development costs properly allocated between land, land improvements, and the low-income buildings. An examiner will need to review the contract between the developer and the taxpayer to answer these questions.

Inadequate Books and Records

The determination that a taxpayer has not maintained adequate books and records is made by the examiner conducting an audit. Factors include, but are not limited to:

1. an alternative or indirect method was used to establish the amount of gross income, deductions, credits, or other matters shown on the taxpayer's return because the taxpayer's records were not sufficient,

2. prior history and present degree of noncompliance,

3. indications of willful intent or evidence of refusal to keep adequate books and records,

4. probability that the inadequacies in recordkeeping will result in significant underreporting of tax liabilities, or

5. other evidence of harm to the Government.

If an examiner determines that the taxpayer has not substantially complied with the law and regulations for maintaining adequate books and records, an Inadequate Records Notice will be issued. For partnerships (most IRC §42 project owners), the original notice will be delivered to the partner who signed the return or, if this is not possible, to a partner who takes an active part in the business. A copy of the notice will be mailed to all the other partners.

An Inadequate Records Notice requires the taxpayer to notify the Service of actions taken to correct its record-keeping to meet the requirements of the law within six months after the notice is delivered. The taxpayer's statements regarding improvement of the recordkeeping will be considered when determining the need for follow-up action, such as a follow-up audit of a tax year subsequent to the tax year originally audited and resulting in the notice.

If, as a result of a subsequent audit, an examiner concludes that the taxpayer is *not* substantially complying with requirements to keep adequate records, then consideration of additional enforcement measures, such as the assertion of penalties, is warranted.

Quiz Time

In the last newsletter, a nit was picked regarding the definition of a "project." Generally associated with the minimum set-aside requirement, the taxpayer's configuration of a project will not only affect how the project is operated, but how the state agency will monitor for compliance. Can you identify the level at which each of the following IRC §42 rules are applied?

1. Household moving to another low-income unit.
2. Annual income recertification exception
3. Student exception rules
4. Utility allowances
5. Transient use
6. Protection against eviction without good cause and rent increases other than allowable under IRC §42
7. Suitability for occupancy
8. Federal grants
9. Available for general public use
10. (Next) Available Unit Rule
11. Vacant Unit Rule
12. Extended use agreement requirement
13. No longer participating in the IRC §42 program
14. Nonprofit participation
15. Applicable Fraction
16. Minimum set-aside
17. Compliance period
18. Hold harmless rule for HERA special income limits
19. Eligible Basis

Answers are listed after "Grace Notes."

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

I've just finished a *big* project. Whew! It took a lot of time to get everything done, coordinated, and approved and while some tasks were harder than others, everything was accomplished without too many really *big* glitches. At the very end, I had to do some computer-based tasks that I had never done before. It just took a few minutes for someone to explain how to do it, and it only took me two times to do it right. You know how it is…just *one* little mistake and the whole thing is wrong…so, with patience, someone slowly explained it to me again, and since it really was a little task to begin with, I was done in no time at all.

But, then I had another file with a similar problem. Will the same solution work in another program? With a little perusing through the menus, I found the sort-of-the-same-but-different commands and fixed the file! Voila! I've learned how to do something new *and* applied the knowledge to solve a new problem. I'm feeling pretty good about myself!

Realistically, it was very simple task and everybody and all their relatives know how to do it…it's right on the menu. But the point is, I found out something I didn't know before. And that reminded me of one of the greatest books I ever read on an airplane, called The Pleasure of Finding Things Out, by Richard Feynman, a physicist who worked on the Manhattan Project and won the Nobel Prize. When asked whether winning the Noble Prize was worth it, he explained, "I don't see that it makes any point that someone in the Swedish Academy decides that this work is noble enough to receive a prize – I've already got the prize. The prize is the pleasure of finding the thing out, the kick in the discovery…."

Back to the menus!

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Reference: The Pleasure of Finding Things Out, the Best Short Works of Richard P. Feynman, by Richard P. Feynman. Published by Helix Books, Perseus Publishing. ISBN 0-7382-0349-1

Answers: (1) project, (2) 100% low-income project, (3) unit, (4) building, (5) unit, (6) household, (7) units (predicated on buildings, common areas, facilities and site), (8) traced building-by-building, (9) unit, (10) building, (11) project, (12) building, (13) building, (14) project, (15) building, (16) project, (17) building, (18) project, and (19) building.

Example 1

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1						X	X	X	X	X	X	X
2										X	X	X
3							X	X	X	X	X	X
4								X	X	X	X	X
5									X	X	X	X
6								X	X	X	X	X
7								X	X	X	X	X
8							X	X	X	X	X	X
9							X	X	X	X	X	X
10							X	X	X	X	X	X
AF	0	0	0	0	0	0	.50	.80	.90	1.00	1.00	1.00

Back to the Article

Example 2

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1		X	X	X		X	X	X	X	X	X	X
2	X	X	X	X			X	X	X	X	X	X
3		X	X	X	X		X	X	X	X	X	X
4	X	X	X	X	X			X	X	X	X	X
5					X	X	X	X	X	X	X	X
6			X	X	X	X	X	X	X	X	X	X
7		X	X	X				X	X	X	X	X
8	X	X	X	X	X		X	X	X	X	X	X
9	X	X	X	X			X	X	X	X	X	X
10		X	X	X	X		X	X	X	X	X	X
AF	.40	.80	.90	.90	.60	.30	.80	1.00	1.00	1.00	1.00	1.00

Back to the Article

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #41, September 2010

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

Auditing Partners
Disallowing and Recapturing Credit
Large partnerships: How Large is Large?
Administrative Reminders
Subscribing to the LIHC Newsletter
♫ Grace Notes ♫

Auditing Partners

Since most IRC §42 projects are owned by partnerships, it only stands to reason that the IRC §42 credit might surface as an issue when a partner's tax return is independently audited. The audit techniques required as part of the Required Filing Checks under IRM 4.10.5.4, for related returns when auditing a partner's return and possible resulting issues are discussed in this article.

Required Filing Checks for Related Tax Returns

Required filing checks are analytical audit techniques used to determine whether taxpayers are in compliance with all federal tax return filing requirements and whether the taxpayer's filed tax returns reflect the substantially correct tax liability. Completion of the Required Filing Checks is an important tool for increasing taxpayer compliance because the analysis is an opportunity to inspect more tax returns in greater detail and in context relative to the taxpayer's span of control. When warranted, the examination can be expanded to include related tax returns.

Identifying Partners

Taxpayers who are partners are relatively easy to identify since, at a minimum, the tax return will includes items such as income (or loss) and the IRC §42 credit flowing through from the partnership. Keep in mind that a partner can be another partnership, was well as a taxpaying entity such as an individual or corporation.

Related Entity Defined

Related returns are tax returns that have a relationship to the return. Returns are considered related if:

1. Adjustments made to one return require corresponding adjustments to the other return to ensure consistent treatment (see IRC §1313(c) and IRC §267), or
2. Returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage transactions (see IRC §267(b)).

Partner is a Partnership or Other Flow-Through Entity

If the investor files a partnership return, it is likely that the partnership has invested in multiple IRC §42 projects. The investments may be made directly as a partner in the partnership owning the IRC §42 project, or through tiers of flow-through entities.

1. Reconcile the amount of credit identified on Schedule K to the K-1s received from the partnerships through which the credit is flowing.
2. Determine whether the partnerships in which the taxpayer is a partner have filed their tax returns.
3. Using the research tools listed in IRM 4.10.5.4.1, confirm that the amount of credit claimed by the partnership when filing its tax return is consistent with the amount included on the Schedule k-1 provided to the partner. For example:

   The taxpayer owns a 10% interest in a partnership claiming a $100,000 credit. The taxpayer claims a $10,000 credit.

   The taxpayer owns a 10% interest in a partnership and claims a $10,000 credit based on the Schedule k-1 provided by the partnership. However, due to noncompliance issues, the partnership claimed zero credit when filing the partnership's tax return several months after distributing Schedules K-1 to its partners.

   If the related partnership has not filed a tax return, then all tax attributes, including the IRC §42 credit, income or loss, and deductions reported on the Schedule K-1 should be removed from the taxpayer's return.
4. Review the taxpayer's portfolio of investments in IRC §42 projects and determine whether the taxpayer has disposed of any investments. Ensure that the gain or loss has been correctly reported and consider whether the taxpayer is subject to the IRC §42(j) recapture provisions.

Partner is a Corporations

Complete the same analyses as for partnerships. In addition, reconcile the amount of credit claimed or carried forward into the tax year with the ordering rules in IRC §38(d) and carryforward/carryback rules in IRC §39.

Partner is an Individual

Complete the same analysis as for corporations, and in addition, apply the passive activity rules under IRC §469.

Conclusion

To summarize, the four basic issues to review are:

1. Does the credit claimed by the taxpayer reconcile to the Schedule k-1 provided by the partnership in which the taxpayer is a partner?

2. Did the related partnership file a tax return?

3. Is the credit claimed by the partnership consistent with the amount included on the Schedule k-1 provided to the partner?

4. If there was a disposition of a partnership interest, did the taxpayer report the gain/loss? Is the taxpayer subject to recapture?

Editor's Note #1: This article is a reprint and update of an article titled "Auditing Related Investor Returns" presented in Newsletter #20, issued in April of 2006.

Editor's Note #2: This article is based on information included in IRM 4.10.4.5, Required Filing Checks, which was recently updated.

Disallowing & Recapturing Credit: What's the Difference?

The terms "disallowing" and "recapturing" are so intrinsic to IRS jargon that it's easy to forget how the vernacular originated.

Disallowing Credit

IRC §38(a) reads, "…There shall be *allowed* as a credit against the tax imposed….for the taxable year an amount equal to the sum of the business credit carryforwards…the amount of the current year business credit, plus the business credit carrybacks…." The IRC §42 credit is included as part of the general business credit in IRC §38(b)(5). Therefore, if, as a result of an examination, the credit is determined not to be allowable, then (obviously) the credit is "disallowed" and voila, "disallowing" is what the examiner does! Disallowing, then, refers to decreasing the allowable credit for the year under examination.

Recapturing Credit

The term "recapturing," has a very specific meaning under IRC §42. Since the owner of an IRC §42 project claims the credit each year for 10 years (the credit period), but agrees to provide low-income housing for 15 year (the compliance period), the owner is claiming credit in advance of providing the associated services. Effectively, a portion of the credit claimed for each year in the credit period is associated with providing low-income housing in the last five years of the compliance period. Under IRC §42(j)(3) this portion of credit claimed in advance of providing the housing is called the "accelerated" credit.

The accelerated portion claimed in prior years is subject to recapture in all subsequent years of the compliance period if, at the close of the taxable year, the low-income building's qualified basis is less than the qualified basis at the end of the preceding taxable year, as reported on the taxpayer's tax return for the prior year. (See Newsletter #21 for discussion of the Duty of Consistency Doctrine.) A decrease in qualified basis is often referred to as a "recapture event." There will be a recapture event anytime an adjustment made to decrease either the Eligible Basis or the Applicable Fraction; i.e., qualified basis = eligible basis x applicable fraction.

The credit recapture amount is defined in IRC §42(j)(2) as the aggregate of the accelerated portion of the credit claimed in each prior year plus interest at the overpayment rate beginning on the due date for filing the tax return on which the credit was claimed. For audit purposes, the interest computation period ends on the date the tax return being audited was due. The percentage of credit subject to recapture decreases of time; .333 for years 2-11, .267 for year 12, .200 in year 13, .133 in year 14, and .067 for year 15. The percentage decreases during the last years because the taxpayer has been providing low-income housing for tax years after the credit period. However, the period of time over which interest is calculated is increasing.

Cautions

IRC §42(j)(4) includes special rules that also need to be considered. While not elaborated here, keep in mind that:

1. There is a tax benefit rule to account for carryforwards and carrybacks of credit by taxpayers actually using the credit to reduce their tax liability.

2. The recapture rules do not apply to credit based on additions to qualified basis under IRC §42(f)(3), as reflected on Form 8609-A line 7.

3. The recapture amount is not treated as a tax for determining any amount of credit.

4. No recapture is required if the reduction in qualified basis results from a casualty loss, but only if the loss is restored by reconstruction or replacement within a reasonable period.

5. Under certain circumstances, the recapture amount can be assessed at the partnership level.

6. The disposition of a low-income building (or interest therein) after July 30th, 2008, is not a recapture event if it is reasonably expected that the building will continue to be operated as a qualified IRC §42 project. However, the taxpayer remains subject to recapture if there is a recapture event after the disposition.

Significance

1. If there is an adjustment to the allowable credit for the current year, consider whether the adjustment has triggered the recapture provisions under IRC §42.

2. If the recapture provisions are triggered, the accelerated portion of the disallowed credit claimed in each prior year is recaptured.

3. There will be two adjustments on the audit report, one for the disallowed credit and one for the recapture amount.

4. Generally, the adjustment for the recapture amount is made only for the year that the recapture event occurred. Credit is not allowable for the year of the recapture event and, if the noncompliance continues in subsequent years, no credit would be allowable.

Evaluating Audit Risks

When evaluating audit risks for possible disallowance of credit in the current year, also consider the significance of recapturing credit originally claimed in prior years. Further, if the adjustment results in a permanent reduction in credit for the remaining years of the credit period, the evaluation should include consideration of revenue protection for tax years subsequent to the year audited.

Large Partnerships: How Large is Large?

A large partnership is a partnership with 35 or more *direct* partners. A large partnership is treated as the taxpayer to whom the credit is allowable for purposes of applying the credit recapture rules *at the partnership level*. As a result, the tax benefit rule under IRC §42(j)(4)(A) does not apply and the increase in tax because of the recapture amount is allocated among the partners in the same manner as the partnership's taxable income for the year is allocated among the partners. However, under IRC §42(j)(5)(C), a large partnership can elect not to be treated as a large partnership on Form 8609, line 10b. The election is irrevocable.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

Form 12813, TEFRA Procedures
Form 13814, TEFRA Linkage Package Checksheet
Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

Just for good measure. You know what I mean. You're 10 minutes late for work, so you stay 15 minutes late just for good measure. You fill your car's gas tank and when it's full and automatically stops, you give one last squeeze on the nozzle just for good measure. You're buying material off a bolt and the clerk measures an extra six inches because the edge is crooked just for good measure. You buy a dozen cookies at the spiffy French bakery and, to your delight, they gave you a baker's dozen just for good measure.

September is the end of the IRS' fiscal year, and as the newsletter is intended to be a quarterly newsletter, I counted to make sure….October and December of 2009, April and August of 2010…yep, four within the year…and one for good measure.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #42, November 2010

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

- LIHC Compliance Unit has New Address
- Compliance Monitoring by State Agencies
- Administrative Reminders
- Subscribing to the LIHC Newsletter
- ♫ Grace Notes ♫

LIHC Compliance Unit has New Address

The LIHC Compliance Unit has moved from its location in Bensalem, north of Philadelphia, to a new office right in the center of downtown Philadelphia. Their new address is:

Department of the Treasury
Internal Revenue Service Center
Philadelphia, PA 19255-0549

- All correspondence should be sent to the new address beginning January 1, 2011.
- It is particularly important that the entire zip code, including the "0549" be included, since "0549" directs mail to the LIHC Compliance Unit.

Compliance Monitoring by State Agencies

From an IRS perspective, one of the most unusual aspects of IRC §42 is the co-administrative responsibilities shared with the state-level housing agencies. Each agency receives a specific amount of credit each year, based on the state's population. The amount is linked to a cost of living index and is currently $2.30 per person. The agencies determine which housing projects will be allocated IRC §42 credit, as well as how much credit. The agencies are also responsible for monitoring the projects throughout the 15-year compliance period and reporting noncompliance to the IRS.

Annual Reports

Under Treas. Reg. §1.42-5(c), taxpayers owning IRC §42 projects are required to annually certify that their projects were in compliance with IRC §42 for the preceding 12-month period. They must report in the form and manner the agency specifies and must certify, under the penalty of perjury, that the information provided is true, accurate, and in compliance with the requirements of IRC §42. Treas. Reg. §1.42-5(c)(1) lists twelve specific requirements that must be addressed in the certification.

The agencies are required to review the certifications. The taxpayer is considered noncompliant if the certification is inaccurate, incomplete, or the taxpayer discloses non-compliance with any IRC §42 requirement.

Physical Inspections

Treas. Reg. §1.42-5(c)(2)(ii) requires state agencies to physically inspect a randomly selected sample of low-income rental units by the end of the second calendar year following the year the last building in the project is placed in service and then, on an on-going basis, at least once every three years. The purpose is to confirm that the rental units are suitable for occupancy. See IRC §42(i)(3)(B)(ii).

Tenant File Reviews

Treas. Reg. §1.42-5(c)(2)(ii) also requires agencies to review the tenant files for the households occupying the low-income units randomly selected for the physical inspection. The purpose is to confirm that the rental units are occupied by income-qualified households.

And All the Other Stuff…

The agencies must also consider the taxpayer's compliance with other requirements under IRC §42; e.g., rent restrictions, the General Public Use Rule, the Next Available Unit, the Unit Vacancy Rule, utility allowances, and the list (it seems) goes on and on.

Compliance Monitoring Timeline

1. *Notification of Inspection/Review* – as a practical matter state agencies provide taxpayers with advance notice of an upcoming inspection/review so that the taxpayer can notify tenants and assemble tenant records. The IRS has recommended that if the inspection/review must be postponed, the delay should not exceed 45 days from the originally scheduled date.

2. *Inspection/Reviews* – State agencies conduct inspections/ reviews to confirm continuous compliance with IRC §42

or, in other words, to identified currently existing noncompliance.

3. *Notifications of Inspection/Review Results* – Once the inspection/review is completed, the agency must *promptly* provide the taxpayer with a written notice if the IRC §42 project is not in compliance; i.e., (1) the taxpayer did not submit its annual certification, (2) the agency was not allowed to review the tenant files, or (3) the agency discovers by inspection, review, or in some other manner, that the project is not in compliance. See Treas. Reg. §1.42-5(e)(2). Many agencies also provide notice to close the inspection/review when no noncompliance issues are discovered.

4. *Correction Period* - The date of the agency's notice to the taxpayer starts the correction period during which the taxpayer can resolve any noncompliance issues identified by the agency. The correction period is not defined by regulation, but is not to exceed 90 days. Agencies also have authority under Treas. Reg. 1.42-5(e)(4) to extend the correction period to a total of six months, but only if the agency determines there is good cause for doing so.

5. *Reporting Noncompliance to the IRS* – Regardless of whether the noncompliance is corrected within the designated correction period, agencies must report any observed noncompliance to the IRS within 45 days after the end of the correction period.

    - Form 8823, Low-Income Housing Agencies Report of Noncompliance or Building Disposition, is used to report noncompliance to the IRS.

    - The IRS has provided the agencies with a guide for completing Form 8823 to help them consistently interpret and apply IRC §42 and consistently report noncompliance to the IRS. The guide is also available to the public on industry websites or by contacting Grace Robertson by e-mail at **Grace.F.Robertson@irs.gov**.

Documenting Agency Reviews

Under Treas. Reg. 1.42(e)(3)(ii), agencies are required to retain records of noncompliance or failure to certify for six years after filing of the associated Forms 8823. In all other cases, the agency must retain the documentation for three years from the end of the calendar year in which the documentation was received.

Annual IRC §42(l)(3) Report

Under IRC §42(l)(3), agencies submit an annual report to the IRS specifying the amount of credit allocated during the year, information about the building receiving the allocation and the taxpayer owning the building, and information about the agency's compliance with IRC §42 requirements.

State agencies satisfy this reporting requirement by filing Form 8610, Annual Low-Income Housing Credit Agencies Report. The report is due February 28th of the following year and is signed by the state agency's official under penalties of perjury.

Part III specifically addresses the agency's compliance monitoring activities for that year:

1. *Question 11:* Does the state's qualified allocation plan… including compliance monitoring procedures as required in IRC §42(m)(1)(B)(iii) and Treas. Reg. §1.42-5(a)(2), including monitoring for habitability standards through regular site visits?

2. *Question 12:* Has the housing credit agency…complied with all applicable requirements under the compliance monitoring procedures in its qualified allocation plan?

3. *Question 13:* Has the housing credit agency….complied with the requirements of its monitoring procedures to fulfill its notification of noncompliance under Treas. Reg. §1.42(5)(e)?

Questions 14, 15, and 16 address specific compliance monitoring requirement based on when the low-income buildings were placed in service.

Q&A – State Agencies

1. How long does an agency have to issue the notification of the inspection/review results?

    The notice should be issued "promptly." According to my Webster's dictionary, "promptly" means "readily or immediately. Word's thesaurus suggests "punctually" or "without delay." Keep in mind that (1) without the notification, the taxpayer really doesn't know if the agency found noncompliance issues that need to be corrected, and (2) the correction period doesn't begin until the notification letter is issued.

2. When is a compliance inspection/review considered completed for reporting purposes on Form 8610?

    For reporting purposes, the inspection/review process can be considered completed when the letter providing notice of the results is sent to the taxpayer. If no compliance issues were discovered, the notice closes the inspection/review process. If noncompliance issues are discovered, then the correction period, which may vary in length, begins.

3. What if the taxpayer doesn't respond to the notification letter?

    If a taxpayer fails to communicate with an agency after issuing a notice indicating noncompliance issues, then the agency should file the Form 8823 with the IRS no

later than 45 days after the close of the correct period. There is no requirement or responsibility to continually follow-up if the taxpayer fails to respond.

4. What happens if an agency fails to comply with its own Qualified Allocation Plan and compliance monitoring procedures?

   As noted in Chief Counsel Advisory (CCA) 200913013, "If upon review, SBSE [Small Business/Self-Employed, an operational unit within the IRS] determines that an Agency is not meeting its compliance monitoring requirements or that the Agency is not making allocations of credit pursuant to a qualified allocation plan (as defined in IRC §42(m)(1)(B)) that meets the requirements under IRC §42(m)(1)(A), then the Service has the authority to reduce the amount of low-income housing credit allocated by an Agency to a building to zero." In other words, the state agency may lose its authority to allocate credit.

Q&A - Taxpayers

1. What happens to a taxpayer subject to compliance monitoring by an agency which doesn't timely complete physical inspections and tenant reviews at least once every three years?

   Assuming that the taxpayer filed annual reports with the state agency and certifies its continuous compliance with all IRC §42 requirements, the state agency's failure to timely conduct inspections or reviews will have no immediate affect for the taxpayer. Having said that, keep in mind that:

   - The taxpayer has lost the opportunity for an inspection or review *in real time*, which allows for the correction of noncompliance before the end of the taxpayer's tax year when the allowable credit is computed. The taxpayer may be able to avoid disallowance of credit for the current year and the recapture of a portion of the credit claimed in prior years.

   - Regardless of the state agency's failure, the taxpayer is subject to audit by the IRS. Conducted after the end of the tax year, IRS audits do not *provide* for correction of noncompliance during the audit so that noncompliance "goes away." The amount of allowable credit will be determined based on the facts and circumstances as they existed at the end of the tax year being audited. The taxpayer may lose credit and be subject to recapture under IRC §42(j).

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

Yesterday was a particularly busy day in the office and my westward drive home through rush hour traffic particularly tiring. As I rolled along, at a particular moment, I looked up to see a particularly beautiful sunset vista of oranges and pinks and yellow-whites and bands of long clouds splitting sunrays like a prism. These late afternoon sunsets only coincide with my commute in late fall, after turning back the clock. I'd almost forgotten.

Its early morning now and I find myself again working by the window. My big cat Hannah is keeping me company and watching the golden Maple leaves twirl around in the wind outside. Olivia, a petite Siamese, is curled at my feet, one paw touching my foot just to make sure I'm still here. Directly across the street my neighbor's huge oak tree is a flaming red torch in the morning sun, like a prima donna in the spotlight. I've never before been sitting right here at exactly this time of day at this time of year. I'm awake and sitting here at this hour only because, coincidently, I'm working at home.

Autumn is my favorite time of year.

Hannah, now bored with the floating leaves, has settled beside my computer. She'd probably doze off except she's watching my hands and is curious about the clicking of the computer keys (her ears are twitching). I'm pretty sure she'll try tapping the keys herself any second now, so I've hit the save key. Olivia has stirred from her early morning nap and is complaining, as only a Siamese can, that she's hungry and wants her mid-morning snack, preferably right now. The sky is bright blue and the sun, now shining high in the sky, is streaming through the window. While there's still the chill of Indian summer in the air…I've got to get going…places to be and things to do…right now.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #43, February 2011

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

- Suitability for Occupancy: Law
- Suitability for Occupancy: State Agency Inspections
- Suitability for Occupancy: HUD's Uniform Physical Condition Standards
- Suitability for Occupancy: IRS Provides Additional Guidance
- Suitability for Occupancy: Audit Techniques
- Suitability for Occupancy: Adjusting the Applicable Fraction
- Administrative Reminders
- Subscribing to the LIHC Newsletter
- ♫ Grace Notes ♫

Editor's Explanation: To qualify as a low-income unit, a residential rental unit must meet three requirements: (1) the unit must be occupied by an income-qualified household, (2) the rent must be restricted, and (3) the unit must be suitable for occupancy. This edition of the LIHC Newsletter is dedicated to a discussion of the last of these three criteria.

Suitable for Occupancy: Law

Under IRC §42(i)(3)(B)(ii), a low-income unit must be suitable for occupancy under regulations prescribed by the Secretary taking into account local health, safety, and building codes.

Annual Certification to State Agency

Under Treas. Reg. 1.42-5(c)(1)(vi), a taxpayer must certify annually to the state agency that, for the preceding 12-month period:

1. the buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes (or other habitability standards), and

2. the state or local government unit responsible for making local health, safety, or building code inspections did not issue a violation report for any building or low-income unit in the project. If a violation report or notice was issued by the governmental unit, the owner must attach a statement summarizing the violation report or notice or a copy of the violation report or notice to the annual certification submitted to the state agency and explain whether the violation has been corrected.

Record Retention

Under Treas. Reg. 1.42-5((b)(3), a taxpayer must retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit for the state agency's inspection. Retention of the original violation reports or notices is not required once the state agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

Casualty Losses

The determination that a unit is unsuitable for occupancy is based on its physical condition, without regard for the cause of the noncompliance. However, there are relief measures in place when the damage is the result of a casualty event. While no credit is allowable, IRC §42(j)(6)(E) provides relief from the credit recapture provisions; i.e., the recapture provisions are not applied when there is a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period. In CCA 200134006, Chief Counsel clarified that a period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties.

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after July 2, 2007, then Rev. Proc. 2007-54 provides the additional relief for damaged projects. Similar relief provisions are provided in Rev. Proc. 95-28 for locations declared major disaster areas before July 2, 2007.

Suitable for Occupancy: State Agency Inspections

State agencies are required to physically inspect IRC §42 projects throughout the entire 15-year compliance period. The inspections are based on a sample of at least 20% of the low-income units in the project. Under Treas. Reg. 1.42-5(c)(2)(ii), the inspections are conducted:

1. by the end of the second calendar year following the year the last building in the project is placed in service, and

2. at least once every 3 years thereafter.

The state agency can choose the standard used for conducting inspections and determining compliance. The state agency can choose either:

1. local health, safety, and building codes (or other habitability standards), or

2. the uniform physical condition standards for public housing established by HUD. If the state agency uses HUD's physical condition standards to conduct inspections, HUD's standards do not supersede or preempt local health, safety, and building codes. A low-income housing project under IRC §42 must continue to satisfy the local health, safety and building codes.

The state agency must also review any local health, safety, or building code violations reports or notices retained by the taxpayer.

Suitable for Occupancy: HUD's Uniform Physical Condition Standards

HUD's Uniform Physical Condition Standards (UPCS) require housing to be decent, safe, sanitary and in good repair. The major areas of consideration include:

1. Site: The site components such as fencing and retaining walls, grounds, lighting, mailboxes/project signs, parking lots and driveways, play areas and equipment, refuse disposal, roads, storm drainage, and walkways must be free of health and safety hazards and in good repair. The site must not be subject to material adverse conditions, such as abandoned vehicles, dangerous walks or steps, poor drainage, septic tank back-ups, sewer hazards, excess accumulations of trash, vermin or rodent infestation, or fire hazards.

2. Building Exterior: Each building on the site must be structurally sound, secure, habitable, and in good repair. Each building's doors, fire escapes, foundations, lighting, roofs, walls, and windows, where applicable, must be free of health and safety hazards, operable, and in good repair.

3. Building Systems: Each building's domestic water, electrical systems, elevators, emergency power, fire protection, HVAC, and sanitary system must be free from health and safety hazards, functionally adequate, operable and in good repair.

4. Dwelling Units: Each dwelling unit within a building must be structurally sound, habitable, and in good repair. The dwelling unit must be free from health and safety hazards, functionally adequate, operable and in good repair. This includes all areas and aspects of the dwelling unit; i.e., bathroom, call-for-aid (if applicable), ceiling, doors, electrical systems, floors, hot water heater, HVAC, kitchen, lighting, outlets/switches, patio/porch/balcony, smoke detectors, stairs, walls and windows.

   Where applicable, the dwelling unit must have hot and cold running water, including an adequate source of potable water. If the unit includes its own sanitary facility, it must be in proper operating condition, usable in privacy and adequate for personal hygiene and the disposal of human waste. The unit must include at least one battery-operated or hard-wired smoke detector in proper working condition on each level of the unit.

5. Common Areas: The common areas must be structurally sound, secure, and functionally adequate for the purposes intended. The basement/garage/carport, restrooms, closets, utility, mechanical, community rooms, day care, halls and corridors, stairs, kitchens, laundry rooms, office, porch, patio, balcony and trash collection areas, if applicable, must be free from health and safety hazards, operable, and in good repair. All common area ceilings, doors, floors, HVAC, lighting, outlets/switches, smoke detectors, stairs, walls, and windows, to the extent applicable, must be free of health and safety hazards, operable, and in good repair.

6. Health and Safety Concerns: All areas and components of the housing must be free of health and safety hazards. These areas include, but are not limited to, air quality, electrical hazards, elevators, emergency/fire exits, flammable materials, garbage and debris, handrail hazards, infestation and lead based paint.
   For example, buildings must have fire exits that are not blocked and have hand rails that are not damaged, loose, missing portions, or otherwise unusable. The housing must have no evidence of infestation by rats, mice, vermin, or garbage and debris. The housing must have no evidence of electrical hazards, natural hazards, or fire hazards. The dwelling units and common areas must have proper ventilation and be free of mold as well as odor (e.g., propane, natural, sewer or methane gas) or other observable deficiencies. The housing must comply with all requirements related to the evaluation and reduction of lead-based paint hazards and have available proper certifications of such.

Dictionary of Deficiencies

To ensure consistent evaluation of the property's physical condition, the UPCS are supplemented by the Dictionary of Deficiencies, which uses the same major sections as the UPCS and identifying specific components and non-compliance issue ranked by severity (level 1, 2 or 3).

Suitable for Occupancy: IRS Provides Additional Guidance

CCA 201042045, released October 22, 2010, provides explanations for two issues related to evaluating the physical condition of IRC §42 projects.

Unit-by-Unit or Building Determinations

The first question addressed the issue of whether the suitable for occupancy requirement of IRC §42(i)(3)(B) must be determined on a unit-by-unit basis, or could the condition of the exterior components of the building (e.g., wall, roof, etc.) be so poor as to lead to a determination that all the units in a building were not suitable for occupancy?

Chief Counsel responded that the suitable for occupancy requirement does not have to be determined on a unit-by-unit basis if the facts exist that the condition of the exterior components of the building (e.g., wall, roof, etc.) are so poor as to lead to a factual determination that all the units in a building are not suitable for occupancy. For example, if an earthquake created large fissures in the foundation and exterior walls of a building then the building could be determined not suitable for occupancy for safety reasons without having to check each unit.

Inspection Standards

Chief Counsel was also asked to explain the relationship between HUD's uniform physical condition standards (UPCS) and the "local health, safety and buildings codes" as described in Treas. Reg. §1.42-5 (d).

Chief Counsel responded that:

1. Under Treas. Reg. §1.42-5(d)(2), an Agency may use the HUD uniform physical condition standard to perform an on-site inspection to satisfy the Agency's inspection responsibility.

2. A violation of the HUD physical condition standard alone is sufficient for a violation of IRC §42(i)(3)(B).

3. "…a taxpayer, in response to the IRS finding a violation, may raise an affirmative defense by proving that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result where as the HUD standard does not reach a taxpayer favorable result. Under these circumstances, the local law would control as respects the violation itself."

Suitable for Occupancy: Audit Techniques

Audit Technique #1: Interview Questions

The taxpayer should be interviewed and asked to explain what internal controls are in place to ensure that the units are suitable for occupancy. What procedures are in place to maintain the project, identify physical deficiencies, and correct problems on an on-going basis? Does the taxpayer follow a routine maintenance schedule? Does the taxpayer regularly inspect the units?

If the IRC §42 project is operated by an independent property manager, what oversight does the taxpayer provide to ensure that the manager maintains the project in compliance? Does the taxpayer conduct internal audits or personally visit the project?

Audit Technique #2: Annual Certification to State Agency

The taxpayer's annual certification to the state agency should be reviewed. If the taxpayer cannot provide the certification, request the documentation from the state agency. Although self-prepared, the certification may be the only evidence of compliance prepared concurrent to the events.

Audit Technique #3: Vacant Units

Vacant units must also be suitable for occupancy. While a reasonable period to clean a unit and repair any damages caused by a prior tenant is acceptable, vacant units that are not move-in ready are not suitable for occupancy.

1. Ask the taxpayer to explain the policies and procedures in place to prepare a vacated unit for a new tenant and how long it usually takes. For example, if the vacancy rate is high, a taxpayer may not be willing to expend the funds until a new tenant has been identified.

2. Review the tenant rent roles to identify rental units that are vacated during the year and estimate the average time between tenants.

3. Identify rental units that are vacant for unusually long periods of time. Ask the taxpayer to document that the units were prepared for occupancy. For example, the taxpayer may show receipts for cleaning expenses or repairs.

Audit Technique #4: Tour the Project Site

The IRC §42 project should be toured to ensure the housing exists, includes the assets described in the records, and is suitable for occupancy. The tour is an opportunity to observe the project's current physical condition and the taxpayer's on-going efforts to physically maintain the housing.

Audit Technique #5: State Agency Inspections

If the state agency inspected the IRC §42 project during the year under audit, the documentation of their inspection can be used as evidence that the project was maintained in a manner suitable for occupancy. If the state agency reported to the IRS on Form 8823 that the buildings were not suitable for occupancy during the year under audit, then the state agency should be able to provide reports (including descriptions), correspondence with the taxpayer or property manager, and in some cases, photographs. Ask the taxpayer

whether the noncompliance has been corrected and to provide documentation evidencing exactly when the project was restored to compliance.

Audit Technique #6: Other Documentation of Compliance

While it is not possible to physically observe the project as it was maintained during the taxable year under audit, documentary evidence of compliance from other sources should be reviewed if available.

1. Ask the owner whether any state or local government conducted an inspection, and if so, if any violations were noted. Copies of the reports should be secured and reviewed to determine if any noted violations were corrected. Alternatively, state and local governments may be contacted directly to determine whether inspections occurred and whether violations were identified.

2. Determine whether the project was physically inspected for another purpose and secure any findings. For example, regular inspections will be conducted if the taxpayer is participating in HUD's housing programs or a commercial lender may conduct inspections to ensure that the assets securing the debt maintain their value.

Suitable for Occupancy: Adjusting the Applicable Fraction

Under IRC §42(c)(1)(B), the Applicable Fraction is the smaller of the unit fraction or the floor space fraction. IRC §42(c)(1)(C) defines "unit fraction" as the fraction, the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units in such building. IRC §42(c)(1)(D) defines "floor space fraction" as the fraction, the numerator of which is the total floor space of the low-income units in such building, and the denominator of which is the total floor space of the residential rental units.

Under IRC §42(c)(1)(A), the applicable fraction is determined on the last day of the taxable year. Low-income units that are not suitable for occupancy at the end of the taxable year are not qualified low-income units and will reduce the Applicable Fraction used to compute the allowable IRC §42 credit for the taxable year.

Example

Suppose a taxpayer owns a 100% low-income building with 10 residential units. As part of an IRS audit, an examiner determined that 3 of the 10 units were not suitable for occupancy at the end of the taxable year under audit. Using the Unit Fraction method, the Applicable Fraction is (10-3)/10 = .7000.

The examiner must also compute the fraction using the Floor Space Fraction method. The 100% low-income building consists of 5 units with 1,000 square feet and 5 units with 1,200 square feet, for a total of 11,000 square feet. All three of the units determined to be unsuitable for occupancy were units with 1,200 square feet. The Applicable Fraction using the Floor Space Method is computed as:

$$\frac{(2)(1{,}200) + (5)(1{,}000)}{11{,}000} = .6700$$

The corrected Applicable Fraction is the smaller of the two fractions, or .6700.

Audit Adjustments

Suppose the allowable IRC §42 credit is $75,000, and that on Form 8609-A filed with the tax return, the taxpayer computed the credit as:

Eligible Basis:	$833,333
Applicable Fraction:	x 1.00
Qualified Basis:	$833,333
Applicable Percentage:	x 0.0900
Allowable Credit:	$75,000

When the Applicable Fraction is reduced to .6700, the allowable credit is $833,333 x .6700 x 0.0900 = $50,250.

The adjustment to the allowable credit is $75,000 - $50,250 = $24,750. Since the adjustment resulted in a reduction of the Qualified Basis, the IRC §42(j) recapture provisions are also applied.

Suppose the year under audit is 2008, and is the 6th year of the 15-year compliance period. The recapture rate is .333. The recapture amount from each prior year is .333 x $24,750, which equals $8,241, plus interest from the due date of the return on which the credit was claimed to the due date of the return on which the recapture is being made. For the example here, the total recapture amount (credit and interest) is $50,461 for tax years 2003-2007.

Helpful Hint

The computation of the allowable credit can be quite complex, unlike the simple computation presented in the example. The easiest method is to follow the format presented on Form 8609-A filed with the tax return.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2485, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

Wouldn't you know? I'm at the office and helping an agent with the computation of an adjustment to Eligible Basis. Unlike nice examples with numbers that are easy to work in your head, I am working with real costs and need my calculator. I reach in my bag for my little HP and…what! It isn't there. Where did I leave it? Oh, it's probably at home on my desk where I was balancing my checking account. Well, not really a problem, I can still add, subtract, multiple and even divide numbers all by myself, right? Okay…how do you set up a long division problem on paper again? Only an almost unnoticeable hesitation as I reached for paper and pen….well, better use a pencil. Can't find one! Then, I needed to multiply one big number by a three digit fraction…how do you move that decimal point again? I haven't not used a calculator for a serious "got-to-be-right" math problem for a very long time!

In the back of my head I can hear my high school math teacher, "…You can't depend on calculators…You have to think for yourself," while sadly shaking his head in disappointment. Obviously, he wasn't about to let us use our spiffy hand-sized calculators. Instead, he taught us how to use a slide ruler…which, even way back in the 1970's when I was in high school, already seemed like… shall we say…a useless exercise?

But it got me to thinking…who do we have to thank for the slide ruler? And by the way….who figured out computer chips? I mean, how does electricity flowing through a bunch of silicon add up numbers, do google searches, identify "questionable" grammar with squiggly green lines, and, just for fun, provide me with 228 fonts to choose from (yes, I counted and that includes the wingdings), and who can decide? Whoever thought anyone *needed* 228 choices?

So, I get home from work and being a little concerned about my not-so-cheap HP, I look for it on my desk and it isn't there. I search a bit more diligently…under several stacks of paper…still can't find it. Did I use it at work, then leave it somewhere on the desk rather than putting it back in my bag…must be…and if you ever saw my office, you'd understand why I'm pretty sure it has to be there. But nope; I looked the next morning and it was not to be found. So, where is it….after more focused searching at home, I still couldn't find it!

So, I applied the "eventually" theory; you know, "eventually" it will turn up. And eventually it did…I was sorting through a stack of Christmas CD's by the stereo…and there it was, stuck right in the middle of the stack…I have absolutely no idea how it got there!

But in case you are curious (I was), the slide rule was invented by William Oughtred in 1625 and continued to be used until the first handheld calculator was produced in 1972 by…you guessed it…Hewlett Packard. I still have my first little calculator and I just love 1970's design with the black finish and silver highlights. But I'm digressing. Think about it. In 1972, when I learned to use a slide rule, I could have time traveled back to any point in time after 1625 (a 347 year span) and would have seen everyone using the same exact tool I was using…I'd fit right in! But if today's high school senior went back to 1971…right before the calculator went on the market…could they multiply $10,957,782 by .0948 without a calculator? Could they even begin to use a slide rule? What about telephones? Would they know to look for a pay phone? Would they know what it would have looked like? Would they know to listen for the dial tone before dialing? Cell phones were not much more than an itsy-bitsy intriguing concept being imprinted on a Star Trek fan's head while watching Captain Kirk stuck on a planet "communicating" with Spock on board the Enterprise ----nothing more than a clever literary device at the time. By the way, have you noticed how your cell phone loses its signal at the most inconvenient moments…just like Captain Kirk's communicator at the most critical point in the plot?

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service **Issue #44, May 2011**

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

- Guide Available on IRS Website
- E-Filing Bug for Partnerships
- Verifying Income and Assets
- Instructions for Rescinding Form 8823
- IRS Audits: What to Expect
- Interviewing Taxpayers
- Administrative Reminders
- Subscribing to the LIHC Newsletter
- ♫ Grace Notes ♫

Guide Available on IRS Website

The Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, is now available on the IRS website, www.irs.gov. Enter "ATG" in the search engine and select the first link on the list, which is a listing of Audit Technique Guides. Select "L" to move down to "Low-Income Housing Credit – Guide for Completing Form 8823." The Guide is available in both .pdf and html format.

Background

The "Guide" was written at the request of the housing agencies responsible for the administration of the IRC §42 program at the state level. Under Treas. Reg. §1.42-5, the agencies are responsible for monitoring taxpayers' compliance with IRC §42 requirements throughout the 15-year compliance period and reporting noncompliance to the IRS using Form 8823.

The Guide includes instructions for completing the form and guidelines for identifying and evaluating taxpayer compliance. Each of the 16 categories of noncompliance identified on the form is addressed in a separate chapter of the Guide.

The Guide was first released for use in January of 2007 and then significantly revised in October of 2009 to reflect changes made to IRC §§42 and 142(d) made as part of the Housing and Economic Recovery Act of 2008 (HERA). However, due to the extensive footnoting and technical issues, the Guide has not been available in an electronic format on irs.gov until now.

2011 Revisions

Asterisks are used to identify significantly revised text. A complete list of these changes is included with the Table of Contents. The text was also updated to correct typing and formatting errors, which do not change the meaning of the text, which are not identified.

Changes to Chapter 18

Noteworthy changes were made to Chapter 18, Owner Did Not Properly Calculate Utility Allowance, and are discussed here.

Out of Compliance

The "Out of Compliance" section has been revised to emphasize that low-income units are considered out of compliance when the gross rent exceeds the maximum gross rent limit. Further, the text now includes discussions and examples for the six noncompliance issues simply listed in the 2009 version of the Guide.

As originally released in March of 2011, Example 1 on page 18-10 included an error. The last sentence of the example should read, "The owner is out of compliance beginning July 1, 2010; i.e., an owner has *90* days to implement new utility allowances." This error, on page 168 of the pdf file, was corrected on May 20, 2011.

For three of the six noncompliance issues, the Guide also clarifies that there is a presumption that the maximum gross rent limit has been exceeded if:

1. Rents are not reduced for a utility allowance when utilities are paid directly by the tenant to the utility provider, even if the rent charged to the tenant is less than the maximum gross rent limits.

2. The owner did not review the basis on which the utility allowance is established at least once during both the prior and current calendar year; i.e., the utility allowance is not current.

3. The owner failed to maintain adequate documentation regarding the computation of utility allowances.

Back in Compliance

Other than the first paragraph and example, the entire "Back in Compliance" is new text and addresses the three noncompliance issues identified above.

Finally, to summarize:

1. Noncompliance is reported to the IRS whenever the rent paid by the tenant plus the correct utility allowance exceeds the maximum gross rent.

2. Noncompliance should not be reported to the IRS if:

   - Regardless of the error, correcting the utility allowance does not cause the rent to exceed the gross rent limit,

   - Noncompliance is corrected before the owner is notified of the state agency's review.

E-Filing "Bug" for Partnerships

Owners of IRC §42 projects are required to file Form 8609-A, Annual Statement for Low-Income Housing Credit. Part I, Compliance Information, satisfies the IRC §42(l)(2) annual reporting requirement. Part II is the computation of the credit for the tax year.

Key Points:

1. A Form 8609-A must be filed each year for the entire 15-year compliance period, even though no credit is allowable after the end of the 10-year credit period, except for the amount allowable under IRC §42(f)(2)(B) in the 11th year.

2. A Form 8609-A must be filed for each low-income building.

3. A separate Form 8609-A is filed for each allocation of credit. For every Form 8609, Low-Income Housing Credit Allocation and Certification, a corresponding Form 8609-A must be filed with the taxpayer's tax return.

4. The filing requirements also apply to low-income housing projects financed with tax-exempt bonds under IRC 142(d).

Owners filing Forms 8609-A also file Form 8586, Low-Income Housing Credit, which summarizes information from the attached Forms 8609-A.

Partners in Partnerships

If you are a partner in a partnership owning low-income housing, then you are required to file the Form 8586 only to report your share of the partnership's credit. You are not required to file Form 8609-A

The E-Filing "Bug" and Temporary Fix

It is quite common for a partner in a partnership owning low-income housing to be another partnership, for which the filing requirement is limited to the filing of Form 8586. However, the e-filing programming for partnerships does not distinguish between a partnership owning low-income housing and a partnership that is a partner in a partnership owning low-income housing. As a result, the programming requires completion of the Form 8609-A whenever the credit is claimed by a partnership.

So, to work around the programming when filing a partnership return for a partner in a partnership owning a low-income project, you will be asked to complete one "dummy" Form 8609-A.

Verifying Income and Assets

When determining whether a household is income-qualified, owners are required to verify the amount of income from all known sources of income, including the income derived from assets. Acceptable methods of verifying information include third party verifications, reviews submitted by the tenant (such as check stubs) and tenant certifications made under penalties of perjury.

Another source of documentation, specifically identified in Treas. Reg. §1.42-5(b)(viii) for households receiving housing assistance payments under Section 8 is a statement from the public housing authority declaring that the tenant's income does not exceed the applicable income limit.

The regulation reads:

> (vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation)…In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement…is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under IRC §42(g).

Instructions for Rescinding Forms 8823

Every once in awhile, a state agency will need to rescind a Form 8823 filed with the IRS, so that the owner is treated as if the Form 8823 had never been filed. To rescind a Form 8823, a state agency must:

1. Write "Rescind" across the top of the Form 8823,

2. Check the "Noncompliance Corrected" box for every category previously marked "Out of Compliance,"

3. The date on line 9, Date Noncompliance Corrected, is the date the Form 8823 is signed, and

4. Mark the "amend" box in the upper right-hand corner of the form.

It is also helpful to include a note explaining what happened.

IRS Audits: What to Expect

Ever wondered what happens during an IRS audit? The IRS has released a new video called *Your Guide to an IRS Audit*. From the IRS website, **www.irs.gov**, enter "Audit" in the search feature or enter http://www.irsvideos.gov/audit/

Interviewing Taxpayers

The purpose of an interview with the taxpayer is to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records in order to evaluate the accuracy of such information.

- The interview should be held with the person(s) most knowledgeable about the development and on-going operation of the IRC §42 project. It may be necessary to interview more than one person.

- The interview should be held early in the examination as the interview is an opportunity to gather information that can help establish, and possibly limit, the scope and depth of the examination.

- Generally, interviews should be conducted after reviewing the documents requested in the first Information Document Request (IDR).

Note: IRC §7521(c) authorizes a representative to represent a taxpayer at any interview. However, the taxpayer's voluntary presence should be requested if the representative cannot provide (1) firsthand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices and the daily operation of the business, (2) factual and reliable responses to questions, (3) timely follow-up information for any questions that could not be answered at the time of the initial interview; or a properly authorized Form 2848, Power of Attorney (POA), or Form 8821, Tax Information Authorization from the taxpayer.

Background and Financial History

The taxpayer should provide background and financial information regarding the formation of the partnership (virtually all IRC §42 projects are owned by partnerships) and development of the project. Generally, the taxpayer should be able to explain how the partnership was organized, the terms of the partnership agreement, and when the partners made their capital contributions. The interview is also an opportunity for the taxpayer to answer any questions arising from a review of the partnership agreement, the prospectus or offering memorandum, or syndication documents.

The taxpayer should specifically discuss the development of the IRC §42 project, including:

1. The people and entities responsible for the planning and construction phases of the project, including the disclosure of related parties.

2. The services provided by the developer, the terms of the development contract, and to what extent the fee has been paid.

3. How the property was acquired; i.e., the land or the land with improvements and existing buildings. The taxpayer should also explain how costs were allocated between land, nonqualifying land improvements and depreciable residential rental property included in eligible basis.

4. The financial resources such as construction loans and permanent financing, grants, and funding from local, state or federal programs.

5. The terms of the IRC §42 credit allocation and any additional requirements imposed on the taxpayer as part of the extended use agreement.

6. How the final cost certification was prepared.

The interview is also an opportunity for the taxpayer to answer any questions arising from a review of the partnership agreement, the prospectus or offering memorandum, the credit allocation application, market study, credit allocation award, final cost certification, or depreciation schedules. For example, if the depreciable basis on the depreciation schedules is substantially different than that reflected on the final cost certification, then the taxpayer needs to explain the differences in costs.

Business Practices

The taxpayer should explain how the IRC §42 project is managed and identify the people and organizations responsible for the day-to-day operations for the project during the tax years under audit, including personnel responsible for determining whether households are income-qualified, preparing and maintaining the tenant files, receiving rents, making bank deposits, and paying expenses, and accumulating financial information used to prepare the tax return.

The taxpayer should explain to what extent the taxpayer is involved with the on-going operation of the project, physically inspects the project, and reviews the financial records. If a management company is involved, how often does the taxpayer receive updates, reports or financial summaries for the IRC §42 project? How and when does the management company notify the taxpayer of any irregularities? Does the taxpayer approve expenditures or to

what extent does the taxpayer delegate responsibilities and to whom?

Does the taxpayer maintain written policies and procedures for the operation of the IRC §42 project describing how the project is intended to operate? Who opens the mail? Who receives rents from the tenants? Who deposits the rents in the bank? Who has authority to write checks? Who approves expenditures? Who reconciles bank statements? Are there periodic reviews by independent third parties?

Internal Controls

Ask the taxpayer to describe the books and records created as part of the day-to-day operation of the IRC §42 project. What are the common transactions? What books and records are maintained? Does the taxpayer review the books to ensure transactions are timely recorded and how often? Does the taxpayer separate the duties of on-site personnel? The taxpayer should explain what checks and balances are in place to establish that all income is properly accounted for from the time the rents are received by the site manager. For expenses, the taxpayer should illustrate the review and approval process for certain expenditures, especially any large or unusual expenditure.

Does the taxpayer conduct internal audits? If so, why and what were the results? Does the general partner report to a representative for the limited partners? Do the limited partners conduct their own independent audits?

Compliance with IRC §42

The taxpayer should explain what policies and procedures are in place to ensure that the project is operated in compliance with IRC §42.

Physical Maintenance: The taxpayer will need to expend resources to make repairs and maintain the project in a manner suitable for occupancy. Does the taxpayer maintain reserves for this purpose? Who decided when maintenance is needed? How often does the taxpayer conduct physical inspections of the project?

Tenant Qualifications: How does the taxpayer ensure that new tenants are income-qualified at move-in? Does the taxpayer train employees? Does the taxpayer review tenant files? Is the taxpayer using an independent management company? Is the taxpayer frequently changing management companies? Does the taxpayer conduct internal audits or reviews of the tenant files?

Tenant Files: Who prepares the files? How are they maintained? Where are they stored?

Rents: How does the taxpayer determine the maximum allowable rent? Are utility costs included in the rent, or does the tenant pay utility costs based on actual use? If the tenant pays utilities, how does the taxpayer compute the utility allowance? Does the taxpayer provide services in addition to providing housing, for which the taxpayer charges fees in addition to rent? Does the taxpayer charge pet fees? And if so, is the fee a one-time fee or a monthly fee? Does the taxpayer charge for the use of a laundry facility? Are there vending machines on site? Does the taxpayer provide cable or satellite for a fee in addition to rent? Does the taxpayer receive rent subsidies from programs such as HUD's section 8 voucher program?

Cash Flows: Generally, it is expected that the rents generated from the operation of the low-income project will be sufficient to pay on-going operating expenses and service debt. Did that expectation hold true? If not, it is important to understand why cash flows are insufficient and how the taxpayer responded. Did the taxpayer forgo maintenance or otherwise limit costs? Did the taxpayer find additional sources of revenue? Did the taxpayer stop servicing the debt, incur additional debt or find alternative financing such as a grant? Did the partners make supplementary capital contributions?

Community Service Facilities: The taxpayer should be asked whether the project includes a community service facility. If so, what services were provided, and were they provided throughout the taxable year? How did the taxpayer determine that the facility is used to provide services primarily for individuals whose income is 60 percent or less than the area median income?

Forms 8823: If the state agency filed any Forms 8823 for the low-income building with the IRS, the circumstances of the noncompliance and subsequent correction should be explained. The taxpayer should also explain how the noncompliance was accounted for when computing the allowable credit for the affected tax year.

Prior and Subsequent Year Tax Returns

If the analysis of the prior and subsequent year returns indicates that the amount of credit claimed varies from the credit claimed for the years under audit, the taxpayer should be asked to explain why.

Large, Unusual, or Questionable Items

If any item on the return is a large, unusual or questionable item (LUQ), inquiries should be made about such items during the initial interview.

Related Parties or Returns

Related returns are tax returns that have a relationship to the tax return under audit because (1) any adjustment to one return will require a corresponding adjustment to the other return to ensure consistent treatment, or (2) the returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

Does the taxpayer own more than one IRC §42 project? While this taxpayer may be a single asset partnership, did the general partner and limited partner form additional partnerships owning IRC §42 projects? If so, how are the books and records for the different entities kept separate? Does the same management company operate all the IRC §42 projects?

Is the project developer or management company also a general partner, or related to a general partner? The inter-relationships of the parties involved in the development and operation of an IRC §42 project can facilitate the efficient production and management of low-income housing. However, these relationships may have tax implications if transactions are not properly accounted for.

Conclusion

Interviews with the taxpayer provide an opportunity to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records in order to evaluate the accuracy of the tax return. In many cases, the dialogue with the taxpayer can help limit both the scope of the audit (issues raised) and the depth (extent of issue development).

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2485, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

♫Grace Notes♫

Procrastination is not a good thing…true, if you wait long enough, the problem may just go away on its own, but I can honestly tell you that the anxiety of waiting it out and the likelihood that the eventual outcome won't be to my liking has usually gotten the better of me and I end up, for better or worse, trying to deal with it. And let's face it; if you know about a problem, then maybe (just maybe) you have some responsibility for creating and/or fixing it, and besides, it is one of those self-evident laws of nature: problems don't just go away.

Case in point. Almost immediately after posting the Guide for Completing Form 8823, someone pointed out that the "60" days I wrote in the example on page 18-10 really should be "90" days, shouldn't it? Well, yes. But I really didn't think it would be the only typo in the guide and I thought I'd wait a few days…then I was distracted, I forgot about it….on and on until, after no one else pointed out any other boo-boos, I thought I really should get a "round to it." But then I forgot about it, something else came up…..and then one tired day, the thought zipped through my mind at the speed of light just before I left work one evening, "I really ought to take care of that." It kept right on going, heading out beyond the confines of this universe to bounce around in an alternative dimension (probably annoying an alternative self who hasn't a clue what a "Form 8823 Guide" is…or, better yet…..she checks the Guide, Chapter 18, page 10. She's totally confused by the stray thought because she did it right in the first place and "90" days is right there on the page! But I digress.

Eventually, I focused and sent an e-mail with a follow-up date (Smart, eh?), but didn't get a response. So I sent another e-mail and wouldn't you know it? Changing something on IRS.gov isn't (as you might expect) as easy as calling someone, even if it is changing just one simple letter. But neither was it all that terrible. Just orderly. And the error has been corrected.

So, now I'm motivated. I'm going to make a list of all the other things I've got to get around to.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #45, July 2011

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

- Building Identification Numbers
- Reporting Noncompliance with Utility Allowance Requirements: Specifics and General Guidelines
- Claiming IRC §42 Credit for the 11th Year of the 15-Year Compliance Period
- Administrative Reminders
- Subscribing to the LIHC Newsletter
- ♫ Grace Notes ♫

Building Identification Numbers

A Building Identification Number (BIN) is assigned to every building receiving an allocation of IRC §42 credit, or, as described in IRC §42(h)(4), is financed with tax-exempt bonds subject to the volume cap under IRC §146. The rules for assigning BINs are outlined in Notice 1988-91.

Purpose

BINs are needed to identify low-income buildings when state agencies and owners report IRC §42-related events to the IRS: The BIN is comparable to an individual's Social Security Number (SSN) or an entity's EIN (Employer Identification Number), which are sometimes collectively referred to as Taxpayer Identification Numbers (TIN). BINs are identified on the following forms:

- Form 8609, Low-Income Housing Credit Allocation and Certification.
- Form 8610-A, Carry-Over Allocation of Low-Income Housing Credit.
- Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
- Form 8609-A, Annual Statement for Low-Income Housing Credit
- Form 8586, Low-Income Housing Credit, if there has been a decrease in Qualified Basis.
- Form 8877, Recapture of Low-Income Housing Credit, if there is a recapture event under IRC §42(j).

Format

The BIN consists of a two character state designation (the postal state abbreviation) followed by a two digit designation identifying the year the credit is allocated, and a five digit numbering designation.

For example, the identification number for one of 25 buildings allocated a credit in 1987 by the Connecticut Housing Finance Authority (the only housing credit allocating agency in the state) might read CT-87-00023.

Unique BIN

The BIN must be unique to the building and must be used for all allocations of credit. Three examples:

- A building may receive separate allocations of credit for the acquisition of the building and the rehabilitation of the building.
- A newly constructed building may receive credit allocations in different calendar years. A separate Form 8609 will be used for each allocation, but the BIN assigned for the first allocation will be used for the subsequent allocation. See Treas. Reg. 1.42-6(d)(2)(x).
- An owner receives an allocation of credit to construct a new low-income building. The building is timely placed in service and completes the 15-year compliance period. The building is then sold to a new owner who applies for and receives an allocation of credit for acquiring and rehabilitating the existing building. The BIN assigned at the time the building was constructed will be used again, even though the allocation of credit is for a new owner and the 15-year compliance period has expired for the first allocation.

Assignment by Authorized Housing Credit Agency

The BIN will be assigned by the housing credit agency that is authorized to make the credit allocation. If there is more than one allocating agency in the state, the agencies should coordinate the assignment of BINs to ensure that BINs are not duplicated.

Reporting Noncompliance with Utility Allowance Requirements: Specifics and General Guidelines

In the last newsletter, the lead article was an announcement that the "Guide for Completing Form 8823" is now available on ww.irs.gov. The article also included a summary of revisions to Chapter 18, which addresses the utility allowance requirements and had been significantly updated. Based on feed-back from the state housing agencies, which use the Guide as a reference, this article provides additional explanations for reporting noncompliance to the IRS.

Specific Instructions in Chapter 18

The reporting of noncompliance with the Utility Allowance requirements is now expressly limited to those instances where the noncompliance causes the rent paid by the tenant to exceed the gross rent limit. It is a two-pronged test:

1. Did the taxpayer make an error when computing the utility allowance?
2. Did the error cause the rent paid by the tenant to exceed the gross rent limit for one or more months?

Only when the answer to both questions is "yes," would a state agency report noncompliance with the utility allowance requirements on Form 8823, line 11m. It follows, then, to ask whether a state agency should also report noncompliance on line 11g, Gross Rent(s) Exceed Tax Credit Limits. Chapter 18 is silent, but Chapter 11 of the Guide, which addresses Gross Rent Limits, on page 11-9, reads:

> If the noncompliance is the result of noncompliance with the utility allowance requirements, the error should be noted under category 11m, Owner did not properly calculate utility allowance.

Does this mean that 11m should be noted *instead* of 11g, or *in addition to* 11g?

To answer this question, reference can be made to the general rules provided in Chapter 2, Instructions for Completing Form 8823. On page 2-2, there's a list of "General Guidelines." The first guideline on the list reads:

1. Select all applicable categories of noncompliance.

   Example 1: The state agency determined that 1 out of 10 low-income units in a building had been rented to a household with incomes that did not meet the income eligibility restrictions. Category 11a, Household income above income limit upon initial occupancy, should be selected.

   Example 2: The state agency determined that 7 out of 10 low-income units in a one-building project were rented to households with incomes that did not meet the income eligibility restrictions. As a result, the owner did not meet the 40/60 minimum set-aside for that year. Category 11a, Household income above income limit upon initial occupancy, should be selected, and category 11f, Project failed to meet minimum set-aside requirement, should be selected.

Applying the general principle demonstrated in Example 2, noncompliance with the utility allowance requirements will result in the reporting of noncompliance with the gross rent limits on line 11g *in addition to* reporting noncompliance with the utility allowance requirements on line 11m.

Corrective Action

Admittedly, the cross-referencing between Chapter 18 and Chapter 11 could have been better and should be updated to reflect the relationship between utility allowances and maximum gross rent. So, in your copy of the Guide:

1. Keep a copy of this newsletter with Chapter 18, and
2. On page 11-9, change #1 to read:

   "If the noncompliance is the result of noncompliance with the utility allowance requirements, the error should *also* be noted under category 11m, Owner did not properly calculate utility allowance."

The text will be updated the next time the Guide is revised.

Amending Forms 8823

What if a state agency reported noncompliance with the utility allowance requirement when the noncompliance resulted in the rents exceeding the gross rent limit, but did *not* identify noncompliance on line 11g?

Amended Forms 8823 are not necessary. Forms 8823 are accepted by the IRS as accurate when filed, but failure to identify a cascade of non-compliance issues resulting from a single error is not a fatal flaw. When evaluating Forms 8823, the IRS will independently conclude that the single error caused multiple violations of IRC §42 requirements. After all, regardless of whether the state agency reports the noncompliance with the gross rent limits, the taxpayer has *actually* violated the requirements and the residential rental units are no longer qualified low-income units.

General Guidelines for Reporting Noncompliance

The revisions to Chapter 18, addressing utility allowances, surfaced underlying issues that should also be addressed in more general terms.

Scope

The scope of the Guide for Completing Form 8823 is limited to providing guidelines for state agencies when evaluating an owner's compliance with IRC §42 requirements and reporting any observed noncompliance, or noncompliance of which the state agency becomes aware, to the IRS.

Our purpose was to help the state agencies more consistently identify and report noncompliance issues. No attempt was made to identify the tax consequence of noncompliance for the owner.

Owner (Taxpayer) Responsibility

Owners are responsible for determining the tax effect of any noncompliance.

1. Will the noncompliance affect the Applicable Fraction reported on Form 8609-A, Line 2?
2. Will the noncompliance affect the Eligible Basis reported on Form 8609-A, Line 1?
3. Will the noncompliance affect the Applicable Percentage reported on Form 8609-A, Line 5?

If noncompliance affects either the Applicable Fraction or Eligible Basis, the owner will also need to determine whether the credit recapture provisions under IRC §42(j) are applicable.

"Out of Compliance" and "Back in Compliance" Dates

State agencies identify the date the building ceased to comply with the IRC §42 provisions (line 8); i.e., the *earliest* date of noncompliance for all the noncompliance issues being reported. And then, when all the noncompliance issues are corrected, the state agency reports the date the *last* issue was resolved (line 9). The reporting of these dates identifies the time span of the noncompliance.

In the Guide, when defining the "back in compliance date," the IRS looks to the date the noncompliance behavior ceases. The date the noncompliance with a specific requirement ceases, however, is not necessarily the date the building again qualifies for the credit. When there is a cascade of inter-related noncompliance issues, the whole fact pattern must be considered.

Specific to correcting noncompliance with the utility allowance requirement, the Guide provides the following explanation on page 18-11.

> "A unit is considered back in compliance when the rent charged is reduced and correctly reflects the utility allowance. The date of correction is [the] date that the rents correctly reflect the utility allowance."

Specific to the Gross Rent issue, the Guide provides the following instructions on page 11-10:

> "Once a unit is determined to be out of compliance with the rent limits, the unit ceases to be a low-income unit for the remainder of the owner's tax year. A unit is back in compliance on the first day of the owner's next tax year if the rent charged on a monthly basis does not exceed the limit."

Therefore, when noncompliance with the gross rent limit occurs because of noncompliance with the utility allowance requirements, the date noncompliance is corrected is always the first day of the owner's next tax year, even though the noncompliance with the utility allowance requirements presumably ceased at an earlier date. In other words, a building is not back in compliance until all of the noncompliance issues are corrected.

"Close of the Taxable Year" Determination

Owners may question whether the credit should be lost for the entire year when the Guide instructs state agencies to report noncompliance with the gross rent limit under 11m rather than 11g when the noncompliance is associated with the utility allowance requirements. This question speaks to the continuous nature of compliance with the gross rent limit requirements.

Under IRC §42(c)(1)(A)(i), the Applicable Fraction is determined at the "close of such taxable year," and is, generally considered a "snap shot" determination. However, each IRC §42 requirement's "snap shot" has its own unique characteristics.

Specific to determining whether an owner is complying with the gross rent limit requirement, the question is not whether the rent was correctly limited at the end of the year, or even if the cumulative rent paid during the year is correctly limited on an annual basis. As explained in Chapter 11 of the Guide, to be considered compliant at the end of the taxable year, the owner must comply with the gross rent limit requirement each month of the taxable year. Further, the Guide also explains that an owner cannot reverse noncompliance with the gross rent limit by refunding excess rent, and then claim the credit as if the noncompliance never occurred.

The gross rent limit requirement is not the only IRC §42 rule requiring consideration of continuous compliance during the taxable year. If a taxpayer received a credit allocation from the IRC §42(h)(5) nonprofit set-aside, the nonprofit organization must materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period. As explained in Chapter 22 of the Guide, a nonprofit is considered to materially participate when it is regularly, continuously, and substantially involved in providing services integral to the operations of a project. The project is out of compliance for any taxable year where the nonprofit entity does not participate (in both management decisions and day-to-day activities) on a basis that is regular, continuous, and substantial. In other words, the determination at the end of the year is based on what happened during the year.

Noncompliance Categories

Line 11a-p identify 16 specific IRC §42 requirements for which noncompliance (and subsequent correction thereof) are reported. Line 11q is a catch-all "other" category. Line 13 is used to report the disposition of a low-income building, which is not necessarily a noncompliance issue, but does have tax consequences.

So, how did the IRS decide which IRC §42 requirements to specifically identify and which would be reported using Line 11(q)? That's not an easy question to answer since the form reflects the views of many groups and individuals over a long period of time. But there are no hidden agendas. Decisions were made based on what information the IRS needed to administrate the IRC §42 program, given the practicalities of data collection and the limits of form design.

Why are the noncompliance categories important? Grouping the reports of noncompliance by category facilitates IRS analysis of taxpayer compliance and improves internal efficiencies. Consistent reporting by state agencies further enhances those efficiencies. Did you know that the first versions of Form 8823 (1992, 1994) did not include noncompliance categories? The state agencies were asked to "describe" the noncompliance.

Isn't it redundant to include a specific line for reporting noncompliance with the utility allowance requirements when the noncompliance will always be reported as noncompliance with the gross rent limit?

Not exactly. Two immediate conclusions can be made based on the identified noncompliance categories.

1. If only 11g is identified, then the noncompliance involves something other than a problem with the utility allowance.
2. If both 11g and 11m are identified, then the problem with the gross rent limit involves the utility allowance and may include additional rent-related issues.

To take it a step further, if 11g and 11m are identified and 11f is checked to note that the project failed the minimum set-aside requirement, then we can also conclude that the problem with the utility allowance is probably systemic.

But the decision to specifically identify certain compliance issues and how individual noncompliance issues are reported is a matter of convention intended to promote consistent reporting of noncompliance and facilitate IRS analysis of the reports.

We could have decided differently. For example, if 11g and 11m are identified, it really isn't clear whether the noncompliance with the utility allowance requirements is the *only* reason the gross rent limit has been violated. We could have asked the state agencies to report problem with utility allowances under 11m *without* identifying 11g. Since noncompliance under 11m *always* results in noncompliance with the gross rent limit, it really isn't necessary to mark both categories. At the same time, identifying 11g without 11m would mean that the noncompliance was not related to the utility allowance requirements. The two types of noncompliance would be distinguishable.

In fact, I (Grace Robertson) am reasonably certain that at a NCSHA conference before the June 2011 conference, I probably advised the state agencies just as described above.

Keep in mind that there is no absolute right or wrong way to report noncompliance. Noncompliance needs to be reported in a manner that best reflects the noncompliance issues and best helps the IRS administer the IRC §42 program. At this point, we have determined that the reporting of a "cascade" of noncompliance issues is more beneficial for the IRS than sorting out the reasons for the noncompliance.

So, from now on, the state agencies are asked to report the noncompliance following the general rules set out in the Guide and report the cascade of noncompliance issues.

Lessons Learned

1. One little word can make a big difference. Please update Chapter 11, page 9, #1 to read: If the noncompliance is the result of noncompliance with the utility allowance requirements, the error should *also* be noted under category 11m, Owner did not properly calculate utility allowance.
2. The scope of the Guide for Completing Form 8823 is limited to the evaluation of an owner's compliance and the reporting of noncompliance.
3. Owners (taxpayers) are responsible for determining the tax consequences of noncompliance regardless of how the state agency reported the noncompliance on Form 8823.
4. The IRS accepts the Forms 8823 as filed, but independently evaluates taxpayer compliance and any possible tax consequences associated with noncompliance.
5. Don't forget the general rules when applying the specific rules.

Quiz

A taxpayer received an allocation of credit in 2007 and builds 50 single-family homes. The buildings are placed in service in 2009. The taxpayer elects to begin the credit period in 2010 and the 40-60 minimum set-aside. The taxpayer does not elect to treat any of the buildings as a multi-building project. In July of 2011, the state housing agency inspects the buildings and conducts a tenant file review. The agency determines that the current tenant in one of the homes, who moved in on August 1, 2009, is not income-qualified.

Should the agency file a Form 8823? If so, which noncompliance category should be identified? The answer is at the end of the newsletter, just before the Administrative Reminders.

Claiming IRC §42 Credit for the 11th Year of the 15-Year Compliance Period

Under IRC §42(f)(2), the allowable credit is limited based on when the low-income buildings are placed in service and when the residential units are first occupied by income-qualified households. Any reduction in the allowable credit that would be allowable if the rule was not applied is allowable in the 11th year of the compliance period. The 11th year credit is reported on Form 8609-A, Annual Statement for Low-Income Credit, line 17, which is filed with the tax return for the entity owning the IRC §42 building(s). Basically, if all goes well:

First Year Credit + 11th Year Credit = Allocated Credit

However, if any of the units were first occupied by qualified tenants after the end of the first year of the credit period, then the taxpayer can claim the 2/3 credit under IRC §42(f)(3) for each remaining year of the 15-year compliance period that the unit is a low-income unit. There's a special rule to limit the credit for the year the unit first qualifies, but no rule com-

parable to the rule under IRC §42(f)(2) allowing the taxpayer to claim credit deferred from the first year in the 11th year of the compliance period.

Completing Form 8609-A

- Even though no credit is allowable for the 11th year, taxpayers should complete the computation of the credit in Part II of Form 8609. Particularly, do not skip lines 1 through 14.
- The amount on line 15, allowable credit for the year, should be zero or the allowable 2/3 credit.
- Line 16 is rarely applicable since low-income buildings are owned by single entities. Read the instructions for consideration of special rules related to dispositions.
- The credit deferred from the first year is entered on line 17.
- The total allowable credit is entered on line 18.

Documentation

If a taxpayer claims deferred credit in the 11th year, then the taxpayer must be able to document how much credit was claimed in the first year and how it was computed.

Miscellaneous

And don't forget to complete Part I, which satisfies the annual reporting requirement under IRC §42(l)(2).

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

Pop Quiz Answers

(1) 11a, Household income above income limit upon initial occupancy, because the tenant was not income-qualified at move-in.

(2) 11f, Project Failed the Minimum Set-Aside, because each building is a separate project and the percentage of qualified low-income units in the building is less than 40% (in fact, it is zero).

(3) 11p, Building is no longer in compliance or participating in the section 42 program, because the project failed the minimum set-aside requirement for the first year of the credit period.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2485, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements. More information is available on the TEFRA website, along with a list of TEFRA Coordinators.

♫Grace Notes♫

Last week I found myself driving on a "connector" road between two subdivisions of housing. Because of the terrain and foliage, the area has a feeling of isolation, except for the sidewalk along one side of the road. It is very unusual to see anyone walking there, so I was rather surprised when I saw a teenager walking her dog, a beautiful little collie. As I drove towards her, I could see that the little collie was having trouble walking slowly enough to keep pace with the girl, who was just shuffling along. I was a little concerned, but as a drove by her, I could see that she was working with a small hand-held device…probably texting or maybe playing a game.

My first thought was "wow," in a million years I couldn't put one foot in front of the other, walk a dog, *and* either type a message coherently or focus on a computer game well enough to win, *all* at the same time! But as I looked back in my rear view mirror, I felt a little sad. She hadn't noticed that it was a beautiful morning or that she was walking through a really nice area. She hadn't even noticed the beautiful little collie looking up at her, trying to get her attention…maybe to play a little or just walk a little faster.

So, wouldn't you know, a few days later I leave work just late enough to be caught in afternoon traffic and find myself first in line at a red light. It's the intersection of two small streets, but traffic is moving so slowly and it so congested that…..well, traffic is at a dead stop. Quite unexpectedly, I see a young woman weaving her way quickly through the cars, approximately in the cross walk. She's tall and her long hair is pulled back tightly to the crown of her head, a long pony tail swinging in rhythm to her long strides. She's wearing a beautiful silk dress with a brown and blue paisley print (I'm partial to paisley prints) and she's moving so quickly that she's almost running on her toes (the really high heels help). She's holding her right arm out to her side and as she moves closer to me, I can tell she's holding a leash. When she's right in front of me, I can see an itsy-bitsy little Pomeranian prancing right along side her, looking up at its mistress, excited and fully trusting her to lead the way. If I dared to interpret their body language, I'd say they both felt absolutely beautiful. But then they were gone, the light changed, and I rolled along.

I promised myself I'm going to play more with Hannah and Olivia (the cats) and wholehearted give them my full, undivided attention. Hmmm…would Hannah walk on a leash?

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

Low-Income Housing Credit Newsletter

Internal Revenue Service Issue #46, October 2011

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!!

The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

In This Edition

- IRC §42(l)(1), First-Year Certification
- Auditing the Year of Disposition by Sale: Credit Recapture Under IRC §42(j)
- Subscribing to the LIHC Newsletter
- Administrative Reminders
- ♫ Grace Notes ♫

IRC §42(l)(1), First-Year Certification

Taxpayers owning IRC §42 housing are required to complete a "First-Year Certification" under IRC §42(l)(1). The certification is made to identify specific information needed for the administration of the program and document specific elections that will govern how the housing is operated. The certification is made by completing Part II of the Form 8609, Low-Income Housing Credit Allocation and Certification, with Part I executed by the state housing agency. The completed certification is submitted, one time, to the IRS.

While it isn't possible to discuss each line's entry in detail, here's the short list of glitches to watch out for when completing the form.

Line 7: Eligible Basis

- The amount on line 7 should reflect any increase under IRC §42(d)(5)(B) for being in a high cost area or specific reconstruction zones such as the Gulf Opportunity Zone (Form 8609, line 3b).
- Generally, the amount on line 7 should equal the amount on Form 8609-A, line 1, filed with the tax return, unless (for one of a number of reasons) the Form 8609-A shows there has been a reduction in eligible basis after the end of the first year of the credit period.

Line 8a: Original Qualified Basis

Enter the Qualified Basis as of the end of the first year of the credit period using the Applicable Fraction as of the end of the first year of the credit period. Do not use the Applicable Fraction computed using the special rule for the first year of the credit period under IRC §42(f)(2). Two brain-teasing "glitches" may occur later:

1. computing the credit allowable in year 11 under IRC §42(f)(2)(B), and
2. computing the credit for additions to qualified basis after the end of the first year of the credit period under IRC §42(f)(3), which is not subject to recapture. See IRC §42(j)(4)(C).

Line 8b: Multi-Building Projects

If you elect to treat a building as part of a multiple building project, then a statement identifying all the buildings that are to be included in the "project" must be attached to the Form 8609. Refer to the instructions for Form 8609 for a list of information that must be included in the statement.

The most common failure is forgetting to submit the attachment when electing to include the building in a multiple building project, which will result in each building being treated as a separate project even if the box on Form 8609 is checked "yes." The most immediate concern will be whether the building met the minimum set-aside requirement under IRC §42(g)(1).

Line 9a

Line 9a is an election related to federally subsidized buildings. The definition of "federally subsidized" is different, depending on when the building was placed in service; i.e., before July 31, 2008, or after July 30, 2008. Refer to the instructions for Form 8609 for complete explanation.

- If neither Line 6a nor Line 6d is checked by the state agency to identify credit allocations to federally subsidized buildings, and Line 4 is zero, then you may either (1) check neither box, or (2) check the "no" box. Either choice is acceptable.
- If Line 6a or Line 6d is checked, and/or Line 4 is greater than zero (depending on when the building was placed in service), then the building is federally subsidized and you must check either "yes" or "no."

Line 9b

Line 9b is an election applicable when two conditions are met; i.e., (1) the building has both market rate units and low-income units, and (2) the quality standards of the market rate units are above the average quality standards of the low-income units in the building. See IRC §42(d)(3)(B).

If both conditions are met, you must check "yes" or "no." Otherwise, you may check "no" or not check either box; either choice is acceptable.

Line 10 – Irrevocable Elections

Line 10 includes four irrevocable elections.

- 10a is the election to begin the credit period the first year after the year the building was placed in service. Make sure your choice is consistent with how you are claiming the credit on your tax return.
- 10b is the election to *not* treat a large partnership (with 35 or more partners) as the taxpayer subject to the recapture provisions under IR §42(j). A partnership with 35 or more partners will be treated as the taxpayer unless the taxpayer makes an affirmative election by checking the "yes" box. For partnerships with fewer than 35 partners, just don't check the "yes" box.
- 10c is the minimum set-aside election, either 20-50 or 40-60. For New York City only, there is a 25-60 option. The most common misunderstanding is that the elected income limit applies to all the low-income units, not just the minimum number of units. For example, if you own a 100% low-income building and elect the 20-50 minimum set-aside, then the income limit used to determine whether a household is income qualified is 50% of the Area Median Gross Income for all the low-income units, not just the 20% minimum number of units.
- 10d is the deep rent skewed 15-40 election. This election does not replace the minimum set-aside election (10c). Every unit qualifying for the deep rent skewed election will also qualify for purposes of the minimum set-aside.

And remember, once these four elections are made, they are irrevocable.

Declaration

The First-Year Certification is signed under "penalties of perjury."

- Signature
- Taxpayer Identification Number (TIN) – identify the TIN of the person signing the certification.
- Date – the date the certification is signed.
- Name (typed or printed) – since the signature is often not legible (but very artistic), please identify the person signing the certification and make sure it is readable.
- Tax Year – identify the first year of the credit period.

Submission and Reconciliation

The First-Year Certification is filed one time with the LIHC Compliance Unit located at the Philadelphia Service Center. The address is:

Department of the Treasury
Internal Revenue Service Center
Philadelphia, PA 19255-0549

Please include the entire zip code as the last four digits identify the LIHC Compliance Unit within a larger IRS facility.

The certification may be returned to you if the certification is incomplete or we have other questions about the submission. Please respond timely.

Auditing the Year of Disposition by Sale: Credit Recapture Under IRC §42(j)

Editor's Caution: This article is limited to discussing possible audit issues when a taxpayer owning an IRC §42 project disposes of the project by sale and the taxpayer selling the project is a partnership.

Although a taxpayer claims the IRC §42 credit over a ten-year credit period, the taxpayer is required to provide low-income housing in compliance with IRC §42 for fifteen years (the compliance period). In effect, the taxpayer is claiming credit in advance of providing housing during the last five years after the credit period has ended. As a result, one-third of the credit claimed each year during the credit period is associated with providing housing during years 11 through 15 of the compliance period.

The one-third portion of the credit claimed each year is known as the "accelerated portion" of the credit or more commonly, it is referred to as the "accelerated credit." If the taxpayer fails to operate the building in compliance with IRC §42 requirements, or disposes of the building, then the one-third accelerated portion of the credit claimed in prior years is subject to "recapture."

Dispositions and Credit Recapture Relief

Generally, the disposition by sale of a low-income building is a credit recapture event. However, under IRC §42(j)(6), the credit recapture provisions are not applied under specific circumstances.

Dispositions After July 30, 2008

IRC §42(j)(6)(A), as amended by the Housing and Economic Recovery Act, provides that the credit recapture provisions are not applicable solely by reason of the deposition of a qualified low-income building (or interest therein) if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period.

Instead, the taxpayer disposing of the low-income building (or interest therein) remains subject to the credit recapture provisions should there be any reduction in the building's qualified basis resulting in the recapture of credit under IRC §42(j)(1) for the year of the disposition or any subsequent taxable year.

In addition, the taxpayer disposing of the low-income building (or interest therein) is required to notify the Secretary (IRS) if there is any reduction in qualified basis resulting in the application of the IRC §42(j) credit recapture provisions. The statutory period for the assessment of the credit recapture amount does not expire before the expiration of three years from the date the taxpayer notifies the IRS. Further, such credit recapture amount may be assessed notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

Dispositions Before July 31, 2008

If a taxpayer disposed of a low-income building (or interest therein) before the 2008 amendment, credit recapture could be avoided if two conditions were met:

1. Under former IRC §42(j)(6)(B), the taxpayer reasonably expected that the building would continue to be operated as a qualified low-income building for the remainder of the 15-year compliance period, and

2. Under former IRC §42(j)(6)(A), the taxpayer furnished the IRS with a disposition bond in an amount satisfactory to the Secretary and for the period required by the Secretary.

Bonds were posted with the IRS using Form 8693, Low-Income Housing Credit Disposition Bond, according to instructions provided in Rev. Proc. 90-60. As an alternative, taxpayers were allowed to provide Treasury securities as collateral instead of a bond. See Rev. Proc. 99-11. The bond or collateral remained in effect until 58 months after the end of the 15-year compliance period.

An owner who disposed of a low-income building (or interest therein) on or before July 30, 2008, and timely posted a bond (or collateral) may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the collateral funds. Instructions for making the election are included in Rev. Proc. 2008-60. (Note: even though it has been three years or so, taxpayers can still make the election.)

The IRS can "call a bond" to recapture credit if it is subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

Computing the Recapture Amount

IRC §42(j)(2) defines the credit recapture amount as equal to the sum of:

1. the aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if the "accelerated portion of the credit" allowable under IRC §42 were not allowed for all prior taxable years with respect to the excess qualified basis described in IRC §42(j)(1), plus

2. interest at the overpayment rate established under IRC §6621on the amount determined under (1) above for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

However, the credit associated with additions to qualified basis under IRC §42(f)(3) is not subject to recapture. (Note: this credit is accounted for on Form 8609-A, Annual Statement for Low-Income Housing Credit, lines 7-11.)

Recapture Rates

If the recapture event occurs during the first eleven years of the compliance period, then the entire one-third accelerated credit is recaptured.

The accelerated portion of the credit subject to recapture decreases during the last five years of the compliance period as the taxpayer provides the housing for which the taxpayer claimed the accelerated credit during the credit period. The recapture rate is:

- For year 12, 0.267 (or 4/15)
- For year 13, 0.200 (or 3/15)
- For year 14, 0.133 (or 2/15)
- For year 15, 0.067 (or 1/15)

Once computed, the credit recapture amount (credit plus interest) is an indivisible amount. No deduction is allowable for the interest described in (2) above for federal income tax purposes.

Reporting Recapture Events

The partnership should complete Form 8611, Recapture of Low-Income Housing Credit, to report the recapture event. A separate form is used for each building for which a computation of the credit to be recaptured is being computed.

The recaptured credit will be a partnership item passed through to the partners on the Schedule K-1, line 20 and identified using Code G, Recapture of Low-Income Housing Credit (other). The individual partners will then complete Form 8611 to apply the IRC §42 (j)(4)(A) tax benefit rule to determine the exact recapture amount and possible reduction of any credit carried forward.

If the partnership is a large partnership under IRC §42(j)(5), with 35 or more partners, that did not elect *not* to be treated as the taxpayer, then the partnership is treated as the taxpayer to which the credit was allowed. The entire recapture amount is calculated at the partnership level and the tax benefit rule under IRC §42(j)(4)(a) is not applied.

Audit Issues

The issues discussed here are specific to partnership returns.

Partnership Reported Recapture Event

1. Was the credit recapture amount reported on Form 8611 correct? At the partnership level, the taxpayer is required to report only the accelerated portion of the

credit to be recaptured. This amount is entered on Form 8611, line 7. Only large partnerships with 35 or more partners are required to compute the interest portion of the recapture amount at the partnership level on line 16 of Form 8611. See IRC §42(j)(5).

2. Did the taxpayer correctly allocate the accelerated portion of the recapture amount among *all* the affected partners? For example, did the taxpayer include Schedules K-1 for former partners subject to the credit recapture provisions?

Taxpayer Did Not Report Recapture Event

1. Did the partnership have reason to expect that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? The taxpayer will need to provide evidence that its expectation was reasonable. If not a reasonable expectation, the taxpayer is subject to the IRC §42(j) credit recapture provisions.

2. Is the building currently being operated in compliance with IRC §42 requirements? If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions. The building's current status can be confirmed by contacting the housing agency that made the credit allocation.

Additional Issues

In addition to considering the IRC §42 recapture issues, there are three additional issues to consider:

1. If the disposition occurs during the credit period, then the allowable credit is allocated between the seller and purchaser. See IRC §42(f)(4) and Rev. Rul. 91-38.

2. Did the taxpayer correctly report the gain or loss on the sale?

3. Since the taxpayer is probably a partnership and the IRC §42 project is probably the partnership's only business activity, the tax return is probably the partnership's final return. Did the taxpayer correctly report the dissolution of the partnership?

Caveat

As noted at the beginning of this article, the discussion here has been limited to the disposition of an IRC §42 project by a partnership (a "nontaxpaying" taxpayer). If the disposition is by a "taxpaying" entity, then additional rules apply and the special rules under IRC §42(j)(4) should be reviewed.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All IRC §42 cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry IRC §42 project code and tracking code designation.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an IRC §42 case, please fax Form 1900 to Grace Robertson, at 202-283-2485, for signature approval.

♫Grace Notes♫

I spent most of September wrapping up fiscal year 2011 and October will be focused on starting the "new" year off right. Beginnings and endings…or is that endings and beginnings…I'm never quite sure…but we measure (granularly and microscopically) and then quantify our success (or progress towards it), and then realize that (so Einstein demonstrated)…it was all relative anyway. But just when all the columns were reconciled, the reports were finalized, and the books were closed, those zippy little neutrinos were clocked going faster than nature's cosmic speed limit (as the theoretical physicists refer to the speed of light) and we've got to rethink the whole concept of "measuring" altogether.

So, while we await the final verdict regarding the reality of our success (and existence as a whole), which might take a year or two as the physicists triple check their speedometers, I pause to contemplate:

- As tumultuous as the past year has been, I hope there were at least one or two absolutely pleasant moments worth remembering now.
- I hope what you are doing right now is worth remembering tomorrow.
- I hope you have lots of tomorrows.

Grace Robertson
Phone: 202-283-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

Internal Revenue Service

ISSUE 47

DECEMBER 2011

The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Impact Fees & Dedicated Improvements	**3**
HUD Releases FY2012 Income Limits	**3**
Annual Certification to the State Housing Agency	**4**
Administrative Procedures	**5**
♫ Grace Notes ♫	**5**

"AMGI" and "MTSP" Income Limits

Editor's Note: This article is a follow-up to information first presented in 35th LIHC Newsletter.

Background

As part of the Housing Assistance Tax Act (HATA) of 2008, IRC §142(d)(2) was amended to add a specific "hold harmless" rule when computing the income limits used to determine whether a household is income-qualified. Specifically, any determination of *area median gross income (AMGI)* for any calendar year after 2008 is not less than the AMGI for the preceding calendar year. In other words, the AMGI may *increase* over time, but will never *decrease.*

Until the change in law, income limits were computed using HUD's determination of AMGI for Section 8. HUD annually provided tables that identified very low-income (50% of AMGI) adjusted for family size, which was used for the 20-50 minimum set-aside requirement. By multiplying the 50% AMGI by 120%, the 60% AMGI could be calculated for the 40-60 minimum set-aside requirement.

HUD is now providing two tables of AMGI determinations. The first is for use for purposes of HUD's section 8 and is subject to fluctuation over time; i.e., annual determination may *decrease* as well as increase over time.

The second table is specifically for use by owners of IRC §42 and §142(d) low-income housing projects and:

- reflects the hold harmless rules; i.e., the AMGI will never *decrease.*
- HUD provides both the 50% AMGI and the 60% AMGI, so it is not longer necessary to multiply the 50% AMGI by 120%.
- For areas where the income limits did not decrease in 2007 and 2008 because of HUD's hold harmless policy, the tables include a second set of income limits identified as "HERA Special."

And finally, to differentiate between the two tables, HUD now collectively refers to low-income housing financed under IRC §42 and §142(d) as the "Multifamily Tax Subsidy Program."

But that's not all. The National Nonmetropolitan Median Gross Income is used if:

- The project was (1) placed in service during 2006, 2007, or 2008, (2) is located in the Gulf Opportunity Zone, and (3) in a nonmetropolitan area as defined in IRC §42(d)(5)(B)(iv)(IV); i.e., the term "nonmetropolitan area" means any county (or portion thereof) which is not within a metropolitan statistical area. See IRC §1400N(c)(4).
- IRC §42(i)(8) is applicable. The IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949) and the NNMGI is greater than the AMGI. IRC §42(i)(8) is not applicable if the low-income buildings are financed with tax-exempt bonds. IRC §42(g)(8) is applicable to determinations made after July 30, 2008.

To sum it all up, as of today, a taxpayer may be using MTSP income limits, HERA Special income limits, or the National Nonmetropolitan Median Gross Income to determine whether a household is income-qualified and compute the maximum gross rent that can be charged for a low-income use.

(Continued on page 2)

(Continued from page 1)

The Here and Now Questions

The availability of so many alternative income limits raises some interesting questions.

Q1: What is "Area Median Gross Income" and how does it compare to "MTSP" income limits?

The key is appreciating the definition of "median." Really, it is just a mathematical formula for defining the center or middle of a group. In this case, it is a way of defining the "average" income for households of varying sizes in a specified area.

To compute the MTSP income limits used for IRC §42 and §142(d) purposes, HUD starts with the determination of "area median gross income," or AMGI for the Section 8 program. HUD then modifies the AMGI to satisfy the requirements imposed by Congress. Even when modified, the MTSP income limits and the HERA Special income limits are measurements of an area's median gross income, as is the National Nonmetropolitan Median Gross Income.

From a practical perspective, it means that wherever you see "area median gross income" or "AMGI" within the Code, official IRS guidance, and the Guide for Completing Form 8823, you can substitute the applicable MTSP, HERA Special, or NNMGI income limit to which the IRC §42 project is subject. HUD's "MTSP" designation doesn't make any difference.

Question #2: An income qualified tenant moved into a low-income unit in 2005, when the owner relied upon the AMGI income limits. It is a mixed low-income and market rate apartment building, so the tenant timely completed an income recertification every year, and on November 16, 2011, for the 2011 year.

The owner needs to consider whether the tenant's income has risen above 140% of the income limit for purposes of applying the Available Unit Rule under IRC §42(g)(2)(D). Which income limit should the owner use to make the comparison?

A. The Section 8 income limit used in 2005 when the household initially occupied the low-income unit,

B. The current Section 8 income limit, since Section 8 income limits were used to determine that the household was originally income qualified in 2005, or

C. The current MTSP "HERA Special" income limit."

And the answer is "C." The owner should use the *current* MTSP "HERA Special" income limits to determine whether the unit is *currently* over-income, since the project was in service during 2007 and 2008.

Question #3: A 100% low-income project is located in an area subject to the HERA Special income limits. The 15-year compliance period ended on December 31, 2010. In 2011, the buildings were purchased by a taxpayer who received a new allocation of credit for acquiring and rehabilitating the buildings for use as low-income housing. The rehabilitated buildings will be placed in service in February 2012 and the taxpayer will start claiming the credit; i.e., 2012 will be the first year of the credit period. What income limits should the taxpayer use?

A. The HERA Special income limits for FY2012, since the buildings were originally placed in service before January 1, 2009, or

B. The MTSP income limits for FY2012.

The answer is "B." For purposes of the second allocation of credit, the buildings were not in service in 2007 or 2008, so the new owner will not continue to use the HERA Special income limits. Instead, the owner will use the MTSP income limits for FY2012.

Question 4: The new owner in Question 2 has another question. Many of the low-income households occupying units at the time of the acquisition are now occupying the newly rehabilitated low-income units. Following the guidelines in the Guide for Completing Form 8823, the owner understands that these households can continue to occupy the units and the units will qualify as low-income units. As appropriate, the Available Unit Rule will also be applied. The new owner would like to know what the maximum gross rent is for these units, since the "in place" households are protected under the terms of the extended use agreement.

A. 30% of the imputed HERA Special income limits for FY2012, just as if the new owner had not acquired and rehabilitated the buildings, or

B. 30% of the imputed MTSP income limits for FY2012, since that is the maximum gross rent for new tenants.

The answer is "B." IRC §42(h)(6)(E)(ii)((II) does not allow any increase in the gross rent "*not otherwise permitted*" under IRC §42. The new allocation of credit establishes the income limits for all purposes, and the maximum gross rent limits based on the FY2012 income limits are "otherwise allowable."

The Guide for Completing Form 8823 is available at http://www.irs.gov/pub/irs-utl/lihc-form8823guide.pdf

Impact Fees & Dedicated Improvements

"Impact fees" are one-time charges imposed by a state or local government against new development or expansion of existing development to finance specific off-site capital improvements for general public use that are needed because of the new or expanded development. Taxpayers are required to pay impact fees to compensate the government entity for the financial impact of the taxpayer's development. The fees, for example, could be used to build a new school or expand a sewage system.

The question, then, is whether impact fee are includable in an IRC §42 building's eligible basis.

Rev. Rul. 2002-9, 2002-1 C.B. 614, provides specific guidance for including impact fees for determining the eligible basis. Impact fees are assessed because of a taxpayer's plans to construct a new residential building and are treated as indirect costs under IRC §263A because they directly benefit, and are incurred by reason of, a taxpayer's production activity. In accordance with Treas. Reg. §1.263A-1(f), the taxpayer must allocate the impact fees to the property produced. Because impact fees are calculated based upon the characteristics of the building and the impact fees are generally refundable if the building is not constructed as planned, the fees are 100% allocable to the building.

Similar to the treatment of impact fees, costs to construct dedicated infrastructure improvements are indirect costs within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) for purposes of IRC §263A and are capitalizable to the property produced because the costs directly benefit, or are incurred by reason of, the construction of the project. Infrastructure, for example, includes streets, curbs, sidewalks, and storm water drainage required by the local government and constructed according to the local government's specifications. To qualify, the improvements must be dedicated to the local government for public use after completion. Upon acceptance of the dedication, the local government will own and maintain the infrastructure assets. For an example, refer to PLR 200916007.

HUD Releases FY2012 Income Limits

On December 1, 2011, HUD released the FY2012 MTSP income limits. The effective date is December 1, 2011. However, Rev. Rul. 94-57 provides that taxpayers may rely on the income limits published by HUD until 45 days after HUD releases a new list of income limits, , or until HUD's effective date for the new list, whichever is later. This year, since the income limits were released and effective on the same day, taxpayers may rely on the 2011 income limits until January 14th, 2012.

The new income limits are available on-line at the address in the box.

Not only are all the income limits available in tables and Excel files, but HUD has developed a Income Documentation System (IDS) that will provide the income limits by location.

To use the system, simply identify the state and county in which the project is located, and the program will provide the 50% and 60% income limits, and if applicable, the "HERA Special" income limits. The system also includes income limits for home rule cities such as Washington, D.C. and U.S. territories.

Equally important, the program provides income limits based on when the buildings were placed in service. HUD refers to this categorization of buildings as the "vintage" and is necessary for correctly applying the hold harmless rules.

FY2012 Income Limits are available at

www.huduser.org/portal/datasets/mtsp.html

The results can be printed out and used as documentation of the income limits relied on to determine whether households are income qualified and when computing the maximum rent that can be charged.

Audit Technique for Examiners

The IDS is also helpful for IRS audit purposes. HUD maintains historical MTSP data back to FY2009, when all the new rules for income limits first took effect.

Critical information for determining the income limits are identified on Form 8609.

- The building's location is identified in Box A.
- The date the building was placed in service is documented on line 5.
- The taxpayer's minimum set-aside election is documented on line 10c.

Generally, under IRC §42(g)(2), the maximum rent that can be charged for a unit is based on the number of bedrooms and as if there are 1.5 persons in the household for each separate bedroom. Examiners will still need the taxpayer being audited to explain how the rent charged was computed, considering all the rules in addition to "generally."

Annual Certification to the State Housing Agency

As if there isn't enough list checking at this time of year, just a reminder that the annual certification to the state housing agency is coming up soon.

Under Treas. Reg. §1.42-5(c)(1), taxpayers are required to certify to the state agency that allocated the credit at least annually that, for the preceding 12-month period, that the *project* was operated in compliance with IRC §42 requirements. Most state agencies have protocols in place so that the "annual period" is the calendar year with due dates for submission.

The regulation outlines twelve specific requirements. So, here's the "Reader's Digest" condensed version of the list. You'll need to refer to the regulation for details and Code references.

1. The project met the minimum set-aside as elected by the taxpayer. If applicable, the project met the 15-40 test or the "deep rent skewed" test.
2. There was no change in the applicable fraction of any building in the project, of if there was, the certification includes an explanation.
3. An annual income certification and documentation to support the certification was received from each low-income tenant. Keep in mind that "recertifications" are not require for 100% low-income projects, but the state agency may require them.
4. All low-income units were rent-restricted.
5. All low-income units were for use by the general public.
6. The buildings and low-income units were suitable for occupancy.
7. There was no change in the eligible basis of any building in the project, or an explanation is included with the certification for the change.
8. Tenant facilities were provided on a comparable basis without charge to all tenants in the buildings,
9. Reasonable attempts were made to rent low-income units before renting units to tenants not having a qualifying income; i.e., compliance with the Vacant Unit Rule.
10. If the income of tenants of a low-income unit in the building increased above the limit allowed, the next available unit of comparable or smaller size in the building was or will be rented to tenants having a qualifying income; i.e., compliance with the Available Unit Rule.
11. An extended use commitment was in effect. This commitment is also referred to as the extended use agreement or land use restriction agreement (LURA).
12. All low-income units in the project used on a nontransient basis, unless an exception applies.

For more information about the filing of Form 8823,

visit www.irs.gov

http://www.irs.gov/pub/irs-utl/lihc-form8823guide.pdf

Even though the certification is made to the state agency, failure to complete the annual certification is reportable to the IRS on Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, line 11d. Some of the common problems reported to the IRS are:

1. The certification is incomplete, e.g., the taxpayer did not certify compliance with a specific IRC §42 requirement.
2. The certification isn't signed, which really means it isn't a "certification" at all.
3. Most state agencies are very forgiving about late certifications, but at some point, usually after sending reminders to the taxpayer, the state agency will report that the certification has not been received, sometimes for multiple years.

Which brings us to another question. Who is responsible for making the certification? As an industry practice, many IRC §42 projects are operated by management companies acting as agents of the taxpayer, and by agreement between the parties, the agent becomes responsible for submitting the certification. For IRC §42 purposes, however, the regulation is quite clear. Treas. Reg. §1.42-5(g) explains that "compliance with the requirements of section 42 is the responsibility of the owner of the building for which the credit is allowable" That includes making the annual certification to the state agency.

So how does the IRS view the annual certification? The certification is documentation prepared contemporaneously to the occurrence of the events, which is, in the absence of evidence to the contrary, credible evidence of compliance with specific IRC §42 requirements, even if "self-prepared."

If audited, the certification can eliminate significantly detailed analysis of a taxpayer's records. But what happens if a taxpayer didn't make the certification?

First, most of the items on the list can be documented with "paperwork" the taxpayer should have, or can possibly be reconstructed if need be. Keep in mind that audits are generally conducted two to three years after the end of the tax year under audit and some "paperwork" is, quite frankly, onerous to reconstruct.

Take for example, the Available Unit Rule. A taxpayer must document compliance by identifying all over-income units and the size of the units every time a unit is rented to a nonqualifying tenant. The rule is specifically applicable to mixed-use projects where the owner is renting units at market rate. If the issue is raised for an owner of a 100% low-income project where income recertifications are not required, the burden of reconstructing tenant files may be impossible. See Newsletter #32 for additional discussion.

The real issue with after-the-fact documentation is that it is often incomplete and lacks credibility. In some cases, it is virtually impossible to provide satisfying evidence of compliance.

(Continued on page 5)

Administrative Procedures

Project/Tracking Code:
All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements:
As IRC § LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

(Continued from page 4)

For example, as part of the annual certifications, taxpayers certify that the project was suitable for occupancy. In the absence of the self-certification, an IRS examiner may ask if the project was inspected by the state agency as part of its compliance monitoring responsibilities, which would provide *very* credible evidence. But what if the state agency didn't inspect the project? What then? Maybe the project was physically reviewed by HUD for one of its programs, or maybe by a local government agency looked at it. But if not, then there is nothing contemporaneously prepared—not a third-party, independent review or self-certification—to evidence that the project was suitable for occupancy. What happens then? Doubt.

Every case is different, but a failure to certify raises questions about the taxpayer's on-going compliance with the requirements for operating the IRC §42 project. Most certainly, an examiner will consider expanding the audit to include a more in-depth analysis. And if so, providing retroactively prepared documentation will most likely be difficult, if not impossible, and will not have the same credibility as evidence contemporaneously prepared at the time that the event occurred.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at ***Grace.F.Robertson@irs.gov****.*

♫ Grace Notes ♫

It's time to thing about my favorite things, which is always a bit of a problem since attempting to rank things I like in priority order baffles me into paralysis. Frankly, the only "favorites" I find useful are bookmarked websites on my computer's browser. But I'll try.

- Whiskers on kittens, particularly those belonging to Hannah, the big white cat with red markings, and Olivia the Siamese.
- Learning new things. Hence this "published" newsletter.
- Words like "onerous" and "contemporaneous." !

And friends, in no particularly order of priority, including, but certainly not limited to:

♫ Friends (all of them) who continue to put up with me, bless their hearts!

♫ New friends who serendipitously (another favorite word) crossed my path this year. My Christmas list is growing and the Post Office is saved!

♫ Old friends who send me a Christmas card first. I'd be first but it's a long commute around the beltway; I have no other plausible excuse!

♫ Older friends that have been friends for so long that I can't remember when we weren't friends. No explanation needed.

♫ Lost friends found this year. Thank goodness for the internet and our total lack of privacy. Well, at least if your name isn't common and you're listed in the white pages.

♫ Friends lost this year. I can't send a Christmas card but they remain safely embraced in my heart.

♫ And not to carry this way too far, childhood friends.

Especially (another favorite word) one little girl who moved away after second grade. I missed her tremendously and for my birthday the following year, my mother arranged for the two of us to see The Sound of Music together. It had just been released and was playing in one of the bigger, fancier, old-time theatres in uptown Salt Lake City ("downtown" Salt Lake was two blocks south). We felt so grown up in our fancy dresses, going to the huge theatre all by ourselves. We had a wonderful time together that I'll never forget. Little did we know that "My Favorite Things" would become a holiday classic. Just can't help thinking of my friend whenever I hear that song...

...but I've digressed. I've got oodles more favorite things on my list, but I've got a couple of "naughty and/or nice" lists to attend to right now...and besides, you're working on your own list of favorite things.

Happy Holidays!

Grace Robertson
(202) 203-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

Internal Revenue Service

ISSUE 48

MARCH 2012

The LIHC Newsletter provides a forum for networking and sharing information bout IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Suitability for Occupancy: Infestations	**3**
Dispositions in the 11th Year of the 15-Year Compliance Period: Allocating the Credit Between the Buyer and Seller	**4**
LIHC Newsletter #47 Corrections	**5**
Administrative Procedures	**6**
♫ Grace Notes ♫	**6**

"Relying" on New Income Limits

As noted in the last newsletter, HUD released the FY2012 MTSP income limits on December 1, 2011, and the effective date is also December 1, 2011. For purposes of IRC §42, Rev. Rul. 94-57 provides that taxpayers may "rely" on the income limits published by HUD until 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list, whichever is later. This year, since the income limits were released and effective on the same day, taxpayers may rely on the 2011 income limits until January 14th, 2012.

The 45-day implementation period hasn't been much of an issue in the past because the new limits remained the same or increased and it was clearly to the taxpayer's advantage to adopt the new income limits as quickly as possible. Where the income limits decreased this year, different issues become apparent and we're left wondering to what extent taxpayers can really "rely" on the outdated income limits during the implementation period.

The straightforward answer is that taxpayers can rely on the outdated income limits for all purposes, and may choose which income limits to use (outdated or new) based on which provides the greater tax benefit.

Three examples are presented here.

Income Certifications

A taxpayer placed a new low-income building in service in July of 2011 and started renting units using the 2011income limits to determine whether households are income-qualified. 2012 will be the first year of the credit period. The 2012 income limits are lower than the 2011 income limits.

- All of the tenants determined to be income-qualified using the 2011 income limits before the beginning of the credit period on January 1, 2012, continue to be qualified low-income households. Further, for purposes of "testing" income at the beginning of the credit period under Rev. Proc. 2003-82, the taxpayer may rely on the 2011 income limits to determine whether the Available Unit Rule is applicable.

- The owner may continue to qualify new tenants using the 2011 income limits, as long as the effective date for the income certification is before or on January 14th, 2012. The effective date is the date the tenant actually moves into the unit.

Gross Rent Floor

Under IRC §42(g)(2)(A), a unit qualifies as a low-income unit when the gross rent does not exceed 30% of the

(Continued on page 2)

"Relying" on New Income Limits

(Continued from page 1)

imputed income limit unit under IRC §42(g)(2)(C). IRC §42(g)(2)(A) includes a rent "floor" so that the income limits used to compute the rent are never less than the income limits used to compute the rents "for the earliest period the building was included in the determination of whether the project is a qualified low-income housing project." In English, the rents are never going to be lower than the maximum gross rent for the first year of the credit period.

But what are the rent limits for the first year? Under Rev. Proc. 94-57:

- If the taxpayer received an allocation of credit under IRC §42(h)(1), the IRS will treat the gross rent floor as taking effect on the date the state agency initially allocated the housing credit to the building.

- For a bond-financed building described in IRC §42(h)(4), the IRS will treat the gross rent floor as taking effect on the date the state agency initially issues a determination letter to the building.

However, in either case, the IRS will treat the gross rent floor as taking effect on a building's placed in service date if the building owner designates that date as the date on which the gross rent floor will take effect for the building. An owner must make this designation to use the placed in service date and inform the state agency that made the allocation to the building no later than the date on which the building is placed in service.

What happens if a taxpayer places a low-income building in service between December 1, 2011 and January 14, 2012 (inclusive), designates the placed-in-service date to establish the rent floor, and the 2012 income limits are lower than the 2011 income limits? Clearly, it is to the taxpayer's advantage to use the 2011 income limits to establish a higher gross rent floor, but can the taxpayer rely on the 2011 income limits for this purpose?

The straightforward answer is that taxpayers can rely on the outdated income limits for all purposes, and may choose which income limits to use (outdated or new) based on which provides the greater tax benefit.

Yes. The taxpayer may rely on the 2011 income limits up to and including January 14, 2012, for all purposes.

Designation as Rural Area

The final example involves low-income housing projects located in rural areas. The National Nonmetropolitan Median Gross Income (NNMGI) is used instead of HUD's MTSP income limits if:

- IRC §1400N(c)(4), Special Rule for Applying Income Tests, is applicable. The IRC §42 project was:
  1. placed in service during 2006, 2007, or 2008,
  2. is located in the Gulf Opportunity Zone, and
  3. in a nonmetropolitan area as defined in IRC §42(d)(5)(B)(iv)(IV); i.e., the term "nonmetropolitan area" means any county (or portion thereof) which is not within a metropolitan statistical area.

- IRC §42(i)(8) is applicable. The IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949) and the NNMGI is greater than the AMGI. IRC §42(i)(8) is not applicable if the low-income buildings are financed with tax-exempt bonds. IRC §42(g)(8) is applicable to determinations made after July 30, 2008.

What happens if the location loses it's designation as a "rural" area?

- For purposes of determining whether a household is income-qualified, the taxpayer can continue to use the NNMGI as long as the effective date of the income certification is before January 15, 2012.

- For purposes of determining whether a household is income-qualified, the taxpayer must start using HUD's MTSP income limits for certifications effective after January 14, 2012.

The gross rent floor established using the NNMGI remains in place and can be relied upon, even though the taxpayer is now using the MTSP income limits.

Suitable for Occupancy: Infestations

No one, under any circumstances, should feel compelled to inspect a unit, building, or site when the situation is dangerous or the life or health of the person conducting the inspection is threatened in any way.

Under IRC §42(i)(3), a "low-income" unit must be rent restricted and the household occupying the unit must be income-qualified. However, even if these two requirements are met, a unit is not treated as a low-income unit unless the unit is suitable for occupancy. The Code provides that the "suitability" of a unit for occupancy is determined under regulations (Treas. Reg. §1.42-5) taking into account local health, safety, and building codes.

In CCA 201042025, Chief Counsel clarified two issues:

- A violation of the HUD physical condition standard alone is sufficient for a violation of IRC §42(i)(3)(B).
- A taxpayer, in response to the IRS finding a violation, may raise an affirmative defense by proving that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result where as the HUD standard does not reach a taxpayer favorable result. Under these circumstances, the local law would control as respects the violation itself. That is, the local law would be the standard against which "suitability for occupancy" would be evaluated.

As a result, for IRS purposes, we look to HUD's Uniform Physical Condition Standards to determine whether low-income units, buildings and sites are suitable for occupancy.

Uniform Physical Condition Standards (UPCS)

The UPCS (24 CFR §5.703) require housing to be decent, safe, sanitary and in good repair. The major areas of consideration include the site, building exterior, building systems, dwelling units, common areas, and health and safety concerns. The description of "Health and Safety Concerns" reads:

> "…All areas and components of the housing must be free of health and safety hazards. These areas include, but are not limited to, air quality, electrical hazards, elevators, emergency/fire exits, flammable materials, garbage and debris, handrail hazards, infestation and lead based paint…"

HUD has also provided a Dictionary of Deficiency Definitions, which describes infestations for inspection purposes as:

> "You see evidence of infestation of insects -including roaches and ants- throughout a unit or room, especially in food preparation and storage areas."

Bed Bugs

Bedbugs are small wingless insects that feed solely on the blood of warm-blooded animals (including humans). They are also a growing infestation problem. Historically, bed bugs were commonly found in homes, dormitories, hotels and motels, and on military bases. In recent years, infestations are spreading to nonresidential public and commercial buildings. The Center for Disease Control has stated that bed bugs are not known to transmit disease, but it is recognized that bed bugs can cause a variety of negative physical health, mental health and economic consequences.

Controlling bed bugs poses unique challenges. Not only is it a complex environment, but early detection is unlikely and visual inspections are difficult. Bed bugs may be dispersed over large areas, so identifying the point of introduction may be problematic and reintroduction is always possible.

Physical Inspections and Reporting Noncompliance

Treas. Reg. §1.42-5 requires state housing agencies to conduct on-site physical inspections for all buildings in the project by the end of the second calendar year following the year the last building in the project is placed in service and at least once every 3 years thereafter. In addition to the buildings, at least 20% of the low-income units must be inspected.
Treas. Reg. §1.42-5 also required state agencies to report noncompliance (including bed bug infestations) to the IRS on Form 8823, Low-Income Housing Agencies Report of Noncompliance or Building Disposition.

(Continued on page 4)

Bedbugs…...

(Continued from page 3)

Questions and Answers

With regard to possible insect infestations, including bed bugs:

1. What should a state agency do if inspecting a building or individual unit poses a threat to the safety of the person doing the inspection?

   No one, under *any* circumstances, should feel compelled to inspect a unit, building, or site when the situation is dangerous or the life or health of the person conducting the inspection is threaten in *any* way.

   Further, if the physical condition is unsafe for the person conducting the inspection, then the unit/building/site is unsafe for low-income households occupying the premises and the unit/building/site should be reported to the IRS as unsuitable for occupancy.

2. Since bed bug infestations are difficult to identify, when should noncompliance be reported?

   Like all noncompliance issues, bed bug infestations should be reported to the IRS if (1) the infestation was discovered through inspection or review, or (2) some other manner; i.e., credible information received from a reliable source and includes reasonable grounds for being believed. Note: If, after filing a Form 8823, it is determined that the building was *never* infested with bed bugs, then an amended Form 8823 should be filed to rescind the original filing. See Newsletter #44 for details.

3. Since bed bug infestations are difficult to eradicate, when should a unit or building be considered back in compliance?

   The noncompliance is considered corrected when the owner demonstrates compliance with local health, safety, or building codes specific to insect infestations and eradication.

Dispositions in the 11th Year of the 15-Year Compliance Period: Allocating the Credit Between the Buyer and Seller

Under IRC §42(f)(1), the *credit* period is defined as the period of ten *taxable years* beginning with the taxable year in which the building is placed in service, or at the election of the taxpayer, the succeeding taxable year. Since the building will most likely be placed in service sometime during the taxable year, there is a special rule for computing the Applicable Fraction to account for when the units are first occupied by qualified low-income tenants. Under IRC §42(f)(2), the applicable fractions for each month of the taxable year that the units were placed in service are summed and divided by 12. Effectively, the Applicable Fraction for the first *taxable year* of the credit period is an "averaged" Applicable Fraction as if the building had been in service the entire *taxable year*. Any credit not allowable for the first year of the credit period is allowable in the first taxable year after the credit period, or more clearly, the 11th year of the 15-year compliance.

The question, then, is how to treat the credit allowable in year 11 of the compliance period, if there is a disposition of the building during the year.

Consider a simple example for a calendar year taxpayer: A low-income building with one low-income unit (single family home) received an allocation of credit equal to $10,000. The home is placed in service in May of 2001 and is first occupied by a qualifying tenant in July. 2001 is the first year of the credit period and the taxpayer computes the Applicable Fraction using the special rule. For July through December the Applicable Fraction is 100%: 6 x 100% = 600%, which is then divided by 12, which is 50%. The taxpayer is entitled to claim $5,000 in 2001 and if the taxpayer remains compliant with IRC §42 re-

(Continued on page 5)

(Continued from page 4)

quirements, the taxpayer will be able to claim $5,000 for the 2011 taxable year.

However, on October 1, 2011, during the 11th year of the 15-year compliance period, the taxpayer disposes of the building. Under IRC §42(f)(4), the credit is allocated between the seller and buyer based on the number of days during such year that each party owned the building. Under Rev. Rul. 91-38, the credit can be allocated based on the number of months each party has ownership. How should the credit be allocated?

Option A:

> Since the credit claimed for 2001 is associated with providing housing from July to December, the 11th year credit is associated with providing housing from January through June 2011. The entire $5,000 credit should be allocated to the seller.

Option B:

> Since the buyer owned the building at the end of the 11th year of the compliance period, the entire credit for the 11th year is allocated to the buyer.

Option C:

> If the building is compliant with IRC §42 requirements at the end of the 11th year of the compliance period, the credit allocated to the seller is 9/12 x $5,000= $3,750 and the buyer would get $1,250, computed as 3/12 x $5,000.

Options A and B are incorrect. The 11th year credit isn't associated with any particular months of the taxable year, nor is the allowable credit associated with the party owning the building at the end of the 11th year of the compliance period because there is a special allocation rule under IRC §42(f)(4) applicable to all years that the credit is allowable.

Option C is the correct treatment as long as the building is compliant with IRC §42 requirements. If, at the end of the 2011 taxable year, the building is not in compliance, then no credit is allowable to either the seller or the buyer to the extent of the noncompliance, and the seller is subject to the IRC §42(j) recapture provisions. The recapture rate for the 11th year is .333.

LIHC Newsletter #47 Corrections

There were three errors in the last newsletter that need to be corrected.

- Even though it is labeled #44, the last newsletter issued in December 2011 really was #47.
- In Question #4 on page 2, there is a reference to the "new owner in Question 2." That should be the new owner in Question 3.
- The phone number at the end of "Grace Notes" is incorrect. It should be (202) 283-2516. My sincere apologies to those of you who tried to call me.

Administrative Procedures

Project/Tracking Codes:

All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project

Revenue Protection:

Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:

If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:

As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

♫ Grace Notes ♫

The last newsletter was prepared in a new pdf format and I asked you to let me know how you like it. Some of you responded almost immediately, emphatically voting to keep the new look; I suspect that anything in Adobe pdf is preferable to anything is Word for these subscribers. More responses were sent over the next week or so, and included considered rationales and suggestions for improvements. Even so, the over-whelming response has been that the new pdf format is preferred.

So, in true democratic fashion, the majority will prevail and I'll be using the Adobe pdf format from now on. However, the reasons why some of you prefer the Adobe pdf format are the exact same reasons why others prefer the Word format. So, for those of you in the minority, who prefer the Word format unencumbered by the preferences of the majority, please send me an e-mail letting me know you want the Word version. Otherwise, you'll just keep getting the pdf format.

And just in case you're thinking, "Gee, isn't Grace being nice?", I want to dispel that fleeting thought right now…I'm really not. I write the newsletter in the Word format (easier for me) and then "publish" in the Adobe pdf format, so it is no extra burden for me to send the Word-formatted newsletter to those who want it. Oh…one last thought…*please* don't ask to receive both versions, which would require me to keep duplicate distribution lists.

Grace Robertson
(202) 283-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

ISSUE #49

SEPTEMBER 2012

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Notice of Proposed Rulemaking for Treas. Reg. §1.42-10, Utility Allowances	**2**
Revised Dictionary of Deficiency Definitions Released by HUD	**3**
Subscribing to the LIHC Newsletter	**4**
Guide for Completing Form 8823	**4**
♫ Grace Notes ♫	**4**

Rev. Proc. 2012-27: Notification Procedures under IRC §42(j)(6)(B)

Background

As amended by HERA in 2008, IRC §42(j)(6) provides that there is no recapture solely because a taxpayer disposes of a low-income building (or interest therein) if the taxpayer reasonably expects that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period. However, if there is any reduction in the building's qualified basis (other than the disposition) which results in an increase in tax in the year of the disposition or any subsequent year, the taxpayer is subject to recapture under IRC §42(j).

The Code also provides a unique statutory period for assessing the recapture amount if a recapture event occurs after the disposition. This special rule is applicable notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment. IRC §42(j)(6)(B)(i) states:

> (i) the statutory period for the assessment of any deficiency with respect to such increase in tax shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of such reduction in qualified basis,...

Providing Notice

Rev. Proc. 2012-27 provides the instructions for providing notice to the IRS if there has been a reduction in qualified basis resulting in an increase in tax under IRC §42(j).

A taxpayer must submit a letter to the Internal Revenue Service, signed by the taxpayer and including the following:

1. A lead-in declaration stating: "By this letter I am making the notification prescribed by IRC §42(j)(6)(B)(i);
2. The taxpayer's name, address, and taxpayer identification number;
3. The name (if any), address, and Building Identification Number of each building to which the taxpayer's disposition relates. If a taxpayer received a credit from a pass-through entity but does not know the information required by the preceding sentence, the taxpayer must provide the name and employer identification number of the pass-through entity from which the taxpayer received the credit;
4. To the extent known, the name, address, and taxpayer identification number of any person(s) to whom the increase in tax under IRC §42(j)(6)(B) applies as a result of a reduction in the qualified basis of any building to which the taxpayer's disposition relates; and

(Continued on page 2)

(Continued from page 1)

5. A concluding declaration stating: "Under penalties of perjury, I declare that I have examined this letter and the representations made therein, and to the best of my knowledge and belief, they are true, correct, and complete."

The taxpayer must mail the letter to the address where the most current Form 8609, Low-Income Housing Credit Allocation and Certification, would be filed. The instructions for Form 8609 contain the address and are available on the IRS website.

For purposes of determining the 3-year period for assessment under IRC §42(j)(6)(B), the Secretary is deemed to be notified as of the postmark date of the letter.

Clarification

It isn't necessary to provide the notice simply because a taxpayer disposed of a low-income building (or interest therein). Notice should be provided only when a recapture event (i.e., reduction of qualified basis) has occurred *after* the disposition.

Helpful Information

Although not explicitly requested in the revenue procedure, including a *concise* description of the event causing the reduction in qualified basis in the notice is helpful.

Notice of Proposed Rulemaking for Treas. Reg. §1.42-10, Utility Allowances

On August 7, 2012, the IRS provided a notice of proposed rulemaking to amend Treas. Reg. §142-10 to clarify 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.

After the 2008 amendment of the 1994 final regulation, commentators requested clarification about how the regulations apply to submetering arrangements. Typically, a submetering system has a master meter, which is owned or controlled by the utility provider and which the utility provider uses to measure overall consumption and then bill the owner. The building owner (or the owner's agent) use unit-based meters (submetering) to measure utility consumption and then bill each residential unit based on actual consumption.

Notice 2009-44 was issued to clarify that, for purposes of Treas. Reg. §1.42-10(a), utility costs paid by a tenant based on actual consumption in a submetered rent-restricted unit are treated as paid directly to the utility company and not by or through the owner of the building. To summarize the notice:

- For RHS-assisted buildings, buildings with RHS tenant assistance, HUD-regulated buildings, and rent-restricted units in other buildings occupied by tenants receiving HUD rental assistance, the applicable RHS or HUD rules apply. See Treas. Reg. §1.42-10(b)(1)-(4)(i).
- For all other tenants in rent-restricted units in other buildings under Treas. Reg. §1.42-10(b)(4)(ii):

  1. The utility rates charged to tenants in each sub-metered rent-restricted unit must be limited to the utility company rates incurred by the building owners (or their agents);
  2. If building owners (or their agents) charge tenants a reasonable fee for the administrative costs of sub-metering, then the fee will not be considered gross rent under *§42(g)(2)*. The fee must not exceed an aggregate amount per unit of 5 dollars per month unless State law provides otherwise; and
  3. If the costs for sewerage are based on the tenants' actual water consumption determined with a sub-metering system and the sewerage costs are on a combined water and sewerage bill, then the tenants' sewerage costs are treated as paid directly by the tenants for purposes of the utility allowances regulations.

The notice also explained that Treas. Reg. §1.42-10 would be amended to incorporate the guidance set forth in the notice and requested comment. Comments were received and the comments were taken into consideration in developing the proposed regulation. The proposed regulation also includes additional modifications.

(Continued on page 3)

(Continued from page 2)

First, if two or more utilities such as electricity and water are treated as submetered under the proposed regulation, then the building owner (or its agent or other party acting on behalf of the building owner) must separately state the amount billed to the tenants for each submetered utility.

Second, if a building owner imposes an administrative fee on a unit's tenants for the costs of administering a submetering arrangement, then the fee generally is not included in gross rent for purposes of IRC §42(g)(2). The exclusion from gross rent does not apply to any amount by which the aggregate monthly fee for all of a unit's utilities under one or more submetering arrangements exceeds the lesser of the following: (A) Five dollars per month or (B) the owner's actual monthly costs paid or incurred for administering the arrangement (whether internal costs or amounts paid to third parties).

The proposed regulation also amends Treas. Reg. §1.42-10(b)(4)(ii)(A) to clarify that for all rent-restricted units not subject to the rules under Treas. Reg. §1.42-10(b)(1)-(4)(i), the owner may choose one of the options under Treas. Reg. §1.42-10(b)(4)(ii)(B)-(E) or the applicable PHA utility allowance for determining the utility allowance for those rent-restricted units.

Before the proposed regulation is adopted as a final regulation, consideration will be given to any comments that are received by the IRS by October 9, 2012. A public hearing is scheduled for November 27, 2012, in Washington, DC.

For a more detailed discussion of the proposed changes to Treas. Reg. §1.42-10, and information about submitting comments or attending the public hearing, the notice is available in the Federal Register, Vol. 77, No. 152, August 7, 2012.

Revised Dictionary of Deficiency Definitions Released by HUD

On August 7, 2012, HUD provided notice in the Federal Register to, in part, make changes to the Dictionary of Deficiency Definitions (Dictionary). This is important for the IRC §42 program because residential rental units must be suitable for occupancy (see IRC §42(i)(3)(B)) and the IRS has adopted the Dictionary for purposes of evaluating whether IRC §42 housing meets this standard.

The dictionary is still divided into the same six sections:

1. Site Inspection
2. Building Exterior Inspectable Items
3. Building Systems Inspectable Items
4. Common Areas Inspectable Items
5. Unit Inspectable Items
6. Health and Safety Inspectable Items

Each section is still divided into "Inspectable Items" with specific deficiencies described in ascending levels of severity. However, revisions have been made for precision of measurements, ranking of the deficiency's severity, and reorganizing the deficiencies (just a little) to be more concise and avoid "double" counting a single deficiency.

Important Points

- The Dictionary is part of HUD's protocol for inspecting their housing projects. The protocol includes a scoring system based on weighted values assigned to the deficiencies and different levels of severity, resulting in an overall score for the project. *The IRS does not use the scoring system or consider an overall "score" when determining whether housing is suitable for occupancy.*
- In CCA 201042025, Chief Counsel explained that even though the IRS uses the Dictionary, "a taxpayer, in response to the IRS finding a violation, may raise an affirmative defense by proving that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result where as the HUD standard does not reach a taxpayer favorable result. Under these circum-stances, the local law would control as respects the violation itself."

Effective Dates

State agencies must inspect LIHC projects to ensure that the low-income buildings and units are suitable for occupancy. Under Treas. Reg. §1.42-5(C)(2)(ii)(B), on-site inspections must be made at least once every three years. State agencies should use the revised Dictionary for all inspections conducted after December 31, 2012.

(Continued on page 4)

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:
As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

(Continued from page 3)

For IRS audit purposes, we will use the version of the Dictionary that was used by the state agency to conduct the inspection and report the noncompliance to the IRS. The determination will be based on the date entered on line 8 of Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

References

The complete Dictionary as revised, with explanations of each change, is included with the notice in the Federal Register, Vol. 77, No. 154, August 9, 2012.

For more information about the "suitability for occupancy" requirement, please refer to Newsletter #43…the *whole* newsletter.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

♫ Grace Notes ♫

I found myself in traffic on August 5th, listening intently to the radio and enthralled as Curiosity sat down on Mars. Incredible! And I almost jumped for joy along with all those NASA engineers! And then, in their jubilation, they explained when they anticipated getting the first pictures of the landing site back from Mars… considering Mars "time."

Mars *time?* What's this? So, as soon as I got home (okay, not really right when I got home, but later that night when the cats were asleep) I got on the internet to find out just what "Mars time" is. So, just in case you, too, want to know….

- Mars tilts and rotates much like the earth, experiences spring, summer, fall and winter, and its day is about the same length.
- It takes longer to rotate around the sun, so it's year is about twice a long as the earth's, and it's orbital "eccentricity" is considerably larger than earth's, which means that it's orbit is much less circular than earth's, which means that the lengths of the Marian seasons differ considerably.
- The average length of a Mars "solar day" is 24 hours, 39 minutes, 35.24409 seconds. For earth, its 24 hours, zero minutes and 0.002 seconds. Thus, Mar's solar day is about 2.7% longer than earth's.
- The operations team works on Mars time, with a work schedule synchronized to the local time at the landing site on Mars, which means that the crew's schedule slides about 40 minutes later in Earth time each day. They even have wristwatches on Mars time.

Cool, huh? There's a whole lot more to learn, but I don't want to spoil your fun (see Newsletter #40). I'm just glad I only have to deal with Eastern, Central, Mountain, and Pacific Time zones, daylight savings time, and a few outlier territories half way around *this* sphere.

Grace Robertson
(202) 283-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

ISSUE #50

DECEMBER 2012

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Hurricane Sandy: IRS Relief Measures	1
Pre-Contact Analysis: Revenue Agent Q&A	2
Income Limits for 2013: New and Revised	3
Revenue Procedure 2012-41: Inflation-Adjusted Items	3
Subscribing to the LIHC Newsletter	4
Guide for Completing Form 8823	4
Administrative Procedures	4
♫ Grace Notes ♫	4

Hurricane Sandy: IRS Relief Measures

According to Wikipedia, Hurricane Sandy devastated portions of the Caribbean, Mid-Atlantic, and Northeastern United States, with lesser impacts in the Southeastern States, Midwestern States, and Eastern Canada. In total, 24 states, including the entire eastern seaboard from Florida to Maine and west across the Appalachian Mountains to Michigan and Wisconsin, were affected. The storm was the largest Atlantic hurricane on record with a diameter of winds spanning 1,100 miles. Losses dues to damages and business interruption are estimated at more the $65.5 billion, second only to damages caused by Hurricane Katrina. At least 253 people in seven countries lost their lives.

IRS Relief Measures

The IRS is providing tax relief for victims of Hurricane Sandy. It's too long a list to include here, but information is available on the IRS website.

IRC §42 Relief Measures

Rev. Proc. 2007-54 provides temporary relief measures for state housing credit agencies and owners of IRC §42 projects in locations declared major disaster areas by the President.

- Relief measures are provided based on stage of development; i.e., under construction, in the first year of the 10-year credit period, and beyond the first year of the credit period but within the 15-year compliance period.
- The time for state agencies to complete their compliance monitoring activities for damaged buildings is extended.
- Under specific circumstances and with agency approval, owners of IRC §42 projects within the agency's jurisdiction can provide temporary emergency housing to displaced low-income individuals that were living within the agency's jurisdiction at the time of the major disaster.

On November 5th, 2012, the IRS released Notice 2012-48 to provide additional relief measures specific to Hurricane Sandy. With the approval of the housing agency having jurisdiction, IRC §42 housing outside the disaster areas can be *temporarily* rented to households displaced by the hurricane, without regard to the household's income.

Pre-Contact Analysis: Revenue Agent Q&A

I'm auditing a taxpayer owning IRC §42 low-income housing. The taxpayer filed Form 8586, Low-Income Housing Credit, and claimed a $750,000 credit on line 3 for buildings placed in service before 2008. On line 1, the taxpayer indicated that there 20 Forms 8609-A, Annual Statement for Low-Income Housing Credit. I'm working on the pre-contact analysis and have a few questions.

Question #1: I reviewed the Forms 8609-A and discovered, based on the building identification numbers (BIN) on line A, that there are two Forms 8609-A for each BIN. Why are there two Forms 8609-A for each of the 10 buildings?

Answer #1: A taxpayer must file a Form 8609-A for each allocation of credit and a low-income building may receive more than one allocation of credit. Two common examples:

- The taxpayer may have acquired an existing building and substantially rehabilitated the building as residential rental units. The cost of acquisition would qualify for the 30% present value credit and the rehabilitation costs would qualify for the 70% present value credit.
- The taxpayer may have incurred more costs than anticipated and received an additional or "supplemental" allocation of credit in a year subsequent to the year of the original allocation of credit.

Credit allocations are documented on Form 8609, Low-Income Housing Credit Allocation and Certification, and there should be a one-to-one match between the Forms 8609 documenting the credit allocations and Forms 8609-A filed with the tax return. The Forms 8609 should be requested from the taxpayer.

Question #2: I also noticed that the taxpayer didn't answer the questions in Part I of the Forms 8609-A filed with the tax return. Is that a problem?

Answer #2: Part I satisfies the annual certification requirement under IRC §42(l)(2), which reads:

> **Regardless of type or class of tax return, IRM 4.10.2.3.2 requires examiners to review the return in its entirety for large, unusual, and questionable items. This review should include not only the line items and credits claimed, but also such things as the balance sheet, elections, schedules, or any other documents attached to the return.**

(2) Annual reports to the Secretary. The Secretary may require taxpayers to submit an information return (at such time and in such form and manner as the Secretary prescribes) for (A) the qualified basis for the taxable year of each qualified low-income building of the taxpayer,

(A) the information described in paragraph (1)(C) for the taxable year, and

(B) such other information as the Secretary may require.

(C) each taxable year setting forth--

The penalty under section 6652(j) shall apply to any failure to submit the return required by the Secretary under the preceding sentence on the date prescribed therefor.

Line A identifies the low-income building by its BIN and Line B describes the type of building (newly constructed, existing building, or rehabilitated building). Without the information on these two lines, it is difficult to match the Forms 8610-A to the associated Forms 8609.

Lines C, D, and E provide a certification of compliance with IRC §42 requirements.

- Line C: Does the taxpayer have the related Form 8609 signed and issued by the state agency that allocated the credit? If a taxpayer does not have the Forms 8609 executed by the state agency, the taxpayer cannot complete the First-Year Certification required under IRC §42(l)(1). See Newsletter #31.
- Line D: Was the building part of a qualified low-income housing project at the end of the taxable year? A qualified low-income "project" must meet the minimum set-aside requirement under IRC §42(g)(1). The low-income housing "project," which may consist of more than one low-income building, will not qualify for *any* credit unless it includes a minimum number of qualified low-income rental units.
- Line E: Was there a decrease in qualified basis? A decrease in qualified basis affects the computation of the credit and if the qualified basis at the end of the taxable year under audit is less than the qualified basis at the end of the prior taxable year, the taxpayer is subject to the IRC §42(j) recapture provisions.

A taxpayer may simply overlook the Part I certification when computing the allowable credit. However, if completing the certification accurately means reporting possible reductions in the allowable credit

(Continued on page 3)

(Continued from page 2)

and/or identifying recapture events, a taxpayer may leave the certification blank rather than file an inaccurate certification. The failure to complete the annual certification should be addressed as part of the interview with the taxpayer.

Question #3: The taxpayer didn't claim any credit and there's an explanation at the bottom of the Forms 8609-A clarifying that the credit period has ended. Do I have an issue?

Answer #3: Yes. Even though the taxpayer didn't claim credit, the credit recapture provisions are still applicable. Any reduction in a low-income building's qualified basis resulting from an adjustment to either the Eligible Basis or Applicable Fraction may result in the recapture of a portion of the credit claimed in prior years.

Taxpayers claim the IRC §42 credit over a ten-year credit period, but are required to provide low-income housing for fifteen years. In effect, taxpayers are claiming credit in advance of providing the low-income housing during the last five year of the compliance period, after the credit period has ended. One-third of the credit claimed each year during the credit period is associated with providing housing during years 11 through 15 of the compliance period. This on-third portion of credit is commonly referred to as the "accelerated credit."

The "accelerated credit" claimed in prior years is subject to "recapture." Under IRC §42(j), the recapture provisions are applied when, as of the close of any taxable year in the 15-year compliance period, the building's qualified basis is less than the qualified basis as of the close of the preceding taxable year. So, even though the taxpayer doesn't claim credit in years 11 through 15, the recapture provisions still apply and may result in the assessment of additional tax.

Two caveats to the general rule explained above:

- Under IRC §42(f)(2), a taxpayer may claim credit in the 11th year that wasn't allowable in the first year. This credit is also subject to recapture.
- The "2/3 credit" for additions to qualified basis under IRC §42(f)(3) is not subject to recapture. If the taxpayer is claiming this credit, it is accounted for on Form 8609-A, lines 7 through 11.

Income Limits for 2013: New and Revised

HUD initially released the FY2013 Multifamily Tax Subsidy Program's (MTSP) income limits on December 4, 2012. Then, on December 11th, HUD released revised MTSP income limits to correct an error in the computation. HUD's webpage has this explanation:

> "Revised FY 2013 data published 12/11/2012, supersedes Medians and Income Limits posted on 12/4/2012 for all areas. In areas where income limits are adjusted (High Housing Cost, Capped, Floored, etc.) no changes to the income limits may be necessary if 12/4/2012 Limits used."

Since the December 11th income limits supersede the income limits released December 4th, the IRS will treat the income limits released December 11th as if they were released on December 4th for all IRC §42 purposes.

Rev. Rul. 94-57 provides that taxpayers may rely on the income limits published by HUD until 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list, whichever is later. This year, HUD did not include an effective date. Based on the December 4th release date, owners must start using the revised 2013 income limits for all purposes no later than 45 days after the December 4th release date, or January 18th, 2013.

Rev. Proc. 94-57 provides that taxpayers may designate the gross rent floor as taking effect on the date the building was placed in service. For buildings placed in service after December 4th, 2012 and before January 18th, 2013, taxpayers may choose to either (1) rely on the 2012 income limits, or (2) rely on the revised 2013 income limits, whichever provides the greater tax benefit. If a taxpayer placed a building in service between December 5th and December 11th (inclusive), 2012 and relied on income limits released by HUD on December 4th, the IRS will honor the designation, but the revised income limit released by HUD on December 11th should be used to calculate the gross rent floor.

For more information about "relying" on the income limits, refer to LIHC Newsletters #47 and #48.

Revenue Procedure 2012-41: Inflation-Adjusted Items

Rev. Proc. 2012-14 was issued on October 18th, 2012, to provide inflation-adjusted items for 2013, including two items for IRC §42.

Substantial Rehabilitation Costs

To treat rehabilitation expenses as a new building and qualify for the 70% present value credit, a minimum amount of rehabilitation costs must be expended. Under IRC §42(e)(3)(A)(ii), the amount of such expenditures during any 24-month period are the greater of either:

- 20% (or more) of the adjusted basis of the acquired building as of the first day of the 24-month period, or
- the qualified basis (applicable fraction x eligible basis) attributable to the rehabilitation costs is $6,000 or more. This is not a unit-by-unit determination; just divide the qualified basis by the number of LIHC units.

(Continued on page 4)

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812 for all IRC 42 issues other than foreclosures. If the return is being audited for a foreclosure issue, use Tracking Code 6495. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:
As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

(Continued from page 3)

IRC §42(e)(3)(D) provides an adjustment for inflation, so that the $6,000 above is multiplied by the cost-of-living adjustment under IRC §1(f)(3). For calendar year 2013, the per low-income unit qualified basis amount under IRC §42(e)(3)(A)(ii)(II) is $6,400.

State Housing Credit Ceiling

Under IRC §42(h)(3)(C)(ii), each state is annually allocated credit on a per capita basis. The amount is the greater of $1.75 per person or $2,000,000. IRC §42(h)(3)(H), however, provides an adjustment for inflation, so that for calendar year 2013, the credit allocated to each state is the greater of $2.25 per capita or $2,590,000.

Effective Date

This revenue procedure applies to transactions or events occurring in calendar year 2013.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file.

♫ Grace Notes ♫

It's that time of year again…you know, between dinner time on Thanksgiving and the last football game on New Year's Day, when, having just recovered from a constant showing of horror movies in October, the television networks seem utterly compelled to provide a continuous stream of "holiday" movies…you know, helping Santa and the elves in a crisis (like losing Mrs. Claus), sappy romances, or yet another version of Scrooge… makes me wonder if Dickens' estate ever sues for copyright infringement.

So, in the midst of all this good will, I was delighted to watch *Madame Curie* with Greer Garson and Walter Pidgeon. Made in 1943, the movie tells the story of how the couple met and worked together to eventually discover radium after overcoming overwhelming difficulties and repeated failure. My favorite scene is when, after struggling for years, discouraged and finally admitting failure, the Curies return to their laboratory late at night and discover the dish of distilled radium glowing in the dark. Cool.

Madame Curie is an inspiring story of vision, dedication, and tenaciousness. But make no mistake, Greer Garson is beautiful and Walter Pidgeon handsome, and the dialogue is just stilted enough to qualify this movie as a "sappy romance," but at least it is a *true* story of enduring love.

Well, okay. The movie does belong on the holiday list – no Santa, no elves, and not because it happens to be a sappy, although true, romance. I'm not going to tell you how the story ends or why I think it belongs on the "holiday" list of "must see" movies; I don't want to spoil the ending and I think you should figure it out yourself. If you get the chance, you should watch it; just make sure you have some tissue handy.

Happy Holidays!

Grace Robertson
(202) 283-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

ISSUE #51

APRIL 2013

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Impact Fees & Dedicated Improvements: Audit Issues and Techniques	1
Credit, Compliance & Extended Use Periods: Audit Significance	2
Subscribing to the LIHC Newsletter	5
Guide for Completing Form 8823	5
♫ Grace Notes ♫	5

Impact Fees & Dedicated Improvements: Audit Issues and Techniques

Impact Fees are one-time charges imposed by a state or local government against new development or expansion of existing development to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. Generally, impact fees are refundable (in full or in part) if the new or expanded development ultimately is not constructed as planned.

The question is, are impact fees includable in Eligible Basis? This issue was addressed in Rev. Rul. 2002-09; i.e., "Impact Fees" incurred in connection with the construction of a new residential rental building are capitalized costs allocable to the building under IRC §§ 263(a) and 263A. Therefore, the costs are included in Eligible Basis to the same extent they are allocable to the building under IRC §§ 263(a) and 263A.

Similarly, the cost of "dedicated improvements" is includible in Eligible Basis. The reasoning provided in PLR 200916007 should be applied:

1. The costs incurred by a taxpayer to construct the infrastructure improvements for a project are dedicated improvements for purposes of IRC §263(a) and Treas. Reg. §1.263(a)-4(d)(8)(iv) and, therefore, are not capitalizable as amounts paid to create an intangible under Treas. Reg. §1.263(a)-4(d)(8)(i).
2. The costs incurred by a taxpayer to construct the infrastructure improvements for a project are indirect costs, within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) for purposes of IRC §263A, and are capitalizable into the bases of the project's residential rental buildings, using a reasonable method of allocation under Treas. Reg. §1.263A-1(f) to allocate the costs among the residential rental buildings.
3. Assuming that project's residential rental buildings will be depreciated as residential rental property under IRC §168, the eligible basis of the project's residential rental buildings under IRC §42(d)(1) includes the cost of the infrastructure improvements.

Audit Issues and Techniques

As for all costs includable in Eligible Basis, there are criteria and substantiation issues to address during an audit.

Character

Is the cost, by definition an "impact fee" or "dedicated improvement?"

In Rev. Rul. 2002-09, the taxpayer was required by the county to pay impact fees for schools, law enforcement, and fire protection facilities to compensate the county for the financial impact of the taxpayer's new buildings. The taxpayer paid the impact fees when the construction permit for the building was issued.

In PLR 200916007, the city required the taxpayer to construct streets and other infrastructure improvements to provide residents of the residential rental buildings access to the existing streets and in-

(Continued on page 2)

Impact Fees and Dedicated Improvements…..

(Continued from page 1)

frastructure; i.e., two-lane streets, curbs, sidewalks, storm water drainage, and domestic water in-flow. In addition, the taxpayer was required to purchase and install, at its own cost, the infrastructure needed by utility companies to install underground utilities, including utility steel casings within the streets through which the utilities run gas lines, electrical wiring, cable, and phone wires.

The taxpayer should provide documentation that the impact fee was imposed as a condition for constructing the low-income building, or that the taxpayer was required to provide specified dedicated improvements.

Dollar Value

As with all substantiation issues, the taxpayer must provide sufficient documentation of the dollar value of the cost incurred.

When Incurred

Generally, under IRC §42(d)(1), a cost must be incurred before the close of the first year of the credit period to be included in eligible basis.

Improvements Dedicated to Government Entity

If the taxpayer constructed dedicated improvements, the taxpayer must also demonstrate that:

1. ownership was transferred from the taxpayer to the government entity, and
2. the government entity assumed responsibility for maintaining the dedicated improvements.

Credit, Compliance & Extended Use Periods: Audit Significance

There are three time period unique to IRC §42; the credit, compliance and extended use periods. These periods are building-specific and should be identified as early as possible in the audit.

Credit Period

IRC §42(f)(1) defines the credit period, with respect to any *building*, as the 10-year period beginning with:

1. the taxable year in which the building is placed in service, or
2. at the election of the taxpayer, the succeeding taxable year.

Language immediately following IRC §42(f)(1) explains that:

- IRC §42(f)(1) only applies if the building is a qualified low-income building as of the close of the first year of such period, and
- The election to begin the credit period the taxable year succeeding the year the building is placed in service is irrevocable, once made.

If a building was acquired and then rehabilitated, there are two credit allocations and the taxpayer will file two Forms 8609-A with its tax return; one for the acquisition credit and another for the rehabilitation credit.

- Under IRC §42(f)(5), the credit period for the existing building (acquisition credit) cannot begin before the credit period for the rehabilitation credit.
- Under IRC §42(e)(4)(B), the applicable fraction for the substantial rehabilitation credit is the same as the applicable fraction for the acquisition credit.

What You Need to Know

Therefore, to determine a low-income building's credit period, an examiner needs to know when the building was placed in service and whether the taxpayer made the election to begin the credit period the succeeding year. Form 8609, Low-Income Housing Credit Allocation and Certification, documents the placed in service date on line 5 and the election on line 10a.

The "credit period" is important because, under IRC §42 (a), the credit is allowable only for taxable years in the credit period. From a taxpayer's perspective, the credit period represents 10-year stream of tax credits to off-set federal income tax liabilities.

There are two important caveats to this general rule.

(Continued on page 3)

(Continued from page 2)

- *Special Rule for the First Year of Credit Period*

Regardless of when during the year a building is placed in service during the taxable year, the credit period begins on the first day of the taxable year. As a result, there is usually a gap in time at the beginning of the year when the building is not providing housing before it is placed in service. To account for this fact pattern, IRC §42(f)(2) provides a special "averaging" rule for computing the Applicable Fraction for the first year of the credit period. It is calculated as the sum of Applicable Fractions computed as of the close of each full month of the year that the building was in service, divided by 12. Any credit not allowed in the first year because of this rule is allowed in the 11th year, the first taxable year after the end of the credit period.

There are three common audit issues associated with this special rule:

1. The Applicable Fraction is determined as the smaller of the unit fraction or the floor space fraction (see IRC §42(c)(1)(B)). For the first year, computing the monthly fractions using both methods and comparing the two resulting first-year Applicable Fractions is recordkeeping intensive and a bit tedious since you need to know when each unit was first occupied by a qualifying low-income tenant. It is very tempting to "estimate" the applicable fraction based on the percentage of months that the building was placed in service.

   For example, a building was placed in service on March 15, 2012. Since the buildings was placed in service nine full months (April through December), a calendar-year taxpayer might incorrectly estimate the Applicable Fraction as 9/12 or 75%.

2. For a variety of reasons, a taxpayer may decide to defer the beginning of the credit period to the year following the year placed in service. In which case, a taxpayer may rationalize that since the building was placed in service the entire year, every unit was occupied by a qualified tenant as of the first day of the taxable year. Therefore, the Applicable Fraction is 100%, regardless of whether you use the unit fraction or the floor space fraction.

   For example, a building was placed in service on October 1, 2010. However, not all the amenities were completed by December 31, 2010. The taxpayer wanted to include the cost of the qualifying amenities in eligible basis, which is determined at the end of the first year of the credit period (see IRC §42(d)), so the taxpayer deferred the first year of the credit period to 2011. In October of 2012, when preparing the 2011 tax return, the calendar-year taxpayer incorrectly computed the allowable credit using an Applicable Fraction of 100% on Form 8609-A, line 2.

While the two issues described above are usually associated with the audit of the tax return for the first year of the credit period, there is a complementary issue when auditing the 11th year, i.e., the year after the end of the credit period.

3. The taxpayer can claim the portion of credit not allowable for the first year of the credit period because of the special rule. The credit claimed the first year and the 11th year should never add up to more than the maximum allowable credit identified on Form 8609 line 1b. An issue surfaces when the taxpayer claims credit less than the maximum allowable for the 11th year, but can't document how much credit was claimed the first year.

   No credit would be allowable in the 11th year unless the taxpayer can substantiate or reconstruct the allowable credit for the first year. For tax purposes, 10 years ago is almost ancient history, but Treas. Reg. §1.42-5(b)(2) requires taxpayers owning IRC §42 projects to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the building's 15-year compliance period (which will be discussed below).

There are three critical time periods associated with the life cycle of an IRC §42 housing project; the 10-year **credit** period, the 15-year **compliance** period, and the +30-year **extended use** period.

Two other issues related to the credit period have also been observed during audits:

1. A taxpayer continues to claim the maximum allowable credit after the end of the credit period. I suppose there's a reason we have 10 fingers! No kidding, I am often counting the credit period out with my finger tips!

2. The taxpayer claims credit inconsistent with the election to begin credit period the first year after the building is placed in service.

   For example, a taxpayer places a building in service in 2002 and claimed credit, but elects to postpone the beginning of the credit period to the following year (2003) when completing Form 8609 Part II. The credit period is 2002 through 2011, with any credit not allowable in 2002 allowed in 2012. Based on the Form 8609 "paperwork," however, the credit period would be 2003 through 2012, and any credit not allowable in 2003 allowed in 2013. Relying on the

(Continued on page 4)

(Continued from page 3)

Form 8609 information in 2012 and 2013, the taxpayer incorrectly claimed the credit an extra year. That is:

2002 – Credit computed using the special rule to account for when the units were placed in service and first occupied by qualifying tenants.

2003-2012 – Ten years that the taxpayer claimed the maximum allowable credit.

2013 – Credit not allowable in 2002 allowed.

- *Increase in Qualified Basis*

There are times when a building is a low-income building at the end of the first year of the credit period, but not all the residential units in the building are low-income units. If these units qualify as low-income units after the end of the first year of the credit period, then there is an increase in qualified basis.

Under IRC §42(f), the applicable percentage used to compute the credit associated with the "excess" qualified basis is 2/3 of the applicable percentage that would otherwise be used. The credit associated with increases in Qualified Basis is often referred to as the "2/3 credit."

- Under IRC §42(f)(3), there's a "special" rule to compute the applicable fraction for the first year the unit is a low-income unit similar to the rule under IRC §42(f)(2).
- The taxpayer can claim the 2/3 credit each year of the 15-year compliance period (after the first year) to the extent there is "excess" qualified basis.
- On Form 8609-A, the 2/3 credit is accounted for by reducing the allowable by the 1/3 that is not allowed. See Form 8609-A, lines 7 through 11.
- The 2/3 credit is not subject to recapture under IRC §42 (j). See IRC §42(j)(4)(C). Any adjustment to the allowable credit made during an audit is first applied against the 2/3 credit.

Increases in Qualified Basis make computing the allowable credit on Form 8609-A a little convoluted and sometime taxpayers compute the allowable credit as:

$$\text{Qualified Basis}_{(\text{First Year})} \times \text{Applicable Percentage} = \text{"Full" Credit}$$

and

$$\text{Qualified Basis}_{(\text{Increase})} \times (2/3)\text{Applicable Percentage} = \text{"2/3" Credit}$$

The taxpayer adds the two together and "forces" the allowable credit on Form 8609-A, line 18, "taxpayer's credit." Claiming this "odd" credit amount must be explained during an audit.

Compliance Period: IRC §42(i)(1)

IRC §42(i)(1) defines the "compliance period" as the period of 15 taxable years beginning with the first taxable year of the 10-year credit period with respect to the low-income building. Once the credit period is identified, the compliance period can easily be computed.

The compliance period is important for the IRS, even though no credit (generally) is allowable during the last five years, because:

1. the taxpayer must file Form 8609-A to complete the IRC §42(l)(2) annual certification each year of the 15-year compliance period, and
2. the taxpayer continues to be subject to the IRC §42(j) credit recapture provisions, although the recapture rate decreases over the last five years.

Extended Use Period: IRC §42(h)(6)(D)

Under IRC §42(h)(6)(d), the extended use period begins on the first day of the building's compliance period and ends on the later of (1) the date specified in the extended use agreement, or (2) the date which is 15 years after the close of the compliance period.

The extended use period is associated with the "extended low-income housing commitment," also referred to as a "land use restrictive covenant" or "agreement." The agreement documents any requirements imposed by the state agency in addition to IRC §42 and is enforceable in state court by the state agency and any prospective, present, or former occupants of the building.

No credit is allowable for any taxable year unless the extended use agreement is recorded in land records.

Common Errors

To summarize, there are three critical time periods associated with the life cycle of an IRC §42 housing project.

- The 10-year credit period,
- The 15-year compliance period, and
- The +30-year extended use period.

Once the 10-year credit period is identified, the 15-year compliance period and +30-year extended use period can be identified. However, there are two easy-to-make and frequently encountered errors.

1. The 10-year credit period begins on the first day of the taxable year that the building was placed in service, or the following year if the taxpayer makes the election. The credit does NOT begin the day the building is placed in service.

(Continued on page 5)

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:

Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:

If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:

As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

(Continued from page 4)

For example, a calendar-year taxpayer places a low-income building in service on July 15th, 2013. The credit period begins on January 1, 2013, or at the taxpayer's election, on January 1, 2014.

2. When counting out the 10-year period, begin with the first year of the credit period. If the first year is 2013, then the credit period is 2013, 2014, 2015….2022. There is a tendency to start with 2014 because it marks the completion of a year, but it will add an extra year to the 10-year period.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

♫ Grace Notes ♫

I love words, particularly words I can neither spell nor pronounce. And so much the better if a word gives Microsoft Word's spell check a tizzy. I just learned a new word, "syzygy," pronounced "siz-dzi." Syzygy refers to the straight-line alignment of three celestial bodies within a gravitational system, such as our solar system. For example, there's syzygy when the Earth, Moon, and Sun line up during a lunar eclipse. The gravitational effects of syzygies on planets are being studied. Did you know that in addition to affecting tides, the Sun-Earth-Moon syzgyy can cause moonquakes? But scientists have yet to find a relationship between syzygies and earthquakes, and don't believe there is one because the Earth is 82 times more massive than the Moon.

According to Wikipedia, syzygy is also "loosely" used to describe interesting configurations of planets in general. Since I can't remember the last time I had reason to speak of Sun-Earth-Moon alignments or even "interesting" configurations of planets (as if I'd notice), I propose we include an alternative use of the word "syzygy" to mean "the interesting alignment of circumstances." Next time my manager asks me, "How are things?" I'd really like to answer, "Great! Everything is syzygized." Unfortunately, I'm still not exactly sure how to pronounce "siz-dzi."

Grace Robertson
(202) 283-2516
Grace.F.Robertson@irs.gov

LIHC Newsletter

ISSUE 52

AUGUST 2013

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Eligible Basis: Construction Loans & Issuing Tax-Exempt Bonds	1
Section 1602 Funds	2
IRC §42(g)(1): Minimum Set-Aside	2
Exception for Married Students	3
♫ Grace Notes ♫	4

Eligible Basis:

Construction Loans and Issuing Tax-Exempt Bonds

Eligible Basis is, by definition, the cost of residential rental property as defined in IRC §103 that is depreciable property under IRC §168. IRC §263A is also considered because an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer are capitalized to the property produced. IRC §263A(g)(1) defines "produce" as including constructing, building, installing, manufacturing, developing, or improving. Indirect costs subject to IRC §263A capitalization are defined in Treas. Reg. §1.263A-1(e)(3)(i) as "…all costs other than direct material costs and direct labor costs (in the case of property produced)…Indirect costs are properly allocable to property produced… when the costs directly benefit or are incurred by reason of the performance of production…"

Construction Loans

A taxpayer's third-party costs and fees incurred in obtaining a construction loan are capitalized and amortized over the life of the loan and are not subject to IRC §168. Therefore, the cost is not includable in an IRC §42 building's eligible basis. IRC §263A, however, requires the amortization deductions relating to the construction loan intangible be capitalized to the produced property during the construction period. The deductions must be reasonably allocated to all property produced. To the extent the amortization deductions are allocable under IRC §263A to the adjusted bases of IRC §168 property that qualifies as residential rental property under IRC §103 or IRC §168 property used in a common area or provided as a comparable amenity to all residential units in the building, the amortization deductions are includable in a low-income building's eligible basis under IRC §42(d)(1).

Costs of Issuing Tax-Exempt Bonds: TAM 200043015

Like construction loans, the costs incurred to obtain tax-exempt bonds are capitalized and amortized over the life of the bond. But unlike construction loans, none of the cost of issuing tax-exempt bonds is includable in Eligible Basis. To summarize the explanation provided in TAM 200043015:

Congress determined that bond issuance costs, the components of which are identified in the legislative history to IRC §142, are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the offering. Characterizing a certain portion of bond issuance costs under IRC §263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Permitting such an IRC §263A characterization of bond issuance costs for purposes of IRC §42 would result in the disparate treatment of the term "residential rental property" between IRC §§ 42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42, that requires that residential rental property have the same meaning for purposes of both IRC §§ 42 and 142.

Accordingly, notwithstanding the general rule of IRC §263A, no portion of bond issuance costs (as these costs are described in the legislative history to IRC §142) are included in eligible basis for purposes of IRC §42(d)(1).

Section 1602 Funds

The Section 1602 program is part of the American Recovery and Reinvestment Act of 2009. In 2009 and 2010, the housing agencies could exchange a portion of their 2009 credit ceiling (IRC §42 credit available for allocation) for an award of funds that could then be "subawarded" to developers for constructing and rehabilitating low-income rental housing. The IRS issued Notice 2010-18 to provide clarifications, two of which are relevant for auditing taxpayer receiving Section 1602 funds from a housing agency:

Clarification #2: Income Tax Treatment of Subawards

Based on the legislative history of the Act, subawards made pursuant to section 1602(c) of the Act are excluded from the gross income of recipients and are exempt from taxation.

Clarification #3: Basis Treatment of Subawards

IRC §42(i)(9)(B), as added by section 1404 of the Act, provides that the basis of a qualified building shall not be reduced by the amount of any grant described in IRC §42(i)(9)(A). The legislative history to the Act provides that grants received under this provision (i.e., cash assistance received under section 1602 of the Act) do not reduce the tax basis of a qualified low-income building. By extension, subawards under section 1602(c) of the Act derived from cash assistance under that section that are used in a qualified low-income building are not federal grants for purposes of IRC §42(d)(5)(A) and do not otherwise reduce the depreciable or eligible basis of the building.

IRC §42(g)(1): Minimum Set-Aside

The "Minimum Set-Aside" requirement reads:

(1) In general. The term "qualified low-income housing project" means any project for residential rental property if the project meets the requirements of subparagraph (A) or (B) whichever is elected by the taxpayer:

(A) 20-50 test. The project meets the requirements of this subparagraph if 20% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50% or less of area median gross income.

(B) 40-60 test. The project meets the requirements of this subparagraph if 40% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60% or less of area median gross income.

Any election under this paragraph, once made, shall be irrevocable. For purposes of this paragraph, any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes.

Making the Election

The election is made on Form 8609, line 10c. The minimum set-aside is a project-based rule, so a taxpayer's election to treat a building as part of a multiple building project is a significant consideration. This election is made on Form 8609, line 8b, with an attachment identifying the buildings to be included in the project.

Example 1: A taxpayer owns 10 low-income single-family homes, each of which received a $10,000 credit allocation, for a total of $100,000. The taxpayer elects to include them in one 10-building project. The taxpayer elects the 40-60 minimum set-aside for all 10 buildings; i.e., at least 4 of the 10 homes must be qualified low-income units for the taxpayer to claim any credit. For 2012, only three of the units were qualified low-income units. The taxpayer cannot claim *any* IRC §42 credit because the minimum set-aside was not met.

If 2012 is the first year of the credit period, then the taxpayer is prohibited from ever claiming the LIHC because the taxpayer failed to satisfy IRC §42(c)(2); i.e., the buildings are not "qualified low-income buildings."

Example 2: A taxpayer owns 10 low-income single-family homes, each of which received a $10,000 credit allocation, for a total of $100,000. The taxpayer elects the 40-60 minimum set-aside for all 10 buildings but does *not* elect to include the buildings in a multi-building project. Each home is a separate project and the minimum set-aside test is applied to each home separately. For 2012, three of the homes units were qualified low-income units and the taxpayer can claim $30,000 in credit.

Minimum Set-Aside Defines "Low-Income"

The taxpayer' election not only establishes the minimum number of low-income units that must be provided, but also identifies the income limit for *all* the low-income units in the project.

(Continued on page 3)

(Continued from page 2)

Example 3: A taxpayer owns a single low-income building with 100 units, which received a $100,000 credit allocation. The taxpayer intends to treat the building as 100% low-income and elects the 20-50 minimum set-aside; i.e., at least 20 of the 100 units must be qualified low-income units for the taxpayer to claim any credit. The taxpayer rented 21 units to households with income less than 50% of the area median gross income and rented the other 79 units to households with income less than 60%, but more than 50%, of the area median gross income. Only the 21units rented to households with less than 50% of the area median gross income are qualified low-income unit. The taxpayer met the minimum set-aside, but can claim credit for only the 21 qualified units.

Minimum Set-Aside v. Applicable Fraction

The Minimum Set-Aside and the Applicable Fraction are two independent concepts. While the Minimum Set-Aside is the *minimum* number of low-income units within a "project" required to qualify for any credit, the Applicable Fraction is a measurement of the low-income portion of a low-income "building," measured as the lesser of the percentage of floor space (of units) or the percentage of units.

Example 4: Same facts as Example 3. The building's Eligible Basis is $1,111,111 and the Applicable Percentage is 9.00%. How much credit can the taxpayer claim? Assuming all the units have the same floor space, the Applicable Fraction is 21/100 or .2100.

The allowable credit is computed as:

$1,111,111	Eligible Basis
x 0.2100	Applicable Fraction
$233,333	Qualified Basis
x 0.0900	Applicable Percentage
$21,000	Allowable Credit

Can the Applicable Fraction be less than the minimum set-aside? Yes.

Example 5: A taxpayer owns three low-income buildings, each has 10 units and all the units in all three buildings have the same floor space. The taxpayer elects the 40-60 minimum set-aside and elects to include all three buildings in one multi- building project. The minimum set-aside is .40 x 30 = 12; i.e., at least 12 units in the three buildings must be qualified low-income unit to meet the minimum set-aside on a *project* basis.

The taxpayer rents 6 units in the first building, 4 units in the second building, and 2 units in the third building to qualified low-income households. Altogether, there are 12 qualified low-income units in the three-building project and the minimum set-aside requirement is satisfied. The Applicable Fractions for the three buildings are 60%, 40% and 20%, respectively.

Exception for Married Students

As explained in the legislative history, "In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under IRC §151(c)(4)), no one of whom is entitled to file a joint income tax return."

While the rule itself is not explicitly included in IRC §42, exceptions for certain 100% full-time student households are specified in IRC §42(i)(3)(D), and includes an exception for full-times students if the students are married and file a joint return.

The Supreme Court recently ruled that a portion of the Defense of Marriage Act is unconstitutional and held that persons of the same sex who are legally married under State law may not be deprived of Federal benefits that are provided to married couples of the opposite sex.

So, how is the exception for married students applied? Registered domestic partners and same-sex partners who are legally married under state law cannot file federal tax returns as "married filing separately" or "married filing jointly" because federal law does not treats same sex partners as married for federal tax purposes. Therefore, the rule continues to be applied only for couples of the opposite sex. Please refer to the Guide for Completing Form 8823, Chapter 17, for additional guidance.

Also, the IRS and Treasury released their joint 2013-2014 priority guidance Plan (Doc 2013-19471) on August 9, 2013. The plan includes providing guidance on the Supreme Court's decision that Section 3 of the Defense of Marriage Act was unconstitutional. The reference for the case is *United States v. Windsor, Sup. Ct. Dkt. No. 12-307 (2013) (Doc 2013-15479).*

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:
As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

♫ Grace Notes ♫

I'm at home today, quietly writing at the table by the window. Hannah (the big white cat) is contentedly sleeping in her favorite spot to the left of the computer… I know it's a favorite spot because she's always there when I work at home and she lays right where the computer's air vent is…a nice warm spot.

But I can't help notice that she's not really asleep. Her ears are twitching and her eyes are not entirely closed. She's looking out the window, so I look where she's looking and I can see a beautiful yellow and black butterfly gathering nectar from a Nasturtium. He moves from flower to flower, gathering nectar from some, quickly skipping over others… and then flitting away. He comes back and starts all over again five or six times before finally flying away. Hannah and I are mesmerized.

The entire flower bed is full of neon-yellow, golden yellow, bright orange, and variegated light and dark orange Nasturtiums all mixed up together. It would be difficult to tell you which one I like most, but it was easy to tell that the butterfly preferred the bright orange flower because he rested longest on those and liked the neon-yellow ones the least since he quickly skipped over those entirely. Perhaps it was the color, maybe the nectar…but he obviously cared and was deliberately choosing the bright orange blossoms.

We all care…the butterfly cares about the flowers, Hannah cares (and chooses carefully) where she naps, and I care about getting home safely from work, which can be a real conscious thought when I'm whizzing around the Washington beltway during rush hour. It's just a guess on my part, but since you're reading this newsletter, you probably care about IRC §42 for one reason or another.

The butterfly cares about survival, the cat cares about comfort, and I care about safety. I know a lot of people care quite passionately about IRC §42. Right now, I mostly care about finishing this newsletter within the time permitted and space allotted.

Grace Robertson
(202) 283-2516
Grace.F.Robertson@irs.gov

PS: Curious about the yellow and black butterfly, I did a little Wikipedia research. Turns out he is an Eastern Tiger Swallowtail, a species common to the east coast. I know he is a "he" because of the markings; the "she" has blue markings around the edges of the wings. Hannah and I have seen "her," too, flitting around the pinkish Echinacea flowers in the back yard when we're watching the squirrels and chipmunks squabble over the peanuts left out for them all…apparently, squirrels really care about peanuts.

LIHC Newsletter

ISSUE 53

OCTOBER 2013

INSIDE THIS ISSUE:

Developer Fees	1
♫ Grace Notes ♫	7

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

Developer Fees

Editor's Note: The treatment of developer fees, and particularly developer fee notes, is largely dependent on the facts of the individual case. As a result, this article includes numerous quotes from court cases and the full citations have been provided.

Introduction

The amount of credit the taxpayer can claim each year is determined as:

Eligible Basis x Applicable Fraction = Qualified Basis

Qualified Basis x Applicable Percentage = Credit

A cost incurred to construct the building is includable in its Eligible Basis under IRC §42(d)(1) if the cost is:

- included in the adjusted basis of depreciable residential rental property (IRC §§168 and 103), or
- included in the adjusted basis of depreciable property used in common areas or provided as a comparable amenity to all residential rental units in the building (IRC §168).

A developer fee represents payment for the developer's services and at least a portion of the fee is includable in Eligible Basis.

Related Parties

Typically, but not always, the developer is the general partner (or managing general partner) of the partnership owning the property.

The developer may also be related to the entity that actually constructed the project or the property management company operating the project. The inter-relationships need to be indentified and understood, as these relationships will effect how transactions are conducted and documented.

While there are specific relationships noted throughout IRC §42, taxpayers are considered related for *tax* purposes if an adjustment made to one return requires corresponding adjustments to the other return to ensure consistent treatment (see also IRC §§ 1313(c) and 267), or more generally for *audit* purposes, returns are considered related if the returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

Audit Issues and Techniques

There are four basic issues to consider when examining the developer fee.

- Character of the services to be provided,
- Services actually provided,
- Reasonableness of the fee amount, and
- Method of payment.

To address these issues, examiners should:

1. Review the development agreement or contract, which will outline all the anticipated responsibilities and remedies if the developer fails to perform according to the agreement. It should also disclose the payment terms. Typically, there will be payments at specific times during development and when development is completed. The developer may also have agreed to defer payment of a portion of the fee.
2. If the developer agreed to defer payment, review the developer fee note documenting the debt. Like the original contract, the note will outline the terms for payment of the deferred fee; e.g., amount of the debt, interest rate, payment schedule, etc.
3. Review the taxpayer's book and records to identify payment of the fee. If the developer agreed to defer a portion of the fee, determine whether payments been made and/or interest accrued according to the terms of the agreement.

Issue 1: Character of the Services Provided

The development services to be provided will be identified in the agreement entered into by the taxpayer and the developer. This contract, as well as any supporting documentation, should be reviewed to determine what

services the developer was expected to perform. Typically, the developer agrees to provide (or may have previously provided) services related to the acquisition, construction, and initial operating phases of development.

Development Costs Includable in Eligible Basis

Examples of services typically associated with the IRC §42 buildings and includable in eligible basis include, but are not limited to:

1. Negotiating agreements for architectural, engineering, and consulting services, the construction of the low-income housing (including interiors) or improvements includable in eligible basis, and the furnishing of the associated supplies, materials, machinery or equipment.
2. Applying for and maintaining all government permits and approvals necessary for the construction of the project and securing the certificates of occupancy (or other equivalent documents) when completed.
3. Complying with the requirements imposed by insurance providers during construction,
4. Providing oversight, including inspections during the course of construction and approving eventual payment for the services rendered.
5. Implementing the taxpayer's decisions made in connection with the design, development, and construction of the project.

Developmental Costs Not Includable in Eligible Basis

Development of a low-income project requires services that are not associated with the IRC §42 buildings and, therefore, the costs are not includable in eligible basis. Typical services include (but are not limited to):

1. Acquiring the property site. Specific activities may include locating suitable sites, performing economic and feasibility studies, market studies, and negotiating the purchase price. The developer may be involved in the purchase (settlement and closing) for a selected site and be responsible for holding and maintaining the site until construction begins. Note: a portion of the purchase price may be included in eligible basis if the purchase included the acquisition of a building that is subsequently rehabilitated for use as low-income residential rental property.
2. Maintaining contracts, books and records sufficient to establish the value of the completed project.
3. Advising the taxpayer regarding available sources of financing, such as federal, state or local subsidy programs, as well as commercial financing. The developer may also negotiate the terms of the financing with lenders or secure financing. (See Newsletter #52 for additional discussion.)

Partnership Costs

Services associated with the partnership's organization and syndicating partnership interests are not includable in eligible basis.

Credit Allocations

Application fees and other costs associated with securing an allocation of IRC §42 credit are not includable in eligible basis. See Rev. Rul. 2004-82, Q&A #3.

Post-Development Costs

Generally, development services end when the buildings are placed in service. However, because of the developer's expertise, the taxpayer may contract with the developer to complete the initial leasing of the rental units. Typical costs include (but are not limited to) hiring on-site managers and trained staff, advertising, and maintaining model units. These costs are not includable in eligible basis. Instead, the costs should be amortized over the life of the lease if long term. If the lease is for a short term, typically at least six months but no more than one year for low-income rental units, then the costs should be amortized over the period necessary for completing the initial leasing of all the rental units.

The developer may also contract to provide on-going management of the day-to-day operations of the project after the initial lease-up. Typical services include providing qualified on-site property managers, physically maintaining the property site, resolving tenant issues, renewing leasing and securing new tenants, including the completion of income certifications for low-income households. The manager will have authority to collect rents, make deposits, and pay expenses below specified dollar criteria without the taxpayer's approval. The management services may also provide for the creation of books and records sufficient to accurately report rental income and period expenses on the taxpayer's federal income tax return. These costs should be expensed and matched against current rental income.

Issue 2: Services Actually Provided

The second issue to consider is whether the developer actually performed the services. While it is generally expected that one developer will initiate development and then provide services throughout the development process until the project is completed, there are instances where more than one developer is involved.

Concurrent Developers

Multiple developers may be involved at the same time. For example, a developer may work with a qualified nonprofit organization to develop a low-income project qualifying for a credit allocation under IRC §42(h)(5). When there are multiple developers, there are two basic questions:

1. How were developmental responsibilities divided among the developers? For example, responsibilities may be assigned based on the developers' areas of expertise.
2. Did the developer have the skills and expertise needed to provide developmental services and complete the project?

Consecutive Developers

A developer may not be able to complete a project and the taxpayer will hire a new developer. Under these facts, it is important to understand why the developer could not complete the project, what services each developer performed, and how the developers were paid.

Substantiation of Services Performed

In *Carp & Zuckerman v. Commissioner*, T.C. Memo 1991-436, the Tax Court concluded that the taxpayers failed to prove that they performed the development services specified in the agreement. The Court explained that the taxpayer bears the burden of proving that the developer fee constituted a qualified expenditure and that the rule found in *Cohan v. Commissioner* did not apply.

Issue 3: Reasonable Fee

While the absolute value of the fee can be large, the developer bears the equally large financial risk of failure. As a best practice, the state agencies have limited the developer fee amount that can be supported by the credit. While the methodologies differ, the state agencies generally limit the fee to a percentage of total costs. The IRS is not compelled to accept the developer fee amount allowed by the state agency and may raise issues involving the reasonableness of the fee amount if the facts and circumstances warrant doing so.

Issue 4: Method of Payment

Developer fee payments made during development, or at the time development is completed, and which are identified in the taxpayer's books as payments of developer fees are generally not challenged. When payment is deferred, however, further consideration is needed.

Performance of Additional Services

1. Since the developer may be (or is related to) the general partner, consider whether the payment is contingent upon providing services usually associated with the duties of a general partner.
2. Since the developer may be (or is related to) the entity operating the low-income project, consider whether payment of the developer fee is contingent on successfully operating the project, or maintaining the project in compliance with IRC §42.

In either case, if the fee is being paid for services rendered after the end of the project's development, then the fee should not be included in eligible basis.

Intent to Pay Deferred Developer Fee

In some cases, the terms and conditions of the deferred developer fee note may suggest that the taxpayer does not intend to pay the deferred fee. This issue is particularly important to address if the parties to the transaction are related. Consider whether:

1. the note bears no interest rate or no payment is required for extended periods of time, suggesting that the agreement is not an arm's length transaction,
2. payment is contingent on events unlikely to occur,
3. payment is subordinate to payment of other debt, and it is unclear that payment would ever be financially possible,
4. the developer holds a right of first refusal to purchase the property for a price equal to the outstanding debt, or
5. the general partner, who is or is related to the developer, is required to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date.

If the above fact patterns exist, separately or in combination, the deferred developer fee note may not be bona fide debt.

Analysis of Debt

Recourse or Nonrecourse Debt

Generally, debt, whether recourse or nonrecourse, is includable in the basis of property. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1, 11 (1947). However, the obligation must represent genuine, noncontingent debt. Nonrecourse debt is not includable if the property securing the debt does not reasonably approximate the principal amount of the debt, or if the value of the underlying collateral is so uncertain or elusive that the purported indebtedness must be considered too contingent to be includable in basis.

Recourse liabilities are generally includible in basis because they represent a fixed, unconditional obligation to pay, with interest, a specified sum of money. However, the mere fact that a note is recourse on its face is not determinative. For example, an obligation, whether recourse or nonrecourse, will not be treated as a true debt where payment, according to its terms, is too contingent, or repayment is otherwise unlikely. A liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.

Genuine Indebtedness

When considering whether transactions characterized as "loans" constitute genuine indebtedness for federal tax purposes, the courts have isolated a number of criteria from which to judge the true nature of an arrangement which in form appears to be debt. In *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3rd Cir. 1968), the court enumerated the following sixteen nonexclusive factors that bear on whether an instrument should be treated as debt for tax purposes:

1. The intent of the parties;
2. the identity between creditors and shareholders;
3. the extent of participation in management by the holder of the instrument;
4. the ability of the debtor to obtain funds from outside sources;
5. thinness of capital structure in relation to debt;
6. the risk involved;
7. the formal indicia of the arrangement;
8. the relative position of the obligees as to other creditors regarding the payment of interest and principal;
9. the voting power of the holder of the instrument;
10. the provision of a fixed rate of interest;
11. a contingency on the obligation to repay:
12. the source of the interest payments;
13. the presence or absence of a fixed maturity date;
14. a provision for redemption by the corporation;
15. a provision for redemption at the option of the holder; and
16. the timing of the advance with reference to when the taxpayer was organized.

As the *Fin Hay* court noted, "Neither any single criterion nor any particular series of criteria can provide an exclusive answer in the kaleidoscopic circumstances which individual cases present." The Sixth Circuit cited *Fin Hay* with approval in *Indmar Products Co., Inc. v. Commissioner*, 444 F.3d 771, (6th Cir. 2006), confirming that "[t} he various factors…are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." The Tax Court has also held that the case-enumerated factors are merely aids to determining whether a given transaction represents genuine debt. *Nestle Holdings, Inc., v. Commissioner*, T.C. Memo, 1995-441.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that may be considered when making such a determination are:

1. whether there is an unconditional promise on the part of the taxpayer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonable foreseeable future,
2. whether the lender has the right to enforce the payment of principal and interest,
3. whether the lender's rights are subordinate to rights of general creditors,
4. whether the instruments give the lender the right to participate in the management of the issuer (in this case, the IRC §42 project),
5. whether the taxpayer is thinly capitalized,
6. whether the lender (stockholders or partners) are related to the taxpayer,
7. the label placed upon the instrument by the parties, and
8. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in *Goldstein v. Commissioner*, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

1. a note or other evidence of indebtedness exists,
2. interest is charged,
3. there is a fixed schedule for repayments,
4. any security or collateral is requested,
5. there is any written loan agreement,
6. a demand for repayment has been made,
7. the parties' records, if any, reflect the transaction as a loan
8. any repayments have been made, and
9. the borrower was solvent at the time of the loan.

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the par-

ties actually intended and regarded the transaction to be a loan.

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. See *Fisher v. Commissioner, 54 TC 905 (1970).*

In *Story v. Commissioner, 38 TC 936 (1962)* the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligation. However, the Commissioner, in C.B. 1965-1, 4, limited his acquiescence in this case to the factual nature of that particular case. See Rev. Proc. 65-4, C.B. 1965-1, 720.

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner, 42 TC 936 (1964)* in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will "continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor…..where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received…" Action on Decision, 1976 A.O.D. LEXIS 364.

Related Party Transactions

In the typical fact pattern for IRC §42 projects, both the general partner of the taxpayer (the purported debtor) and the developer (the purported creditor) are controlled by the same entity (or may be the same entity). Where borrowing transactions occur between related entities rather than as arm's length, the are "subject to particular scrutiny because the control element suggests the opportunity to contrive a fictional debt." *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998). Stated another way, where "the same persons occupy both sides of the bargaining table," the form of a transaction "does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will" in order "to create whatever appearance might be of…benefit to them despite the economic reality of the transaction." *Geftman*, 54 F.3d 61 at 75, citing *Fin Hay Reality v. United States*, 398 F.2d 694, 697 (3d Cir. 1968). *Accord, Anchor Natl. Life Ins. Co. v. Commissioner*, 93 T.C. 382, 407 (1989).

As the *Geftman* court explained, "[t]he rule in *Fin Hay* accords with the general principle that tax consequences must be determined not from the "form of the transaction," but from its "true substance." *Geftman*, 154 F.3d at 75. Thus, "a transaction must be measured against an objective test of economic reality and characterized as a bona fide loan only if its intrinsic economic nature is that of a genuine indebtedness." Where the transaction is not the project of an arm's length relationship, much less weight is accorded to the factors relating to the form of the transaction than to those factors that go to the substance of the arrangement. See *Laidlaw v. Commissioner* T.C. Memo. 1998-232; 75 TCM (CCH) 2598, 2617.

Intrinsic Economic Nature

In form, the deferred developer fee will be structured as a promissory note or other debt instrument. However, given the relationship between the parties, a court may accord little weight to the form of the transaction. Instead, the essential question is whether the instrument's "intrinsic economic nature is that of a genuine indebtedness."

1. Independent Creditor Test

   Consider the substantive terms of the alleged debt. For example, the note does not provide for installment payments; rather, the note is due and payable only after a extended period of time. It is only payable after all the taxpayer's operating expenses and all other sums due are paid. The debt is nonrecourse and unsecured. In the event of default, the not holder's sole remedy is a judgment against the taxpayer, to be collected against whatever assets (if any) the taxpayer has at the time of default. Despite these unusually generous terms, the debt is interest-free.

   The acid test of the economic reality of a purported debt is whether an unrelated outside party would have advanced funds to the borrower under like circumstances. *Fischer v. U.S.*, 441 F.Supp. 32, 28 (1977). It is highly unlikely that an outside lender would have advanced funds to a taxpayer under the terms described above. Generally, creditors avoid subjecting funds to the risk of the borrower's business as much as possible and seek a reliable return. See *Laidlaw*, T.C. Memo 1998-232. Commercial lenders thus impose borrowing terms that ameliorate risks and charge interest rates that are reasonably calculated to compensate for those risks and provide a reasonable return on the lender's investment. As described above, none of the note terms suggest any effort to limit risks. The note is due and payable far in the future. There are no installment payments due in the interim. The note is subordinated to other debt and is only payable after all the taxpayer's operating expenses have been paid. The note is unsecured and nonrecourse. An economically motivated lender would charge significant interest to account for these

risks, but the deferred developer fee note considered here is interest-free. Altogether, these features indicate that the debt instrument's "intrinsic economic nature" is not that of genuine debt.

2. Debt-Equity Ratios

   Another factor that can indicate an absence of substance to purported debt is thinness of the taxpayer's capital structure relative to accumulated debt. *Fin Hay*, 398 F.2d 694, 696; *Laidlaw*, 75 TCM (CCH) at 2620. Court generally consider a borrower's debt to equity ration and other financial data in deciding if it is thinly capitalized. *Tyler v. Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969). A taxpayer's thin capitalization adds to the evidence that a deferred developer fee is not genuine debt. However, even if the taxpayer's capital structure were more robust, that alone, especially in light of the highly favorable terms of the debt, would not necessarily tip the balance in favor of treating a deferred developer fee as described above as genuine debt.

3. Potential Sources of Repayments

   A related factor when considering the substance of the transaction is the taxpayer's ability to repay the advance and the reasonable expectation of the repayment. *Laidlaw*, 75 TCM (CCH) at 2624. Normally, there are four such possible sources: (1) liquidation if business assets, (2) profits, (3) cash flow, and (4) refinancing with another lender. "The burden is on the taxpayer to establish this, of course, and such a conclusion must be based on concrete facts and sound assumptions about the [taxpayer's] future." *Fischer v. United States*, 441 F.Supp 32, 39 (1977).

   Consider the taxpayer described in TAM 200044004, which was a partnership formed to construct, develop, and operate a low-income housing tax credit property. The taxpayer's managing partner was related to other parties, including the developer. The other general partner was a nonprofit corporation. At completion of the construction, the taxpayer did not have sufficient funds to pay the entire development fee so it issued a note for the balance owing. The note was payable at maturity, 13 years from completion of the project. The note was unsecured and source-of-payment restrictions were in effect during the term of the note. Payment was subordinate to other debts. The note bore interest which was compounded annually and added to the unpaid principal during the term of the note. The taxpayer was obligated to pay off the note in full at maturity and the general partners were obligated to make additional capital contributions necessary to pay off the note at maturity. Financial statements also indicated that payments had been made on the note.

   The TAM concluded that the amount of the developer fee note was includable in the building's eligible basis. The note was an obligation on the part of the taxpayer to pay a fixed amount, with interest, at maturity. Although payments were contingent on cash flow or receipts from capital transactions prior to maturity, all remaining principal and accrued interest were payable at maturity. Also, although sources of payment were contingent, and the developer could not foreclose on any security interest in any specific asset, the general partners were obligated, at maturity, to contribute an amount sufficient to pay off the note in full. Repayment of the note was also backed by the equity the taxpayer had in the assets beyond the general partners' guarantee. In other words, it appeared the taxpayer has sufficient equity and assets to repay the note.

   Critical to the determination in the TAM was the fact that the note bore interest to compensate the lender for the various financial risks posed by the note. The TAM cites an excerpt from *Gibson Products v. United States*, 637 F.2d 1041 (5th Cir 1981), in which the court stated that, "the single most important factor dictating that the transaction…was not a true loan is the fact that the total combined assets….were not sufficient to pay the note on or before the maturity date…absent production from any of the leases." 637 F.2d at 1047.

Summary

Ultimately, the burden is on the taxpayer to demonstrate that the developer fee was earned and includable in Eligible Basis. If the taxpayer has deferred payment, the taxpayer will also need to demonstrate the deferred fee note is bona fide debt. For related party transactions, when a court may accord little weight to the form of the transaction, the intrinsic economic nature of the transaction must be considered; i.e., would an unrelated outside lender advanced funds to the taxpayer under like circumstances? Particularly when the absence of interest provisions (or very low interest rates), unsecured, nonrecourse, subordinated, balloon payment would normally dictate a significant interest rate in a commercial setting to compensate the lender for the associated risks.

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:
As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

New Phone Number for Grace Robertson

Not that its earth shattering news, but Grace Robertson has been assigned a new phone number: 240-613-6671.

♫ Grace Notes ♫

I added a few vacation days to my Labor Day holiday and while I hope all of you enjoyed last-of-the-summer fun, I ended up laboring in the garden, pulling weeds from flower beds that, because of the preponderance of overgrown grass and weeds, might better be defined as "weed beds."

"More than slightly annoyed" would best describe my mood and with each tug at some roots, I silently scolded myself for such procrastination. Oh, I had all the excuses ready…other "priorities" were higher on my "to do" list, but right then I couldn't think of a one that had kept me from this task *all* summer. Maybe I just hoped they'd go away or die of some blight. How can a word starting with "pro" have such a negative meaning…I mean, when has procrastination ever been thought of as a *good* thing?

So, of course, I had to look it up. According to Webster, its roots are French and *pro* means "forward" and *crastinus* means "of tomorrow." It means "to put off intentionally and habitually."

I paid for my procrastination…my knees were sore and the muscles in my legs were even sorer. Even my hands and shoulders hurt from clenching and pulling. But now, weeks later, I'm looking out the window, and just beyond the Marigolds, I can see three beautiful flower beds with ornamental grasses flowering with purple blossoms a little like grape hyacinths (*not* high grass with seed like ears of corn and no creepy crawly stuff) and I'm quite pleased with the results of my labor.

I've promised myself that I won't wait so long next time. What's the antonym for procrastinate? Curiously, there doesn't seem to be a precise one-word antonym for "procrastinate." The best I could find on the internet was "to deal with beforehand." I'm a little puzzled how I can deal with the weeds before they appear in the flower beds, so I'm just hoping I got enough of the weeds' roots to keep them in check for a while…maybe the snow will freeze them while I'm wrapping Christmas presents!!

Grace Robertson
Phone: (240)613-6671
Fax: (877) 477-9143
Grace.F.Robertson@irs.gov

LIHC Newsletter

ISSUE 54

DECEMBER 2013

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

HUD Handbook 4359.3, Chapter 5: Income-Qualified Households	1
Subscribing to the LIHC Newsletter	3
Guide for Completing Form 8823	3
♫ Grace Notes ♫	3

HUD Handbook 4350.3 Chapter 5: Income-Qualified Households

Background

Under IRC §42(g)(1), taxpayers elect to provide low-income housing for individuals whose incomes is either 50% or less of Area Median Gross Income (AMGI), or 60% or less of AMGI. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10c.

Under §142(d)(2)(B), an individual's income is determined in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937. IRC §42(g)(4) applies §142(d)(2)(B) to IRC §42 projects.

Notice 88-80 explains that individuals' income for purposes of IRC §42(g)(1) are determined using HUD's definitions of income for section 8 purposes and will not be made by reference to items of income used in determining gross income for purposes of computing federal income tax liabilities.

HUD maintains handbooks for administrating section 8. Handbook 4350.3, Chapter 5, Section 1 is the source document and authority for how income is treated when determining whether a household is income-qualified for IRC §42 purposes. The Handbook is available on the HUD website.

The Handbook is one of the authorities cited in Chapter 4 of the Guide for Completing Form 8823 (Form 8823 Guide), which also includes an in-depth discussion of how income from different sources is treated.

HUD Updated Handbook 4250.3

On August 7, 2013, HUD issued changes to the Handbook, which is designated CHG-4. Revisions within the Handbook are identified by asterisks (*) at the beginning and ending of the change. Pages with revisions can be identified by the date 8/13 in the bottom right-hand corner. The effective date is also August 7, 2013.

Questions & Answers

Q1: Should owners continue to rely on the IRS' Guide for Completing Form 8823?

A1: No. Owners should rely on HUD's handbook as the legal authority when determining a household's income. The Form 8823 Guide is not an authority itself; it is a compilation of authoritative references with explanations for applying the rules.

Q2: Must owners obtain documentation of income as described in Chapter 5, Section 3, of the Handbook?

A2: While the documentation requirements described in handbook are sufficient for IRC §42 purposes, Handbook 4250.3, Chapter 3, Section 3, Verification, is not the authority for documentation requirements.

(Continued on page 2)

(Continued from page 1)

RC §42 Requirements

In general, under IRC §6001, all taxpayers are held to a documentation standard of "sufficiency." Treas. Reg. §1.6001-1 explains:

1. Taxpayer must keep permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.
2. The required books or records must be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

Specific to determining whether a household is income qualified, Treas. Reg. §1.42-5(b) requires that taxpayer maintain:

1. The income certification for each low-income tenant completed at the time the household moved into the unit and, if required, annual income recertifications.
2. Documentation to support each low-income tenant's income certification. For example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation. In the case of a tenant receiving housing assistance payments under section 8, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under IRC §42(g).

Record Retention

Taxpayers must maintain records such as the income certifications and documentation for a specific tax year for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year.

The records for the first year of the credit period must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

Third Party Verification

The HUD Handbook includes a helpful discussion of third party verification on pages 5-54 through 5-56.

1. A document generated by a third party source provided by the tenant is still considered "third party" verification because the document originated from a third-party source. For example, a tenant may provide pay stubs or a W-2 prepared by the tenant's employer. When evaluating the documents, consider:

   Is it current? The tenant's circumstances may have changed since the document was created.

   Is it complete? For example, pay stubs can be used to verify income. Actual paychecks (or copies) are not acceptable because deductions are not identified on the paycheck.

   Is it the original document? If the document is a copy, it may have been altered by using high-quality copying equipment. Documents with original signatures are the most reliable.
2. Written documentation sent directly by the third-party may be received by mail, fax, or e-mail. If received by fax, the fax should include the company name and fax number of the third party. If received by e-mail, the e-mail address should be for the third party and include the name of the party sending the email.
3. Information verified on the Internet is considered third party verification if the information is from a reliable source. A printout from the Internet is adequate verification.
4. Third party verification may be made over the telephone. To ensure that the person on the telephone is the right party, it is best to call the verification source rather than accepting verification from a third party initiating the telephone call.

State Agency Requirements

The state housing agencies can require taxpayers to obtain specific documentation of income based on local practices and circumstances. Taxpayers are advised to consult with the state housing agency regarding documentation requirements for income certifications.

———

Q3: Paragraph 5-6, Q-3, has been added to the Handbook (page 5-20) and specifies that for section 8 tenants only, any deferred disability benefits from the Department of Veterans Affairs (VA) that are received in a lump sum or in prospective monthly amounts are excluded from annual income. Should deferred disability benefits from the VA be excluded for all households for IRC §42 purposes, or just households receiving section 8 assistance?

A3: The exception applies only to tenants receiving section 8 assistance. If the exception does not apply, the lump sum deferred payments are counted as an asset. If the lump sum payment was caused by delays in processing periodic payments, then the lump sum payment is included in income.

NOTE: The treatment of educational scholarships or grants is also dependent on whether the student is receiving section 8 assistance. See page 5-11 of the HUD Handbook

(Continued on page 3)

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:
As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

(Continued from page 2)

and page 4-18 of the Guide for Completing Form 8823.

Q4: How should income from IRAs be treated once someone begins receiving periodic payments, even if it is just one payment per year?

A4: Before the latest revision, Chapter 5, paragraph 5-6 L-2, read:"Withdrawals from retirement accounts such as Individual Retirement Accounts and 401K accounts that are not periodic payments are not counted in annual income." (See 5-7 G-4.) The references paragraph 6-7, G-4, read:

(b) Balances held in retirement accounts are counted as assets even though withdrawal would result in a penalty.

(d) Include in annual income any retirement benefits received through periodic payments.

HUD has clarified how these payments should be treated. As before, paragraph 5-6, L-2, reads: Withdrawals from retirement accounts such as Individual Retirement Accounts and 401K accounts that are not periodic payments are not counted in annual income (see 5-7 G-4). But paragraph 5-6, L-2(d) now clarifies that IRA, Keogh, and similar retirement savings accounts are counted as assets, even though withdrawal would result in a penalty, unless benefits are being received through period payments."

Therefore, IRS, Keogh, and similar retirement savings accounts are not considered assets if the person is receiving periodic payments.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov. Also designate whether you would like to receive the Adobe pdf version or the Word document.

♫ Grace Notes ♫

It's that time of year again and surely there will be children who ask us, "Is there really a Santa Claus?" They'll ask with pleading eyes and your heart will break. You can tell from their voices that they really want you to tell them that the magic is real, that Santa lives at the North Pole and travels the earth in a sleigh full of toys driven by flying reindeer…but they're just a little too grown up. So, what do we tell them? Maybe we can fudge a little and for one more year, for ourselves really, the magic will survive. But sooner or later, inevitably, the magic will evaporate --- poof!

We'll tell them that there really *was* a Santa Claus, an extraordinarily compassionate man who, to help relieve the suffering of poor children, anonymously delivered shoes and toys to poor children. The only evidence left behind were the ruts from the sled in the snow and hoof prints of the reindeer pulling it. We'll tell them that it is just as much fun planning and executing "Santa Claus" for the "little" kids as finding gifts under the tree on Christmas morning. And, without lecturing too much, we'll try to explain that it feels wonderful to remember the less fortunate; to give generously and anonymously without expecting anything in return, like Nicholas so long ago. It's even "fun" to be anonymous.

But why should they believe us? I always think of a wonderful M*A*S*H* Christmas episode titled "Death Takes a Holiday," Its Episode #199.

Happy Holidays!

Grace Robertson
(240) 613-6671
Grace.F.Robertson@irs.gov

ADMINISTRATIVE PROCEDURES

LIHC Newsletter

ISSUE #55

APRIL 2014

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

New IRC §42 Mailbox	1
Foreclosures	1
PHA Utility Allowance Update	2
Noncompliance Correction Period: A Common Misunderstanding	3
IRC §42 Audit Technique Guide	3
♫ Grace Notes ♫	5

New IRC §42 Mailbox

Got a question about IRC §42? You can now email your question to the new IRS mailbox, sbse.lihc@irs.gov. "SBSE" is the acronym for "Small Business Self-Employed," the division within the IRS administering the IRC §42 program.

Foreclosures

Unfortunately, low-income housing projects fail and foreclosures happen.

Foreclosure Defined

A "foreclosure" is a legal procedure occurring when an owner defaults on a loan, and the lender takes legal action because the property was used as security for the loan. As a result, the property is sold to recover the debt. Foreclosure proceedings are governed by state law in the state where the property is located.

Alternatively, an owner may deed the property directly to the lender in a "transaction in lieu of foreclosure" in full or partial satisfaction of the mortgage debt.

Foreclosures do not include:

- Bankruptcy proceedings, although the property may ultimately be sold to pay the owner's debt.
- Selling a failing property to a third party who will assume the debt, with the lender's approval.

Law

IRC §42(h)(6) requires taxpayers to enter into an extended use agreement to provide low-income housing for a period not less than 30 years, beginning at the same time as the 10-year credit period. The agreement is made with the housing agency that allocated the credit and is recorded in the land records. The agreement is often referred to as a "land use restriction agreement" or "LURA." A building is not considered a qualified low-income building, and no credit is allowable, if an extended use agreement meeting all the requirements is not in place.

Generally, in the event of a foreclosures or transactions in lieu of foreclosure, the extended use agreement terminates as of the date the building is acquired by foreclosure (or instrument in lieu of foreclosure).

Effect on New Owner

Under IRC §42(d)(7)(A)(ii), a taxpayer acquiring an IRC §42 project during the 15-year compliance period can claim any credit that would have been allowable to the prior owner. In the event of a foreclosure or transaction in lieu of foreclosure, the lender or new owner may decide to operate the project in compliance with IRC §42. In which case, the lender or new owner will need to enter into a new extended use agreement with the allocating housing agency by the end of the taxable year for which the new owner intends to claim the credit.

(Continued on page 2)

PHA Utility Allowance Update

Gross rent, under IRC §42(g)(2)(B)(ii), includes a utility allowance to account for utilities paid by the tenant.

- Utilities do not include telephone, cable television, or Internet service.
- A separate estimate is computed for each utility.
- Different methods can be used to compute the individual utility allowances.
- The utility allowance is computed on a building-by-building basis.
- The maximum rent that may be paid by the tenant must be reduced by utility allowance(s).

Treas. Reg. §1.42-10 provides guidance for determining and applying utility allowances.

HUD Utility Schedule Model

One of the acceptable methods for calculating a utility allowance is the HUD Utility Schedule Model, which can be accessed on HUD's website.

The Utility Schedule Model uses codes assigned to the Public Housing Authorities (PHAs) to identify locations when calculating an allowance. HUD recently updated the webpage to include a listing of PHAs and the related code needed to calculate the utility allowance.

Updating Utility Allowances

* If the applicable utility allowance for units changes, the new utility allowance must be used to compute gross rents of the units due 90 days after the change (the 90-day period).
* A taxpayer using a utility company estimate, the HUD Utility Schedule Model, or an energy consumption model must submit copies of the utility estimates to the Agency that has jurisdiction over the building and make the estimates available to all tenants in the building at the beginning of the 90-day period before the utility allowances can be used in determining the gross rent of rent-restricted units. Any utility estimates obtained under the Agency estimate must also be made available to all tenants in the building at the beginning of the 90-day period.
* The taxpayer must pay for all costs incurred in obtaining the estimates and providing the estimates to the Agency and the tenants.
* The taxpayer is not required to review the utility allowances, or implement new utility allowances, until the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period, whichever is earlier.
* The building owner must review at least once during each calendar year the basis on which utility allowances have been established and must update the applicable utility allowance accordingly. The review must take into account any changes to the building such as any energy conservation measures that affect energy consumption and changes in utility rates.

Foreclosures

(Continued from page 1)

Otherwise, the new owner is under no obligation to continue operating the project in compliance with IRC §42, except for one provision. IRC §42(h)(6)(E)(ii) includes protections for tenants in the event of a foreclosure or transaction in lieu of foreclosure. For three years following the termination of the extended use agreement, the owner is not permitted to evict or terminate the tenancy (other than for good cause) of an existing tenant of any low-income unit, or increase the gross rent with respect to a low-income unit not otherwise permitted under IRC §42.

Effect on Former Owner

Foreclosures and transactions in lieu of foreclosure are treated as any other disposition. See CCA 201146016.

- The termination of the extended use agreement results in the disallowance of the credit for the year of disposition (unless the new owner enters into a new extended use agreement by the close of the year of disposition or IRC §42(h)(6)(j) otherwise applies), but does not automatically result in recapture under IRC §42(j).

(Continued on page 4)

Noncompliance Correction Period: A Common Misunderstanding

State housing agencies are required to review IRC §42 projects at least once every three years. As part of the review, the agencies physically inspect all the low-income building and, for at least 20% of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units. All observed noncompliance is reported to the IRS on Form 8823, Low-income Housing Credit Agencies Report of Noncompliance or Building Disposition, regardless of whether the noncompliance has been corrected.

Before sending the Forms 8823 to the IRS, however, the taxpayer is provided an opportunity to correct the noncompliance. As explained in Treas. Reg. §1.42-5(e)(4), the "correction" period is the period specified by the state agency during which the taxpayer must bring the project into compliance with IRC §42 requirements. The correction period is not to exceed 90 days from the date of the notice given to the taxpayer. An agency may extend the correction period to a total of six months, but only if the agency determines that there is good cause for granting the extension.

It is commonly believed (and argued by taxpayers during IRS audits) that noncompliance corrected within the correction period provided by the state agency has no tax consequences; i.e., no loss of credit or recapture under IRC §42(j). This is not true. The correction period is simply an administrative convenience allowing a taxpayer to correct noncompliance before submitting the Form 8823 to the IRS.

The tax consequences of noncompliance are not the same for all noncompliance issues and must be determined by applying the law to the particular circumstance of the noncompliance event.

IRC §42 Audit Technique Guide

Audit Techniques Guides (ATGs) help IRS examiners conducting audits by identifying issues and accounting methods unique to specific industries. While ATGs are designed to provide guidance for IRS employees, they're also useful to taxpayers and tax professionals who prepare returns.

A new ATG has been drafted for IRC §42, the Low-Income Housing Credit, and was released for public comment in December of 2013. Comments were due March 28, 2014.

The draft IRC §42 ATG has also been reviewed within the IRS by Revenue Agents. You might say the ATG has been "road tested" and the tires kicked. After considering all the feedback, the draft ATG will be revised. The completed ATG will then be made available on the IRS website.

IRC §42 ATG v. Form 8823 Guide

◊ The IRC §42 ATG does not replace the Form 8823 Guide, which was written to assist state housing agencies evaluate taxpayer compliance with IRC §42 requirements and report noncompliance to the IRS. The Form 8823 Guide is considered an ATG for IRS administrative purposes and is available to the public as well as state housing agencies.

◊ The two documents are complementary. Combined, they provide a reasonably complete discussion of IRC §42.

◊ The Form 8823 Guide is referenced in the IRC §42 ATG rather than duplicating information.

Other ATGs

For more information about ATGs, visit the IRS website, where there's a link to a very short video. Other ATGs that might be helpful include:

Conservation Easements

Construction Industry

Rehabilitation Tax Credit

Foreclosures

(Continued from page 2)

- The former owner is subject to recapture upon disposition unless IRC §42(j)(6) applies; i.e., there is no recapture on disposition of building if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the building's remaining compliance period, including entering into an extended use agreement for the remainder of the building's entire +30-year extended use period.

State Agency Responsibilities

State housing agencies should:

1. Report the disposition to the IRS on Form 8823, line 13a, and check the "foreclosure" box. If the building will no longer participate in the program, check the box for line 11p.

   If available, include the foreclosure documentation as an attachment. Check the box for line 12 on Form 8823.

   If the new owner has entered into a new extended use agreement and is continuing to operate the building in compliance with IRC §42, include an attachment to affirm for the IRS that the building is participating in the program.

2. Make sure the tenants are aware of their rights; i.e., the three-year tenant protections can be enforced by tenants.

Planned Foreclosures

Under IRC §42(h)(6)(E)(i)(I), the extended use agreement terminates on the date the building is acquired by foreclosure or instrument in lieu of foreclosure *unless the Secretary determines* that such acquisition is part of an arrangement with the taxpayer a purpose of which is to terminate such period.

A state housing agency that becomes aware of a situation that it believes constitutes a "planned" foreclosure can provide a letter detailing the characteristics of the transaction to James Holmes in the IRS Office of Chief Counsel, Passthroughs & Special Industries, Branch 5.

IRS Audits

The scope of an IRS audit is not limited to the IRC §42 issues. The IRS also considers the foreclosure itself and whether the taxpayer properly reported the gain (or loss) upon disposition and any income from cancellation of the debt.

Whose flag is this? Answer at the end of the newsletter after ♫Grace Notes♫.

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just send an email to sbse.lihc@irs.gov. Please specify whether you would like to receive the Adobe pdf version or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

♫ Grace Notes ♫

Its April Fools' Day today and time to execute a well-planned "prank" on a friend… all in good fun, of course. Ever wonder why we engage in this delightful ritual?

From 1568 until 1648, the Dutch were at war with the Spanish…and yes, that's 80 years of warring. The king of Spain gained control of the southern part of the country, what we now know as Belgium, and then his soldiers marched north to conquer the rest of the stubborn Netherlanders.

The nobles of Holland, led by Prince William of Orange (known as William the Silent and grandfather of the William of Orange that would become king of England), did their very best to free the cities occupied by the Spanish. The Prince and his sons dedicated their lives to liberating the Netherlands from the Spanish rule. Not to be redundant, but this war went on for 80 years.

A small town in the south called Brielle, close to the sea and rivers, was an important stronghold for Spain. From here, the Spanish could control the flow of weapons and supplies to the soldiers further north. Liberating this town was imperative to breaking the Spanish hold on the Netherlands. So, freedom fighters, called Sea Pirates, decided to liberate Brielle.

The pirates smuggled soldiers into the city by hiding them in the bottoms of two flat bottom barges loaded with vegetables, fruits, wine, and beer on top. The barges entered the city using one of the many canals. As planned, the barges arrived in the market place so late in the afternoon that it was too late to unload them before dark, so they were tied to the dock until morning. During the evening, while still hidden in the barges, one of the pirates began coughing. Not wanting to endanger the operation, he allowed himself to be strangled to death. By midnight the Spanish guards were all asleep, except for a few guards, and they had enjoyed the beer and wine confiscated from one of the barges a bit too much.

In the middle of the night of April 1, 1572, the pirates crept off the barges and the weak Spanish garrison was thrown out. Brielle was liberated and the Netherlanders celebrated breaking the Spanish stronghold on the north. It was a pretty good joke, too, because "Brielle" means spectacles in Dutch and the Spanish had lost their spectacles and were blindly wandering around without control of Brielle.

Other cities were liberated and joined William of Orange, and the Spanish finally responded by sending more soldiers to the north to suppress the rebellion. Cities withstood sieges and starvations, dams were broken to flood the land, and the sea pirates came to their rescue. The world marveled at the courage of the small Dutch towns in watery Holland who dared to resist the Spanish, whose realm was worldwide.

The strategy was successful and the Spanish never again succeeded in subjecting Holland and the Netherlanders to their rule. The Dutch remember the pun each year on the April 1st anniversary by playing tricks and silly jokes on each other.

And the Dutch people carried on the tradition when they immigrated to other countries. I should know. I'm the daughter of a Dutch immigrant who will tell you herself that she left everything behind in one free country to be an American, no other free county would do.

Grace Robertson
Phone: (240) 613-6671
Fax: 877-477-9143
Grace.F.Robertson@irs.gov

The Eighty Years War is a complicated subject. For more information you might want to read A Short History of the Netherlands by Allert de Lange, or, for shorter but not necessarily short or complete articles, see Wikipedia: April Fools' Day, William the Silent, and the Capture of Brielle.

The Netherlands…more information is available on Wikipedia.

LIHC Newsletter

ISSUE #56

SEPTEMBER 2014

The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

New Analyst Joins the IRC §42 Program	1
IRS Completes Audit Technique Guide For IRC §42, Low-Income Housing Credit	1
Building Identification Numbers (BINS)	2
Form 8823: Reporting Noncompliance	3
Form 8609 Part II, First-Year Certification: Line 7, Eligible Basis	3
♫ Grace Notes ♫	5

New Analyst Joins the IRC §42 Program

Milton Pagan, a senior program analyst at the Internal Revenue Service, has joined SBSE's Technical Issues group and will be working with the IRC §42 program. Although new to the IRC §42 program, Milton has been with the Service for over 27 years, with assignments including the Examination of Income, Ponzi/Investment Theft Losses, Fraud, and the Whistleblower Program. Milton is located in San Diego, California. Communications should be directed to the IRC §42 mailbox.

IRS Completes Audit Technique Guide For IRC §42, Low-Income Housing Credit

The new audit technique guide (ATG) for IRC §42, Low-Income Housing Credit, is finished. The ATG was prepared to assist IRS examiners audit taxpayers, usually partnerships, owning IRC §42 projects. It is organized in the order an examiner might address issues during an examination, starting with an overview of the credit and how to complete a precontact analysis through calculating an adjustment to the credit and writing the audit report. Two related topics, auditing partners and completing the Examination of Income, are also addressed.

IRC §42 ATG v. Form 8823 Guide

The new IRC §42 ATG does not replace the Form 8823 Guide, which was written to assist state housing agencies evaluate taxpayer compliance with IRC §42 requirements and report noncompliance to the IRS. The two documents are complementary, however, and the Form 8823 Guide is referenced in the IRC §42 ATG rather than duplicating information.

Industry Review

A draft of the guide was released for public comment last December. Comments were due by the end of March and 19 groups and individuals responded. The comments covered a wide range of issues and included technical corrections, suggestions for additional topics, and one group even checked citations, which was very much appreciated.

Internal Review

The draft was also shared with interested revenue agents, field group managers, and program analysts. Their comments are also reflected in the final document.

Revisions

Here are some of the changes made to the January 2014 draft:

(Continued on page 4)

ATG Tidbits:

- *Appendix A is a compilation of IRC §42 terms.*
- *Appendix B is a listing of IRC §42 references, with complete citations and summary of the document. If a complete reference is not provided in the ATG, you'll find it in Appendix B.*
- *Appendix C answers the most frequently asked IRC §42 question: whether an asset or cost is includable in Eligible Basis.*

Building Identification Numbers (BIN)

A Building Identification Number (BIN) is assigned to every building receiving an allocation of IRC §42 credit, or, as described in IRC §42(h)(4), is financed with tax-exempt bonds subject to the volume cap under IRC §146. The rules for assigning BINs are outlined in Notice 1988-91.

Purpose

The BIN is comparable to an individual's Social Security Number (SSN) or an entity's EIN (Employer Identification Number), which are sometimes collectively referred to as Taxpayer Identification Numbers (TIN). BINs are identified on the following forms:

- Form 8609, Low-Income Housing Credit Allocation and Certification.
- Form 8610-A, Carry-Over Allocation of Low-Income Housing Credit.
- Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
- Form 8609-A, Annual Statement for Low-Income Housing Credit
- Form 8611, Recapture of Low-Income Housing Credit, if there is a recapture event under IRC §42(j).

Format

The BIN consists of a two character state designation (the postal state abbreviation) followed by a two digit designation identifying the year the *first* credit allocation is made, and a five digit number designation assigned by the state housing agency.

For example, the identification number for one of 25 buildings allocated a credit in 1987 by the Connecticut Housing Finance Authority (the only housing credit allocating agency in the state) might read CT-87-00023.

Unique BIN

The BIN must be unique to the building and the same BIN must be used for all allocations of credit. As described in See Treas. Reg. 1.42-6(d)(2)(x):

> The BIN must reflect the year an allocation is first made to the building, regardless of the year that the building is placed in service. This BIN must be used for all allocations of credit for the building. For example, rehabilitation expenditures treated as a separate new building under section 42(e) should not have a separate BIN if the building to which the rehabilitation expenditures are made has a BIN. In this case, the BIN used for the rehabilitation expenditures shall be the BIN previously assigned to the building, although the rehabilitation expenditures must have a separate Form 8609 for the allocation. Similarly, a newly constructed building that receives an allocation of credit in different calendar years must have a separate Form 8609 for each allocation. The BIN assigned to the building for the first allocation must be used for the subsequent allocation.

Four examples:

- A building may receive separate allocations of credit for the acquisition of the building and the rehabilitation of the building.
- A newly constructed building may receive credit allocations in different calendar years. A separate Form 8609 will be used for each allocation and the BIN assigned for the first allocation will be used for all the subsequent allocations.
- An owner received an allocation of credit to construct a new low-income building. The building was timely placed in service and has completed the 15-year compliance period. The building is still within the 30-year compliance period when it is sold to a new owner who applies for and receives an allocation of credit for acquiring and rehabilitating the existing building. The BIN assigned at the time the building was constructed will be used again, even though the allocation of credit is for a new owner and the 15-year compliance period has expired for the first allocation.
- An owner received an allocation of credit in 1988 to construct a new low-income building. The building began the credit period in 1989 and the 15-year compliance period ended in 2003. The building was never subject to an extended use agreement. In 2014, the building was sold to a taxpayer who applies for and receives an allocation of the credit for both the acquisition and rehabilitation of the building. The BIN assigned to the building in 1988 should be used for the new allocation of credit even though the building was not subject to IRC §42 requirements at the time it was acquired in 2014.

Assignment by Authorized Housing Credit Agency

The BIN will be assigned by the housing credit agency that is authorized to make the credit allocation. If there is more than one allocating agency in the state, the agencies should coordinate the assignment of BINs to ensure that BINs are not duplicated.

Form 8823: Reporting Noncompliance

Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, is filed with the IRS by state housing agencies to report noncompliance events. Before reporting the noncompliance, however, the owner is provided a period of time to correct the noncompliance. The correction period is not to *exceed* 90 days from the date of the notice to the owner that noncompliance was identified. The state agency may identify a shorter period depending on the nature of the noncompliance. The correction period may be extended by the state agency for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

Regardless of whether the noncompliance was corrected during the correction period, the state agency must report the noncompliance to the IRS within 45 days after the end of the correction period using Form 8823. The form includes a list of noncompliance categories with a "out of compliance" and "compliance corrected" box.

- If the noncompliance was not corrected within the correction period, then the "out of compliance box" is checked and the noncompliance date is reported on line 8.
- If the noncompliance was corrected within the correction period, then *both* the "out of compliance" and "compliance corrected" boxes should be checked. The noncompliance date is reported on line 8 and the date the noncompliance was corrected is reported on line 9.
- If the noncompliance is corrected within three years after the end of the correction period and the agency has already filed a Form 8823 to report the noncompliance, then only the "noncompliance corrected" box is checked.

To summarize, there should always be a "out of compliance" and corresponding "noncompliance corrected," whether reported on the same Form 8823 or separate Forms 8823.

Form 8609 Part II, First-Year Certification: Line 7, Eligible Basis

The First-Year Certification requirement under IRC §42 (l)(1) is satisfied by completed Form 8609 Part II of the Form 8609 Part I executed by the state housing agency and then filing the form with the IRS. On line 7, the taxpayer reports the eligible basis for that credit allocation.

The form's instructions for line 7 includes "If the housing credit agency has entered an increased percentage in Part I, line 3b, multiply the eligible basis by the increased percentage and enter the result." The reference is to IRC §42 (d)(5)(B).

The line 3b instructions read:

> Line 3b. Special rule to increase basis for buildings in certain high-cost areas. If the building is located in a high-cost area (i.e., "qualified census tract," "difficult development area," Gulf Opportunity (GO) Zone, Rita GO Zone, or Wilma GO Zone), the eligible basis may be increased as follows.
>
> - For new buildings, the eligible basis may be up to 130% of such basis determined without this provision.
> - For existing buildings, the rehabilitation expenditures under section 42(e) may be up to 130% of the expenditures determined without regard to this provision.
>
> Enter the percentage to which eligible basis was increased. For example, if the eligible basis was increased to 120%, enter "120."
>
> Buildings placed in service after July 30, 2008. For these buildings, the definition of a "difficult development area" has been expanded to include any building designated by the state credit agency in order to be financially feasible as part of a qualified low-income housing project.

A state agency made also determine that, although the building is located in an area qualifying for the increase in eligible basis, no increase was necessary for the financial feasibility and viability of the building as part of a qualified low-income housing project. In which case, the state agency would enter 100% on line 3b and the taxpayer would enter the actual eligible basis (without any increase) on line 7, even though the building was in a location qualifying for the increase.

New Audit Technique Guide

(Continued from page 1)

- Chapter 2, Precontact Analysis, now includes Exhibit 2-1, IDR & Crosswalk to Issues. This explanation of documents to request from the taxpayer includes references to the chapters in the ATG related to the documents.

- Chapter 7, No Longer Participating in the IRC §42 Program, includes an expanded discussion of the state agencies' authority to determine that a building is no longer participating in the program (see page 7-1).

- Chapter 8, Eligible Basis: Includable Costs:

  ◊ The definition of "Residential Rental Property" on page 8-1 has been expanded to reference Notice 88-91, which explains that a townhouse can be a "qualified low-income building" along with apartment buildings, single-family dwellings, rowhouses, duplexes, and condominiums.

  ◊ The discussion of deferred developer fees, starting on page 8-19, clarifies that a deferred developer fee may be documented by a note or by another document.

- Chapter 12, Applicable Fraction

  ◊ A new section titled "Units Occupied by On-Site Managers, Maintenance Personnel, and Security Guards" was added on page 12-9. Audit techniques for this issue are outlined on page 12-14.

  ◊ A new section titled "Emergency Housing Relief" was added on page 12-9, and references revenue procedures 2007-54 and 2014-49.

  ◊ "Deep Rent Skewing" on page 12-17 was revised to correct a technical error. #1 on the list now correctly explains that, for deep rent skewed units, the gross rent does not exceed 30% of the applicable *income limit* applicable to the individuals occupying the unit.

  ◊ "Casualty Losses in Federally Declared Disaster Areas" was expanded to include reference to newly released Rev. Proc. 2014-49.

  ◊ Examples #4 and #5 on pages 12-44 and 12-45 were expanded to demonstrate the computation of the applicable fraction for the first year of the credit period under IRC §42(f)(2)(A) using the lesser of the Unit Fraction or the Floor Space Fraction methods as required by IRC §42(c)(1)(B).

  ◊ "Project Defined" on page 12-47 now includes Treas. Reg. §1.103-8(b)(4)(ii) as a reference, as well as IRC §42(g)(7).

- Chapter 17, Examples, was expanded to include a new section on page 17-4 titled "Partial Disallowance of Credit During the 10-Year Credit Period."

- Appendix C, Treatment of Assets/Costs for IRC §42 Purposes, has also been expanded.

  ◊ Accounting Costs are separately addressed on page C-1.

  ◊ A new category titled "Acquiring Occupied Building: Tenant Relocation Costs" has been added on page C-10.

  ◊ The section titled "Real Estate Taxes" on page C-10 has been expanded to include taxes incurred during the pre-production period.

  ◊ IRC §266 is addressed in a new section titled "Carrying Charges Other Than Interest" on page C-11.

And all this just proves that it is perfectly fine to have a whole bunch of cooks in the kitchen, as long as just one cook stirs the pot! Thanks to all of you who contributed to making this ATG a better source document for information about IRC §42.

IRS Web and 508 Compliance

The finalized ATG will be available on IRS.gov as both a searchable html file and a 508 compliant Adobe .pdf document.

Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:
Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:
If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just send an email to sbse.lihc@irs.gov. Please specify whether you would like the Adobe pdf format or the Word document.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file.

On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

♫ Grace Notes ♫

My life has a soundtrack. The overture includes my great-grandfather's favorite aria, my grandfather's favorite waltz, my grandmother's favorite hymn, the Liszt rhapsody that always makes my mother cry, and the Tchaikovsky concerto that my dad whistled while painting our home turquoise (it looked nicer than it sounds). I hear Sousa's Stars and Stripes Forever and I'm transported back at the old Utah state fair grounds on the 24th of July (Utah's founder's day), hot and dusty, watching the magnificent palomino horses with their silver bridles and saddles parading in formation around the grounds, the American flag leading the way…the piccolo solo still thrills me. Just mention the Tijuana Brass and I'm back in my 9th grade gym class (ugh!) doing exercise routines to Spanish Flea. Dark winter mornings riding on the school bus listening to the radio come back whenever I hear The Captain and Tennille singing about muskrats in love.

But it was Roger Whitaker's "The First Hello, The Last Goodbye" that played on a loop in my head during my senior year of high school. I'd emerge from deep sleep early in the morning to hear his rich deep baritone voice on the clock radio, singing the verses over and over (at least is seemed like it) until the words were etched on my brain, "…the end of the beginning is the beginning of the end….and the first time that we said hello began our last goodbye." There's a discreet period of time after the beginning and before the inevitable goodbye, an unknown measure of time.

Another song has been looping around in my thoughts lately. It's a song I learned from a friend long lost. It's titled "Sometimes" and the first verse begins, "… Sometimes, not often enough, we reflect upon the good things and those thoughts always center around those we love…" It's true. I have been welcomed among you and it has been the opportunity of a lifetime for me to work together with you for such a praiseworthy purpose. How blessed I have been. I have no words to express my gratitude but to say "thank you." It seems so totally inadequate. I wish I could give all of you a great big hug!

Do I have any recommendations for your soundtrack? Well…not really. But I do so hope you'll spend your measure of time wisely. I hope that wherever you go, you'll go wholeheartedly, and wherever you find yourself, I hope you will be do what's right and do it well. You are, after all, responsible for no one's actions but your own.

I've been the IRC §42 program analyst for 15 years now, and as a friend reminded me, my compliance period is about to expire. On September 26th, I will be commuting home around the Washington beltway for the last time. But there's no melancholy last goodbye for me. I'll be listening to the soundtrack from Star Trek VI: The Undiscovered Country.

I'll think about Captain Kirk and his crew, just three months from retirement, when they are called up for one last diplomatic mission, which (of course) goes all awry. I'll listen to the ominous overture leading up to the explosion of a Klingon moon, a lonely trumpet solo as Kirk and Dr. McCoy hike across a glacial expanse, and as I approach home, I'll hear the crew of the starship Enterprise, having saved the entire known civilization yet again, return safely back home to the bridge of the Enterprise. Chekov asks Captain Kirk, "Course setting, Captain?" And, with a sigh, knowing this is their last mission together, knowing that they are soon standing down, he gives his last command. As the Star Trek theme crescendos to a full orchestral swept, Kirk looks forward and commands, "Second star to the right and straight on 'til morning." It's all about the future and that's where you'll find me.

Until we meet again,

Grace Robertson