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.

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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.

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Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 3 **May 2001**

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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.

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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 not 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.

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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.

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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.

<u>Information from the LIHC Compliance Unit</u>

- 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.

<u>Information from the State Housing Agency</u>

- 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.

<u>Examine Rental Income</u>

- 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.

<u>Examine the Tenant Files</u>

- 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.

<u>Examine Eligible and Qualified Basis of the Project</u>

- 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!

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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 taxpayer 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.

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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!

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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 <u>and</u> 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:

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

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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!

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

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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.

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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.*

<u>Project Financing</u>

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.*

<u>Day-to-Day Operations</u>

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.

Form 8823 Notices of Noncompliance

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?

Due Diligence

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!

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Low Income Housing Credit Newsletter

Internal Revenue Service

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

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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 <u>not</u> 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 <u>not</u> 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.

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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!

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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.

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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 <u>and</u> 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 <u>not</u> 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!

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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.

<u>Credit for Substantial Rehabilitation</u>

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 <u>not</u> 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.

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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!!!

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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 <u>not</u> 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?

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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.

<u>Revised Form 8609</u>

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).

<u>Submission to the IRS</u>

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.

<u>New Form 8609-A</u>

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.

<u>Required Filing Checks (Partnerships and Other Flow-Through Entities)</u>

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).

<u>Required Filing Checks (Corporations)</u>

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. 21 ***August 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!!

Reviewing Tenant Files: State Agency Requirements

Under Treas. Reg. 1.42-5, state housing agencies are responsible for periodically reviewing tenant files. The files must be reviewed at least once every three years and the files for at least 20% of the units in the project (which may be multiple buildings) must be reviewed.

The purpose of the review is to determine whether the household occupying the unit is income-qualified; i.e., the household's income does not exceed the limit. The dollar limit on income is determined based on (1) the number of people in the household, (2) the Area Median Gross Income determined by HUD for the location of the building and (3) the taxpayer's minimum set-aside election.

Defining Income

Income for purposes of determining a household's income is not "Taxable Income" as reported on a tax return. 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, not in accordance with the determination of gross income for federal income tax liabilities. HUD's Handbook 4350.3, chapter 5, is the reference for determining the treatment of income for Section 8 purposes. (For *IRS employees*, Handbook 4350.3, chapter 5 is available on the Examination Specialization & Technical Guidance webpage at **http://sbse.web.irs.gov/TG/TGIndustryIssues.htm#LowIncome**.)

To determine whether a household is income-eligible, the owner must estimate the amount of income the household will receive during the next 12 months. Generally, annualizing the household's current income is a reasonable method for anticipating future earning. In addition, owners must account for any anticipated changes. Examples within the handbook clearly indicate that "anticipated changes" are those events where the source of the anticipated funds is identifiable, as well as an approximate amount of income.

Similar to IRC §61, income for Section 8 purposes includes everything not specifically excluded by regulation.

Documenting Income

The HUD handbook also outlines standards for collecting evidence and documenting the tenant's file. Most state agencies have adopted these standards for IRC §42 properties and owners are required to meet the standards as set forth by the states. However, the IRS standard, as stated in Treas. Reg. 1.42-5(b)(vii) is very broadly stated:

> 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 verification of income from third parties such as employers or state agencies paying unemployment compensation).

Evaluating Income Certification

When evaluating tenant files, state agencies are determining whether the households were income-qualified at the time of move-in or last annual income recertification.

- Have all the potential sources of income been accounted for?
- Are the methods for estimating income reasonable based on the facts?

- Was the correct income limit used?
- Was the computation correct?
- Is the evidence sufficient?
- Does the information make sense?

Basically, does the certification and documentation support the conclusion that the household is income-qualified?

Once the review of the sampled tenant files is complete, the state agency evaluates whether the sample should be expanded to include more files. Was the same mistake made over and over again (systemic) or was there a significant number of different mistakes (extensive)?

The owner is then presented with the state agency's finding and provided a period of time to correct any items of noncompliance.

<u>Reporting Noncompliance</u>

Once the correction period (generally 90 days) has expired, the state agency is required to report any findings of noncompliance to the IRS, regardless of whether the taxpayer corrected the noncompliance. Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, is used for this purpose. The form includes a list of common noncompliance issues, as well as an "other" category for issues not specifically identified.

The completed forms are submitted (with supporting documentation) to the LIHC Compliance Unit, where they are processed. Taxpayers receive a contact letter to provide notification that the IRS has received a Form 8823. The Forms 8823 are also evaluated for audit potential.

Auditing Tenant Income Issues: IRS Procedures

Kent Rinehart, Program Analyst

By the time a case reaches a revenue agent, the case will quite probably include a significant amount of case-building information, including Forms 8823 and supporting documents submitted by the state agency. For tenant income issues, the state agencies often include a summary, unit-by-unit, of the noncompliance items and associated dates.

At a minimum, and regardless of whether noncompliance has been reported by the state agency, the following audit steps should be completed.

<u>Interview the Taxpayer</u>

The focus of the interview should be on the taxpayer's internal controls intended to ensure that households are properly qualified. 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?

- What are the procedures for income-qualifying potential tenants and making sure the requirements are met?

- How does the taxpayer identify and monitor changes in household size? What procedures are in place to do this? How diligent is the taxpayer in making sure that the actual size of the household matches tenant information in the file.

The rules for LIHC properties are detailed and 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.

- Have 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?

<u>Evaluate Procedures for Qualifying Households</u>

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. 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 is student status confirmed? How does the property manager know when it is time for the annual recertification?

<u>Evaluate Internal Controls</u>

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?

<u>Review Tenant Files</u>

Although the state agency may have conducted a thorough review of a sample population of tenant files, examiners should conduct an independent inspection of the records. Two issues need to be considered; (1) whether the household's income has been correctly computed, and whether the correct income limit (based on the AMGI and the taxpayer's minimum set-aside) has been applied.

Testing 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 an estimate of the tenant's total anticipated gross income for each year. Generally, if the tenant's gross income on the tax return and nontaxable income added together 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.

Testing Income Limits (Household Size)

Since the income limit is dependent on the size of the household, the next step is to determine whether the tenant's file identifies 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 from the LIHC project's address using IDRS commands. 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. 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.

Auditing Tenant Income Issues: A Tax-Exempt Bond Case Study

Robert T. Main, TEB Agent

Local housing authorities or government entities promote the development of low-income housing in their communities by issuing tax-exempt bonds and loaning the proceeds to developers to build low-income housing projects. These developers can save millions of dollars in interest expense by using this tax-exempt debt. The low-income credits are an additional economic incentive.

To be a "qualified" low-income facility and qualify for the low-income credits, the owner must comply with the record keeping and record retention provisions used to determine tenant income under Treas. Reg. §1.42-5(b)(vii). Failure to comply with this regulation could put the tax-exempt bond in jeopardy.

Qualified low-income housing projects must comply with the minimum set-aside test (20-50 or 40-60), as elected by the taxpayer. In both tests, the first number describes the percentage of the rental units that must be occupied by low-income tenants. The second number represents the percentage of the area median gross income (AMGI) for the location where the housing is built, and determines the income limit The same tests are used for IRC §42 properties (IRC §42(g)(1)) and IRC §142 tax-exempt bond properties (IRC §142(d)(1)) These tests are used to determine whether the project qualifies as low-income housing and, if financed with bonds, whether the bonds are tax-exempt.

<u>Income-Qualified Tenants</u>

In a recently closed tax exempt bond case, it was necessary for me to determine whether new tenants were income-qualified using the AMGI for the area. This was a mixed-use property, so I wanted to make sure the owner was complying with the Next Available Unit Rule under IRC §142(d)(3)(B) by renting vacant units to income-qualified tenants. This rule is intended to ensure that as households' incomes increase above 140% of the income limit, these "over-income" households are replaced by households with qualifying income. Remember, for purposes of the tax-exempt bond, only the minimum number of low-income units must be maintained.

First, I accessed internal sources using social security numbers for the tenants living in the housing. (See IRM Exhibit 4.10.4-2, Internal Sources of Information.)

Second, I determined the household's income by adding the W-2 wages, net schedule C income, interest, dividends, and periodic payments of the tenant(s) for each low-income designated unit.

Then, after adjusting for family size, I compared the income limit to my determination of gross income for tax purposes. If the tenant(s) gross earnings for tax purposes exceeded the HUD limits, I knew it was probably a nonqualifying low-income unit.

Outcome

The disqualified units will affect the Applicable Fraction and the amount of LIHC will be reduced. If the number of qualifying units drops below the owner's elected 20% or 40% minimum in any year after the first year of the credit period, the entire credit is disallowed for that year. If a project fails the minimum set-aside requirement for the first year of the credit period, the owner is prohibited from ever claiming the LIHC. Disallowance of credits may also cause a failure in the tax-exempt bond financing for the low-income project.

If the tax-exempt bonds are determined to be taxable bonds, what is the downside to the owner of the facility? The owner could end up paying the tax exposure of all the bondholders. Tax exposure consists of the bond issuer and conduit borrower (usually the developer) entering into a closing agreement with the IRS (TE/GE Tax Exempt Bonds Divisions [TEB]) to capture 29% of the interest paid to bondholders going back three years and going forward for as long as the bonds are on the market. The owner's interest deduction paid on the loan could also be denied under IRC §150(b)(2)(B) for all open statute years.

Issues Related to Tax Exempt Bonds

An owner who uses tax-exempt bonds to finance his low income facility could have income tax problems even if he meets the LIHC requirements under both IRC §§ 42 and 142.

- Take a look at the depreciation schedule of the facility. Did the owner use accelerated depreciation on the portion of the facility purchased using tax-exempt bond proceeds? If the owner used anything other that straight-line depreciation under IRC §168(g)(1)(C), there's an income tax adjustment for an improper depreciation deduction. (No referral to TEB is necessary for this adjustment.)

Referrals to Tax Exempt Bonds (TEB)

You've just completed a Low-Income Housing Credit (LIHC) examination and determined that there is a serious issue with nonqualifying households or the owner's records are insufficient or nonexistent. As a result, you have adjustments eliminating some or all the low-income housing credits. Is your examination complete?

One important aspect of your examination should include a determination of how the low-income facility was financed and whether tax-exempt bonds were involved in this financing.

- Form 8609, line 4, identifies the percentage of aggregate basis (land and building) that is financed with tax-exempt bonds. Also, buildings financed with tax-exempt bonds are limited to the 30% present value credit, which is reflected on Form 8609, line 2.

- Ask the owner in your initial interview if the low-income facility was financed with tax-exempt debt.

- Request a copy of Form 8038, which is an information return for Tax-Exempt Private Activity Bond Issues.

- Review deductions on the income tax return for costs of bond issuance or expense reimbursements from bond proceeds.

Owners claiming low-income credits on the residential rental units, but have poor records of qualifying tenant incomes, face substantial financial penalties when tax-exempt bonds are part of the financing. Local housing authorities and local governments want low-income housing to be occupied by households who need the benefits. They are not pleased when their efforts are circumvented by owners who allow tenants with higher incomes to occupy the units and limit the availability of affordable housing for those who truly need the housing.

If tax-exempt bonds were used in financing of the building or rehabilitation of a low-income housing facility, and you have adjustments because units were occupied by nonqualifying tenants, consider a referral to TE/GE Tax Exempt Bonds Division, Acting Compliance Program Manager, Steven A. Chamberlin, (636) 940-6466.

Tenant Income Issues: A Tax Court Case

A recently decided Tax Court case, Bentley Court II L.P., T.C. Memo 2006-113, involved a determination that an apartment complex did not qualify for the credit because the households were not income-qualified.

Facts

The taxpayer received an allocation of credit and constructed the housing during 1990 and 1991. The taxpayer claimed IRC §42 credits for six years, 1990-1995, as follows:

Year	Credits
1990	$28,508
1991	$699,780
1992	$859,543
1993	$918,155
1994	$926,819
1995	$927,606

The tax returns for 1993, 1994, and 1995 were audited. The revenue agent determined that the taxpayer had falsified documents, including changing income amounts and indicating that certain tenants were not students when, in fact, they were. A review of the tenant files by the state agency revealed that 90% of the tenants in the apartment complex were students.

The revenue agent concluded that the apartment complex did not qualify for the LIHC because the households occupying the units were not qualified and disallowed the entire credit for all three years under audit. In addition, the revenue agent applied the recapture rules under IRC §42(j) to recapture 1/3 of the credit claimed in 1990, 1991 and 1992; $9,493, $233,027 and $286,228 respectively.

Outcome

Although the taxpayer originally alleged errors in the IRS' determination, the taxpayer eventually conceded all the low-income housing credit for 1993, 1994, and 1995 during settlement negotiations.

The general partner was sentenced to 30 months in prison based on his guilty pleas to 1 of 22 counts of obstructing and impeding the administration of the internal revenue law "by losing and concealing tenant files… [two tenants] of Bentley Court Apartments, which tenant files were to be examined by the Internal Revenue Service as part of an audit of the partnership…" The remaining 21 counts were similar and related to the one described and concerned allegations that the general partner willfully made false reports of occupancy beginning in late 1992 through mid-1997. The 21 related counts were dropped.

The taxpayer did not concede the recapture of one third of the credits claimed in 1990, 1991, and 1992.

Issue Before the Court

The sole issue before the Court in Bentley Court II was whether the taxpayer, under IRC §42(j) must recapture in 1993, $528,747 in low-income housing credits claimed in prior years.

IRC §42(j)(1) states that if, as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the taxpayer's tax …for the taxable year shall be increased by the credit recapture amount.

Qualified Basis is computed as:

Eligible Basis x Applicable Fraction

The taxpayer argued that not only was it *not* entitled to the credits for 1993, 1994, and 1995, but that the same fact pattern existed in earlier years. Therefore, even though the tax years were barred from examination by the expiration of the statute of limitation, the actually Qualified Basis in those years is also zero. Because there is no difference in the Qualified Basis between 1992 and 1993, the credit recapture rules cannot be applied. Bentley Court argued that the government was overreaching or maneuvering by determining deficiencies in open year and using the recapture provisions to circumvent the closure of years in which a deficiency would or should have been determined.

The government responded that since the Qualified Basis, as determined in the audit, was less than the Qualified Basis of $11,537,221 reported on the taxpayer's 1992 return, the recapture rules under IRC §42(j) are applicable. The government argued that:

- Bentley Court offered no evidence to show that the apartment complex was not a qualified low-income building during 1990, 1991 and 1992 tax years;

- Bentley Court is bound by a *duty of consistency* not to take inconsistent positions; contending now that it failed to qualify or that qualified basis was zero for 1990, 1991 and 1992, when the taxpayer had previously claimed the credit and reported on the tax return that a qualified basis existed for those same years.

<u>The Duty of Consistency Doctrine</u>

The Duty of Consistency doctrine is intended to prevent a taxpayer from taking a position in a earlier year and a contrary position in a later year after the limitations period has run on the first year. As noted in <u>Beltzer v. United States</u>, 495 F.2d 211, 212 (8th Cir. 1974), a duty of consistency arises where:

1. the taxpayer has made a representation or reported an item for tax purposes in one year,
2. the Commissioner [IRS] has acquiesced in or relied on that fact for that year, and
3. the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial year.

The government argued that the facts of the case show that all three of the criteria had been met and that Bentley Court should be held to a duty of consistency.

Bentley Court contended that the duty of consistency is inapplicable, or if it is, it should be applied to estop the government from recapturing the credit because (1) Bentley Court report low-income credits in 1990 to 1995, and the government "disallowed" those credits in all year by criminally prosecuting the general partner; (2) because of the indictments against the general partner, respondent did not acquiesce to the credits claimed for 1990, 1992, and 1992; and (3) Bentley Court was compelled to change its initial representation or claim of credits due to the criminal prosecution of the general partner.

In an alternative position, Bentley Court argued that the Duty of Consistency doctrine is limited to cases involving a mistake of fact, not a mistake of law; i.e., the general partner did not understanding which types of students could qualify as low-income individuals.

<u>The Tax Court's Decision</u>

The Tax Court upheld the government's position. In framing its decision, the Court addressed the three criteria presented in <u>Beltzer.</u>

1. The taxpayer claimed credits and reported Qualified Basis on its 1990, 1991, and 1992 tax returns.
2. The government acquiesced to and relied upon the taxpayer's representation by "accepting" the 1990, 1991 and 1992 tax returns as filed. The indictment and criminal proceeding against the general partner started after the normal 3-year statutes of limitation had expired for the taxpayer's 1990, 1991 and 1992 tax returns.

Further, the audit did not extend back prior to the 1993 year. Therefore, it appears that the government (during the audit) did not gain access to facts that would have put the government on notice that the credit claimed for 1992 was erroneous.

3. Bentley Court first represented that it qualified for the credit for the years 1990, 1991, and 1992. The taxpayer, now that the statutes of limitation have closed for those years, is claiming that the previously reported year-end qualified bases were actually zero.

As for the taxpayer's argument that the general partner made a "mistake of law", the Court stated it had no basis and was not worthy of further consideration; i.e., that "it is obvious…that the criminal matter had to do with misrepresentations and/or concealment of facts on Bentley Court's behalf by [the general partner]."

<u>Lessons Learned</u>

The Tax Court has confirmed that IRC §42 is "detailed and complex". Yes, the judge actually included the statement in his opinion.

As is often the case, attempts at concealment just make matters worse. In this case, the general partner served 30 months in jail. All taxpayers are subject to the recordkeeping requirements outlined in Treas. Reg. §1.6001.

- Reg. 1.6001-1(a): In general, any person subject to income tax "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…"

- Reg, 1.6001-1(e): "The books and records …shall be kept at all times available for inspection by authorized internal revenue officers and employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

Specific to owners of LIHC properties, Reg. 1.42-5(b) requires owners of LIHC properties to retain records that show that the taxpayer was in compliance with IRC §42. The requirements are presented as a list of nine items. The 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. However, the records for the first year of the credit period must be maintained 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 – that's approximately 21 years! Under Rev. Rul. 2004-82, an electronic storage system can be used as long as it satisfies the requirements of *Rev. Proc. 97-22*. However, the taxpayer must also satisfy any additional recordkeeping and record retention requirements required by the state agency.

This case also definitively determines that an adjustment to either the Eligible Basis or the Applicable Fraction as the result of an IRS audit will trigger the application of the recapture provisions. It has long been contemplated that, because the Qualified Basis in the year before the year under audit is actually the same as the corrected Qualified Basis for the year under audit, the recapture rules are not applicable.

For example, a taxpayer overstates the Eligible Basis for the first year of the credit period and every year thereafter. As a result of an audit in one of the later years, the revenue agent identifies the overstatement and reduces the Eligible Basis for that year. Instead of looking to the *actual* Eligible Basis in the prior year, we would, under the Duty of Consistency Doctrine, look to the Eligible Basis reported on the taxpayer's tax return for the prior year.

Clarifications

When filing Form 8823, line 5, *Total credit allocated to this BIN*, should reflect the total amount of credit allocated to the building. This is computed by adding the amounts of credit allocated to that BIN on all Forms 8609, line 1b. Do not include Forms 8609 for which the compliance period has expired. Remember that a separate Form 8823 must be filed for each BIN.

The new Form 8823 now includes a box to identify when an amended form is being filed. An amended Form 8823 should be filed with the IRS only if it is necessary to correct an error on a Form 8823 that was previously filed with the Service. For example, the wrong category is selected or an address is incorrect. A copy of the amended Form 8823 should be sent to the owner concurrent to filing the form with the IRS.

Subscribing to the LIHC Newsletter

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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

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♫Grace Notes♫

The Low Income Housing Credit Program was enacted by Congress as part of the Tax Act of 1986 with the expressed purpose of increasing the availability of affordable housing to households with the greatest need. As the industry celebrates the low-income housing credit's 20th anniversary, attention is again focused on efforts to ensure that qualified households have safe, secure, and affordable housing opportunities.

For example, I recently attended a conference with representatives of all the state housing agencies to discuss current LIHC developments and issues. The number one topic for discussion was tenant income certifications, with enough related issues to make me dizzy.

If Kent's article on audit procedures for auditing tenant income sounds vaguely familiar, you are probably a long-term subscriber to the newsletter. It's an edited version of an article originally appearing in the December 2002 edition, but is as relevant today as it was when he wrote it. This time, however, it follows how the state reviews tenant files and is then followed by a case study in which these techniques were used.

I don't often have the opportunity to analyze a Tax Court case involving IRC §42, but isn't it nice that the recently decided Bentley Court case is right on point?

Sometimes, newsletters write themselves.

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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.

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♫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!

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Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 23 ***December 2006***

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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.

<u>Reconcile Schedule M-1, M-2</u>

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

<u>Required Filing Checks</u>

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.

<u>Interview the Taxpayer</u>

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?

<u>Tour the Business Site</u>

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.

<u>Evaluate Internal Controls</u>

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.

<u>Test Gross Receipts</u>

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.

<u>Business Ratio Analysis</u>

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!

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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 all 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

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♫*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!

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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

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♫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.

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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 #27, October 2007

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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:

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♫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."

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Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #27, December 2007

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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

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♫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

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[1] *A favorite line from the song "Sometimes", words by Felice Mancini and music by Henry Mancini.*

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Internal Revenue Service Issue #29, February 2008

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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.

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♫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!"

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Examination Specialization and Technical Guidance's

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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 <u>and</u> 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 <u>minimum gain</u> 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

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♫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.

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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.

<u>Examination Requirements: Taxpayer Does Not Obtain Forms 8609 from State Agency</u>

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.

<u>Penalties</u>

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.

<u>Conclusion</u>

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

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♫*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.

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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.

<u>Background</u>

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?

<u>Applying the Available Unit Rule to 100% LIHC Projects</u>

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.

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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.

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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 notwithstanding 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

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♫*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

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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

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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

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♫*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.

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Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

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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.

<u>New Law Incorporates "Hold Harmless" Policy</u>

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.

<u>The General "Hold Harmless" Rule</u>

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.

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♫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!

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