

Low-Income Housing Credit Newsletter

Internal Revenue Service

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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.

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Auditing the Applicable Fraction for the First Year of the Credit Period

Taxpayers participating in the IRC §42 program are required to file Form 8609-A, Annual Statement for Low-Income Housing Credit, for each taxable year of the 15-year compliance period. Part II shows the computation of the year's allowable credit. The Applicable Fraction is identified on line 2 and is always a fraction carried out to at least four places. Basically, after accounting for specific fact patterns, the allowable credit is computed as:

$$\begin{array}{l} \text{Eligible Basis} \\ \times \text{Applicable Fraction} \\ \hline \text{Qualified Basis} \\ \times \text{Applicable Percentage} \\ \hline \text{Allowable Credit} \end{array}$$

Law

Under IRC §42(c)(1)(B), (C), and (D), the Applicable Fraction (determined as of the close of the taxable year) is the smaller of the unit fraction or the floor space fraction. The term "unit fraction" means the fraction, the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units (whether or not occupied) in the building. The term "floor space fraction" means the fraction, the numerator of which is the total floor space of the low-income units in the building, and the denominator of which is the total floor space of the residential rental units (whether or not occupied) in the building.

Under IRC §42(f)(2)(A), there is a special rule for the first year of the credit period. The numerator is the sum of the Applicable Fractions determined as of the close of each full

month of the taxable year that the building was placed in service, and the denominator is 12. The result is an "averaged" Applicable Fraction that accounts for the period of time during the taxable year that the units were not available for occupancy.

Pursuant to IRC §42(f)(2)(B), any reduction in allowable credit for the first year of the credit period under IRC §42(f)(2)(A) is allowable in the eleventh year of the compliance period and is accounted for on Form 8609-A, line 17.

In the case of buildings that were acquired and then rehabilitated, there are two credit allocations and two Forms 8609-A will be filed with the tax return; one for the acquisition credit and another for the rehabilitation credit. However, the taxpayer is not required to determine two Applicable Fractions. Under IRC §42(e)(4)(B), the Applicable Fraction for the substantial rehabilitation credit will be the same as the Applicable Fraction for the acquisition credit.

Example 1: New Construction

A taxpayer constructed a new IRC §42 building with 10 identical units; i.e., the floor space of all the units is the same. The building was placed in service on June 15, 2009, and 2009 is the first year of the credit period. The [first schedule](#) at the end of the newsletters identifies with an "X" which months during 2009 that the units were occupied by qualifying low-income tenants and the units were otherwise qualifying low-income units (rents restricted and suitable for occupancy).

The Applicable Fraction for January through June is zero. Even though a tenant lived in a unit during June, the unit was not placed in service the entire month. The Applicable Fraction for 2009 is 0.4333, computed as:

$$(0+0+0+0+0+0+.50+.80+.90+1.00+1.00+1.00) \div 12$$

Example 2: Acquisition and Rehabilitation

A taxpayer acquired and rehabilitated a building qualifying for both the acquisition and rehabilitation credit under IRC §42. The building has 10 identical units (same floor space) which were all occupied at the time the building was

purchased. The building was placed in service on May 15, 2008, the acquisition date, and the taxpayer elected to begin the credit period the following year, 2009. The [second schedule](#) at the end of the newsletters identifies with an “X” which months during 2009 that the units were occupied by qualifying low-income tenants and the units were otherwise qualifying low-income units (rents restricted and suitable for occupancy). Typically, gaps occur at the beginning of the year because the units are not occupied by qualifying tenants and during the year when the units are being rehabilitated. The Applicable Fraction for 2009 is 0.7250, computed as follows:

$$(.40+.80+.90+.90+.60+.30+.80+1.00+1.00+1.00+1.00) \div 12$$

Audit Techniques

1. Determine when the building was placed in service. Certificates of occupancy issued by a state or local government inspector will provide the information.
2. Review how the taxpayer calculated the Applicable Fraction, including which units were included each month, and the calculation for both the unit fraction and floor space fraction.
3. Review the rent roles. Based on this analysis, a sample of tenant files can be selected and requested from the taxpayer.
4. Review the tenant files to ensure that the tenant is income-qualified. (This is a complex analysis beyond the scope of this article.) If significant errors are identified, expand the sample or review all the files if feasible.
5. Compute the Applicable Fraction based on the results of the analysis using both the unit fraction and the floor space fraction. The correct Applicable Fraction is the lesser of the two results. Compare to the Applicable Fraction reported by the taxpayer.

Common Errors

1. The taxpayer computed the Applicable Fraction based on the month the building was placed in service. For example, the building was placed in service in April, so the Applicable Fraction is reported to be 0.7500, computed as 9 month \div 12 months.
2. The taxpayer included the month the unit was placed in service if the unit was occupied the same month, even though the unit was not in service the entire month. To include the unit in the Applicable Fraction, the unit must be in service the entire month and occupied at least one day.

3. The taxpayer does not compute both the unit fraction and floor space fraction to determine the lesser fraction allowable.
4. The taxpayer cannot document that the tenants are income qualified. Treas. Reg. 1.42-5(b)(2) requires taxpayers to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the 15-year compliance period of the building; i.e., approximately 22 years.

Initial Request for Information

When auditing the first year of the credit period, the taxpayer should provide:

1. Certificates of occupancy
2. Rent roles, maintained unit-by-unit, and indicating when each low-income unit was first occupied and by whom.
3. Documentation for the taxpayer’s computation of the Applicable Fraction, including the computation of the Applicable Fraction on a monthly basis, and using both methods (unit fraction and floor space fraction).
4. The income limits used to determine whether a tenant was income-qualified and how the income limit was determined.

Documentation & Record Retention

IRC §6001 reads:

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title....”

Treas. Reg. S1.6001-1(a) clarifies that, generally, “...any person subject to tax under Subtitle A of the Code...or any person required to file a return of information with respect to income, shall keep such *permanent* books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, *credits*, or other matters required to be shown by such person in any return of such tax or information.” Paragraph (c) further explains that the taxpayer’s books and records shall be:

1. Kept at all times available for inspection by authorized internal revenue officers or employees, and
2. Retained so long as the contents thereof may become material in the administration of any internal revenue law.

The IRS has also provided guideline for retaining records specific to claiming IRC §42 credit in Treas. Reg. 1.42-5(b)(1). Specifically, the owner of a low-income housing project must be required to keep records for *each qualified low-income building in the project* that show for each year in the *15-year compliance period*:

- (i) The total number of residential rental units in the building (including the number of bedrooms and the size in square feet of each residential rental unit);
- (ii) The percentage of residential rental units in the building that are low-income units;
- (iii) The rent charged on each residential rental unit in the building (including any utility allowances);
- (iv) The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under section 42(g)(2) (as in effect before the amendments made by the Omnibus Budget Reconciliation Act of 1989);
- (v) The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;
- (vi) The annual income certification of each low-income tenant per unit. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building) [*Editor's Note: For tax year ending before July 31, 2008, an owner may have received a waiver from this requirement under Rev. Proc. 2004-38 or Rev. Proc. 94-64, but only if the low-income housing project consisted entirely of 100% low-income buildings. For tax years ending after July 30, 2008, owners are not required to complete annual tenant income recertifications if all the low-income buildings in the project are 100% low-income buildings.*]
- (vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation). For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building). [*Editor's Note: See Editor's Note for (vi) above.*] Tenant income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937 ("Section 8"), not in accordance with the determination of gross income

for federal income tax liability. In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement of this paragraph (b)(1)(vii) is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under section 42(g);

- (viii) The eligible basis and qualified basis of the building at the end of the first year of the credit period; and
- (ix) The character and use of the nonresidential portion of the building included in the building's eligible basis under section 42(d) (e.g., tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project).

Treas. Reg. 1.42-5(b)(2) is the record retention provision under which the owner of a low-income housing project must be required to retain the records described above for *at least 6 years* after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for *at least 6 years* beyond the due date (with extensions) for filing the federal income tax return for the *last* year of the compliance period of the building.

Under Treas. Reg. 1.42-5(b)(3), the taxpayer is subject to an *inspection* record retention provision. The owner of a low-income housing project must be required to retain the original local health, safety, or building code violation reports or notices that were issued by the State or local government unit for the Agency's inspection. Retention of the original violation reports or notices is not required once the Agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

And finally, specific to the computation of utilities allowance, Treas. Reg. 1.42-10(d) explains that owners must retain any utility consumption estimates and supporting data as part of the taxpayer's records for purposes of Treas. Reg. §1.6001-1(a).

Storing Records Electronically

The IRS has also addressed the feasibility of using electronic storage options. In Rev. Rul. 2004-82, Q&A #11, the IRS provided guidance on recordkeeping and record retention requirements for purpose of IRC §6001 and the associated regulations.

Q-11: May a taxpayer comply with the recordkeeping and record retention provisions under §1.42-5(b) by using an electronic storage system instead of maintaining hardcopy (paper) books and records?

A-11: Yes, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97-22, 1997-1 C.B. 652. This revenue procedure provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optical disk. Rev. Proc. 97-22 provides that records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of §6001.

However, *and this is important*, complying with the Service's recordkeeping and record retention requirements does not exempt an owner from having to satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the state agency. For example, the housing credit agency may require the taxpayer to maintain hardcopy books and records. For the basic requirements of maintaining records in an automated data processing system, including electronic storage systems, see Rev. Proc. 98-25, 1998-1 C.B. 689.

Purpose

A taxpayer's books and records are the primary source of information needed to prepare an accurate tax return. If audited, the books and records will be used by the examiner to determine whether the tax return actually discloses the amount of gross income, deductions, *credits*, or other matters required to be shown. In addition to the basic requirements under IRC §6001, the Service has, by regulation, identified specific information needed to demonstrate compliance with IRC §42. Why was this necessary? Consider:

1. Needed information is not created as part of the taxpayer's normal operation of a residential rental property. For example, a taxpayer does not usually require a potential tenant to submit to an intense income certification process to determine whether the household is a qualified low-income household.
2. IRC §42 requires unique computations "outside" the books and records. Eligible Basis, for instance, is (more or less) depreciable residential rental property, but not *all* depreciable residential rental property is includable in Eligible Basis. As a result, Eligible Basis will be comparable to, but not exactly the same as, the asset's adjusted basis identified in the depreciation schedules.
3. Compliance requires unique recordkeeping. Consider compliance with the Available Unit Rule, where a taxpayer needs to know, building by building and on a continuous basis, which low-income units are over-income and which units are subsequently rented to qualified low-income households. The method of recordkeeping must reflect current occupancy so the taxpayer can continuously comply with the requirement and at the same time create an audit trail so that compliance can be evaluated later.

4. The 15-year compliance period creates a particularly long retention period, at least 21 years for the some of the records.
5. The recapture provisions under IRC §42(j) can be financially devastating. Suppose a taxpayer is allocated an annual low-income credit of \$30,000 and claims the entire credit each year for 10 years, 1997 through 2006. The taxpayer's 2007 tax return is audited. The taxpayer cannot establish that the minimum set-aside was met that year, the 11th year of the compliance period, resulting in the recapture of the accelerated portion of the credit (\$10,000) and interest associated with each prior year. The total liability is just a little less than \$147,000.

Standard of Sufficiency

IRC §6001 requires taxpayers to maintain books and records that are *sufficient* to show whether or not the taxpayer is liable for tax, or in the case of IRC §42, that the taxpayer is entitled to claim the credit. As defined in the dictionary, "sufficient" means adequate, much as is needed, or enough.

Specific to IRS audits, examiners review a taxpayer's books and records to gather facts needed to correctly determine a taxpayer's tax liability. Therefore, a taxpayer's books and records are sufficient when an IRS examiner can make a reasonable determination of the correct tax liability.

Alternative Sources of Information

The best source of information is the taxpayer's own written books and records, preferably created concurrent to when the transaction occurred. But realistically, taxpayers can rarely maintain books and records in such pristine condition and there's always a certain amount of digging through old shoe boxes. And, there are times, due to unusual circumstances, when the taxpayer's books and records simply are not complete or available, or may no longer exist. In such cases, an examiner may consider alternative sources of information, accept credible oral testimony, or rely on documentation from third parties. But the examiner will always be evaluating whether the source of the information is credible, as well as whether the facts and information gathered from alternative sources makes sense and is really sufficient.

For audits of IRC §42 issues, there is one credit-specific source of information which an examiner may, under very limited circumstances, want to consider. Under IRC §42(m)(2)(C)(i)(III), the state agency performs a final evaluation of the sources and uses of funds when the low-income building(s) are placed in service. As described in Treas. Reg. §1.42-17(a)(5), the taxpayer must submit a schedule of project costs. This final cost certification details the project's total costs as well as those costs that qualify as eligible basis.

Treas. Reg. §1.42-17(a)(5) also requires that for projects with more than 10 units, the schedule of project costs must be accompanied by a Certified Public Accountant's audit report on the schedule. For projects with less than 11 units, the

state agency may require an audited schedule of project costs. If a certified audit was performed, the accountant's audit workpapers may provide additional information needed to resolve tax issues involving the eligible basis. On the other hand, the accountant's workpapers may be unavailable or simply not include information about the issue at hand.

Nor should the accountant's audit workpapers be considered sufficient for all purposes. For example, the workpapers will describe the accountant's audit procedures and may include a summary of the verified construction costs which the examiner determines to be sufficient. On the other hand, the audit workpapers will probably not be sufficient to resolve issues involving a developer fee; i.e., what services were provided, when were they provided, and are development costs properly allocated between land, land improvements, and the low-income buildings. An examiner will need to review the contract between the developer and the taxpayer to answer these questions.

Inadequate Books and Records

The determination that a taxpayer has not maintained adequate books and records is made by the examiner conducting an audit. Factors include, but are not limited to:

1. an alternative or indirect method was used to establish the amount of gross income, deductions, credits, or other matters shown on the taxpayer's return because the taxpayer's records were not sufficient,
2. prior history and present degree of noncompliance,
3. indications of willful intent or evidence of refusal to keep adequate books and records,
4. probability that the inadequacies in recordkeeping will result in significant underreporting of tax liabilities, or
5. other evidence of harm to the Government.

If an examiner determines that the taxpayer has not substantially complied with the law and regulations for maintaining adequate books and records, an Inadequate Records Notice will be issued. For partnerships (most IRC §42 project owners), the original notice will be delivered to the partner who signed the return or, if this is not possible, to a partner who takes an active part in the business. A copy of the notice will be mailed to all the other partners.

An Inadequate Records Notice requires the taxpayer to notify the Service of actions taken to correct its record-keeping to meet the requirements of the law within six months after the notice is delivered. The taxpayer's statements regarding improvement of the recordkeeping will be considered when determining the need for follow-up action, such as a follow-up audit of a tax year subsequent to the tax year originally audited and resulting in the notice.

If, as a result of a subsequent audit, an examiner concludes that the taxpayer is *not* substantially complying with

requirements to keep adequate records, then consideration of additional enforcement measures, such as the assertion of penalties, is warranted.

Quiz Time

In the last newsletter, a nit was picked regarding the definition of a "project." Generally associated with the minimum set-aside requirement, the taxpayer's configuration of a project will not only affect how the project is operated, but how the state agency will monitor for compliance. Can you identify the level at which each of the following IRC §42 rules are applied?

1. Household moving to another low-income unit.
2. Annual income recertification exception
3. Student exception rules
4. Utility allowances
5. Transient use
6. Protection against eviction without good cause and rent increases other than allowable under IRC §42
7. Suitability for occupancy
8. Federal grants
9. Available for general public use
10. (Next) Available Unit Rule
11. Vacant Unit Rule
12. Extended use agreement requirement
13. No longer participating in the IRC §42 program
14. Nonprofit participation
15. Applicable Fraction
16. Minimum set-aside
17. Compliance period
18. Hold harmless rule for HERA special income limits
19. Eligible Basis

[Answers are listed after "Grace Notes."](#)

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at Grace.F.Robertson@irs.gov.

♪ Grace Notes ♪

I've just finished a *big* project. Whew! It took a lot of time to get everything done, coordinated, and approved and while some tasks were harder than others, everything was accomplished without too many really *big* glitches. At the very end, I had to do some computer-based tasks that I had never done before. It just took a few minutes for someone to explain how to do it, and it only took me two times to do it right. You know how it is...just *one* little mistake and the whole thing is wrong...so, with patience, someone slowly explained it to me again, and since it really was a little task to begin with, I was done in no time at all.

But, then I had another file with a similar problem. Will the same solution work in another program? With a little perusing through the menus, I found the sort-of-the-same-but-different commands and fixed the file! Voila! I've learned how to do something new *and* applied the knowledge to solve a new problem. I'm feeling pretty good about myself!

Realistically, it was very simple task and everybody and all their relatives know how to do it...it's right on the menu. But the point is, I found out something I didn't know before. And that reminded me of one of the greatest books I ever read on an airplane, called The Pleasure of Finding Things Out, by Richard Feynman, a physicist who worked on the Manhattan Project and won the Nobel Prize. When asked whether winning the Noble Prize was worth it, he explained, "I don't see that it makes any point that someone in the Swedish Academy decides that this work is noble enough to receive a prize - I've already got the prize. The prize is the pleasure of finding the thing out, the kick in the discovery...."

Back to the menus!

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Reference: The Pleasure of Finding Things Out, the Best Short Works of Richard P. Feynman, by Richard P. Feynman. Published by Helix Books, Perseus Publishing. ISBN 0-7382-0349-1

Answers: (1) project, (2) 100% low-income project, (3) unit, (4) building, (5) unit, (6) household, (7) units (predicated on buildings, common areas, facilities and site), (8) traced building-by-building, (9) unit, (10) building, (11) project, (12) building, (13) building, (14) project, (15) building, (16) project, (17) building, (18) project, and (19) building.

Example 1

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1						X	X	X	X	X	X	X
2										X	X	X
3							X	X	X	X	X	X
4								X	X	X	X	X
5									X	X	X	X
6								X	X	X	X	X
7								X	X	X	X	X
8							X	X	X	X	X	X
9							X	X	X	X	X	X
10							X	X	X	X	X	X
AF	0	0	0	0	0	0	.50	.80	.90	1.00	1.00	1.00

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Example 2

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1		X	X	X		X	X	X	X	X	X	X
2	X	X	X	X			X	X	X	X	X	X
3		X	X	X	X		X	X	X	X	X	X
4	X	X	X	X	X			X	X	X	X	X
5					X	X	X	X	X	X	X	X
6			X	X	X	X	X	X	X	X	X	X
7		X	X	X				X	X	X	X	X
8	X	X	X	X	X		X	X	X	X	X	X
9	X	X	X	X			X	X	X	X	X	X
10		X	X	X	X		X	X	X	X	X	X
AF	.40	.80	.90	.90	.60	.30	.80	1.00	1.00	1.00	1.00	1.00

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