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## IRC §42, Low-Income Housing Credit

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The scope of this guide is limited to guidelines for IRS examiners conducting audits of taxpayers owning IRC §42, low-income housing projects.

### **Audit Technique Guide**

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This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.



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## PREFACE

This audit technique guide was prepared to assist IRS examiners audit taxpayers, usually partnerships, owning IRC §42 low-income housing projects.

The guide is organized in the order an examiner might address issues during an audit, working from high-level issues to issues requiring more detailed analysis, and chronologically from the Precontact Analysis through Report Writing. Two related topics, auditing partners and completing the Examination of Income, are also addressed.

- Part I presents an overview of the IRC §42 credit, instructions for completing the precontact analysis, and a discussions of how audit techniques are applied for IRC §42 issues. Appendix A is a glossary of terms specific to IRC §42.
- Part II presents four high-level issues that can usually be addressed at the project level.
- Part III focuses on auditing Eligible Basis, which are the costs of depreciable residential rental property upon which the credit amount is computed.
- Parts IV, V and VI address the remaining three factors needed to compute the allowable credit; i.e., the Applicable Fraction, Qualified Basis, and Qualified Percentage.
- Part VII provides guidelines for computing adjustments to the allowable credit and computing the credit recapture amount under IRC §42(j). Examples of computations for common fact patterns are included in Chapter 17. Chapter 18 presents unique report writing requirements for partnership audits.
- Part VIII provides guidelines for auditing taxpayers who are partners in partnerships owning IRC §42 projects. This is necessary because some IRC §42 rules are applied at the partner level. Further, Chapter 19 provides guidelines for applying the credit ordering rules and tax benefit rules when making adjustment to the credit as a flow-through adjustment resulting from a partnership audit.

The guide is extensively referenced. If the entire citation is not included in the text, refer to Appendix B.

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# Chapter 1

## Introduction

### Introduction

The IRC §42 Low Income Housing Credit Program was enacted by Congress as part of the Tax Reform Act of 1986 to encourage new construction and rehabilitation of existing buildings as low-income rental housing for households with income at or below specified income levels. Congress recognized that a private sector developer may not receive enough rental income from a low-income housing project to cover the costs of development and still provide a return to investors sufficient to attract the needed equity investment. The IRC §42 program provides tax incentives for investors to make equity investments. In exchange for equity, investors receive tax credits and other tax benefits associated with ownership of the project to offset federal income taxes for a ten year period. These tax benefits, plus the possibility of cash proceeds from the eventual sale of the project, represent the investors' return on investment.

### Topics

- Overview of the IRC §42 Program
- State Housing Agency Responsibilities
- IRS Responsibilities: Chief Counsel
- IRS Responsibilities: LIHC Compliance Unit
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### Overview of the IRC §42 Program

The taxpayer agrees to provide low-income housing for at least thirty years.

1. In exchange for the investment in low-income housing, the taxpayer will receive tax credits for each of ten years, which is known as the “credit period.”
2. To keep the credit, the taxpayer must provide low-income housing for fifteen years, which is known as the “compliance period.” Failure to maintain the housing in compliance with IRC §42 requirements for the entire compliance period can result in the recapture of a portion of the credit allowable in prior years.
3. After IRS jurisdiction ends, the state agency has sole jurisdiction and the taxpayer must continue to provide low-income housing for at least another fifteen years. The “extended use period” is at least 30 years, beginning with the first year of the credit period.

All three time periods begin on the same day; i.e., the first day of the tax year in which the building is placed in service, or if the taxpayer elects, the beginning of the following tax year.

### Types of Housing

The credit supports a variety of housing opportunities. The taxpayer can build new housing or rehabilitate existing buildings. The housing can be apartments, single-family housing, single-occupancy rooms, or even transitional housing for the homeless. A building may be mixed low-income and market-rate rental units, and a portion of the building may be for commercial use. Generally, the housing must be

used on a nontransient basis; i.e., an initial 6-month lease term. Also, the housing must qualify as residential rental property; e.g., no hotels, hospitals, or nursing homes, etc.

**Combining with Other Tax Credits**

Besides qualifying for the Low-Income Housing Credit under IRC §42, the taxpayer may also qualify for the Rehabilitation Credit under IRC §47 and the Energy Credit under IRC §48, but not the New Markets Credit under IRC §45D. A building may also qualify for tax-exempt bond financing 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 to finance and operate the building.

**Computation of Allowable Annual Credit**

The amount of credit the taxpayer can claim each year is determined as:

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

$$\text{Qualified Basis} \times \text{Applicable Percentage} = \text{Annual Credit Amount}$$

**Eligible Basis**

The Eligible Basis is the total allowable cost associated with the depreciable residential rental project. If the building is located in a high cost area, the eligible basis may be increased to 130% of the actual costs.

**Applicable Fraction**

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, the unit must be occupied (or last occupied) by an income-qualifying household and, if the household is comprised entirely of full-time students who otherwise qualify as low-income tenants, the unit is qualified only if an exception under IRC §42(i)(3)(D) is met. The housing must be suitable for occupancy and free from health and safety hazards. The rent must also be restricted; i.e., the rent cannot exceed 30% of the income limit applicable to the building location.

**Qualified Basis**

Qualified Basis is the product of the Eligible Basis and the Applicable Fraction.

**Applicable Percentage**

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.

**Compliance Requirements**

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.

1. Minimum Set-Aside – A housing project will not qualify for any credit unless it includes a specified minimum number of qualified low-income rental units.



2. Available Unit Rule – Generally, 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.
3. Vacant Unit Rule – If a low-income unit becomes vacant, the taxpayer must make reasonable attempts to rent the unit to income-qualified tenants before renting any market-rate units to tenants who are not income-qualified.
4. General Public Use – The rental units must be available for use by the general public and rented in a manner consistent with housing policy governing nondiscrimination. A determination that the taxpayer violated the Fair Housing Act or other law governing nondiscrimination in housing may result in the loss of credit.
5. Material Participation of Qualified Nonprofit Organizations – If the taxpayer received an allocation under IRC §42(h)(5), a set-aside of credit designated for projects owned by qualified nonprofit organizations, then the qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period.
6. Extended Use Agreement – No credit is allowable for a taxable year unless this agreement between the taxpayer and the state agency allocating the credit is in effect as of the last day of such taxable year. The agreement must be recorded in the land records as a restrictive covenant and is enforceable under state law.
7. Certifications and Annual Reports – A taxpayer completes a certification with respect to the first year of the credit period, which is a one-time filing of Form 8609, Low-Income Housing Credit Allocation and Certification, with the IRS. Part I is completed by the state agency and Part II is completed by the taxpayer. The taxpayer also files Form 8609-A, Annual Statement for Low-Income Housing Credit, with its tax return for each year of the 15-year compliance period. The taxpayer is also required to certify at least annually to the state agency that the project met all the requirements.
8. Inspections by State Agency – Tenant records and the low-income project are subject to physical inspection by the state agency.

**Credit  
Disallowance  
and Recapture**

The credit may be disallowed (in part or in whole). Not only is the credit disallowed in the year of a noncompliance event, but if the qualified basis is less at the end of that taxable year than the qualified basis at the close of the preceding taxable year, the taxpayer is subject to the credit recapture provisions under IRC §42(j). The recapture amount is computed as a percentage of the credit claimed in prior years plus interest. The recapture percentage is based on the year within the 15-year compliance period that the noncompliance occurred.

No credit is allowable for the year in which a taxpayer disposes of a building (or interest therein) and 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.

## State Housing Agency Responsibilities

The program is jointly administered by the IRS and state-authorized tax credit allocating agencies. Each state receives tax credits on an annual basis. Under IRC §42(h)(3), the amount of credit available to the state for allocation to taxpayers for any calendar year is the “credit ceiling.”

### Qualified Allocation Plan (QAP)

The state agencies are responsible for determining which housing projects should receive credits and the dollar amount allocated. Under IRC §42(m)(1), the state agency must develop a Qualified Allocation Plan (QAP) that is approved by the governmental unit having jurisdiction over the state allocating agency. The QAP must have the following characteristics:

1. Identifies the selection criteria to be used for determining housing priorities that are appropriate to local conditions. The selection criteria must include project location, housing needs characteristics, project and sponsor characteristics, tenant populations with special needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project.
2. Gives preference to projects serving the lowest income tenants, for the longest periods, located in qualified census tracts, and which will contribute to a concerted community revitalization plan.

### Allocating Credits

The allocating agencies are responsible for allocating tax credits to qualifying projects that meet the QAP’s criteria. The allocation process varies among the states, but generally, real estate developers apply for the credit and submit proposals which are then ranked according to the criteria in the QAP. If accepted, the state agency and developer will enter into a contract, documented with a “reservation” of credit, followed by a “binding commitment” to allocate credit in the future, or “carryover allocation,” which is documented on Schedule A (Form 8610), Carryover Allocation of Low-Income Housing Credit. Generally, owners must place the projects in service by the close of the second calendar year following the year the carryover allocation of credit is made or return the credit to the state for reallocation to other projects.

An allocating agency is to provide no more credit than deemed necessary to ensure the project's financial feasibility throughout the 15-year compliance period. In general, the agency is to compare the proposed project’s total developmental costs with the anticipated private and governmental financing (other than equity raised from tax credits). The difference between the total development costs and financing (other than equity raised through the credit) is commonly referred to as the “equity” gap the IRC §42 credit is intended to fill. The Agency will allocate to the project only the amount of credit necessary to fill this equity gap.

The credit allocation is documented on Form 8609, Low-Income Housing Credit Allocation and Certification. The agency executes Part I and then mails the Form 8609 to the taxpayer. The taxpayer then completes the certification required under IRC §42(l)(1) for the first year of the credit period by completing Part II of the Form 8609 and submitting it to the IRS.

**Compliance Monitoring**

The QAP must also provide procedures that the state agency will follow to monitor the project for continuous compliance with IRC §42 requirements and notify the IRS if noncompliance occurs. The compliance monitoring requirement was made effective on January 1, 1992, and applies to all buildings for which a low-income housing credit under IRC §42 is, or has been, allowable at any time.

Treas. Reg. §1.42-5 provides the minimum standards for conducting compliance monitoring activities. At least once every three years, the state agency must conduct on-site inspections for all buildings in the project and, for at least 20% of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.

The compliance monitoring regulations also require the owner of a project, at a minimum, to certify annually to the state agency that for the preceding 12-month period the project was in compliance with the requirements of IRC §42. The certification covers a variety of requirements, including that the owner has received an annual income certification from each low-income tenant and documentation supporting that certification, and that each building in the project was suitable for occupancy, taking into account local health, safety, and building codes. Treas. Reg. §1.42-5(c)(1) lists the annual certification requirements.

**Reporting Noncompliance to the IRS**

When noncompliance is identified or there has been a building disposition, the state agencies are required to notify the IRS using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. If the state agency reports that the owner is "out of compliance," the IRS sends a notification letter to the owner identifying the type of noncompliance reported on Form 8823 with instructions to contact the state agency to resolve the issue. Once the issue is resolved, a "back in compliance" Form 8823 is filed with the IRS.

**Annual Report to the IRS**

IRC §42(l)(3) requires state agencies to submit annual reports to the IRS identifying the annual credit amount allocated to each building for such year, sufficient information to identify each such building and the taxpayer with respect thereto, and other information needed for the administration of the program.

The annual report is made by submitting Form 8610, Annual Low-Income Housing Credit Agencies Report, with copies of the Forms 8609 issued that year and Schedule A (Form 8610), documenting credit carryover allocations, to the IRS by February 28<sup>th</sup> of the following year. Part I is a reconciliation of the forms submitted with Form 8610, Part II is a reconciliation of the state's credit ceiling and credit allocations, and Part III is a report of the state agency's compliance monitoring activities and compliance with the requirements of Treas. Reg. §1.42-5.

State agencies are subject to penalties under IRC §§ 42(l)(3) and 6652(j) for any failure to submit the report timely.

## **IRS Responsibilities: Chief Counsel**

The Chief Counsel is the chief law officer of the IRS and is the legal advisor to the Commissioner and the Commissioner's employees. The Office of Chief Counsel furnishes legal opinions for the preparation and review of rulings and memoranda of technical advice; prepares, reviews, and assists in the preparation of proposed legislation, treaties, regulations, and Executive orders relating to laws affecting the IRS; represents the Commissioner in the Tax Court; and determines which civil actions should be litigated under the laws relating to the IRS and prepares recommendations for the Department of Justice regarding commencement of legal actions. In the Office of Chief Counsel, Branch 5 in the Passthroughs and Special Industries division is responsible for IRC §42, as well as §§ 45D, 47, and certain other tax incentives.

## **IRS Responsibilities: LIHC Compliance Unit**

The Low-Income Housing Credit (LIHC) Compliance Unit is responsible for processing information submitted to the IRS by state agencies and taxpayers, providing assistance, and evaluating noncompliance for audit potential.

**Form 8610, with Form 8609 and Schedule A (Form 8610)** Form 8610, Annual Low-Income Housing Credit Agencies Report, with Forms 8609, Low-Income Housing Credit Allocation and Certification, and Schedule A (Form 8610), Carryover Allocation of Low-Income Housing Credit, submitted by the state agencies are reconciled and processed. Forms 8609 submitted by taxpayers are matched to the state agencies' submissions and processed.

**Form 8823** Forms 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, are processed and a notification letter is sent to the taxpayer identifying the potential noncompliance issues. The Forms 8823 are also evaluated for audit potential.

**Form 8821** On May 19, 1999, a Memorandum of Understanding (MOU) was finalized as part of a FedState initiative to improve the administration of the LIHC program. The state agencies can require project developers to complete Form 8821, Tax Information Authorization, as part of their application for an allocation of IRC §42 credit. The taxpayer designates the state agency as the appointee to receive tax information regarding the applicant's prior compliance with IRC §42 requirements; i.e., audit results and Form 8823 filings from other state agencies. The information is used to help the state agency make better informed decisions about credit allocations. The LIHC Compliance Unit provides the information to the state agencies upon request.

## **IRS Responsibilities: Audits**

Based on the state agencies' noncompliance reports, taxpayers are identified for further consideration of audit potential. The taxpayer's tax returns, Forms 8823 filed for the buildings, and other information are evaluated. If it is determined that an audit is warranted, the complete file is sent to the appropriate field office. The taxpayer is then notified that an audit has been scheduled. This is not the only method for selecting tax returns on which the low-income housing credit has been claimed, and, at the examiner's discretion, the audit may be expanded to include additional issues or tax returns.

## Summary

1. IRC §42 provides federal tax incentives for equity investments in low-income housing.
2. 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 project may include both low-income and market-rate rental units, and a portion of the property may be for commercial use. The housing must qualify as residential rental property; e.g., no hotels, hospitals, or nursing homes, etc.
3. The taxpayer agrees to provide low-income housing for at least thirty years. The taxpayer receives credit for ten years (credit period), must provide low-income housing under IRS jurisdiction for fifteen years (compliance period), and under the state agency's sole jurisdiction for at least an additional fifteen years (extended use period). All three time periods begin on the same day; i.e., the first day of the tax year in which the building is placed in service, or if the taxpayer elects, the beginning of the following year.
4. The amount of credit the taxpayer can claim each year is determined as:

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

$$\text{Qualified Basis} \times \text{Applicable Percentage} = \text{Annual Credit Amount}$$

The eligible basis is the total allowable costs associated with the depreciable residential rental project. The applicable fraction is the portion of rental units that are qualified low-income units. The applicable percentage is the discount factor needed to limit the annual credit to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing

5. The allowable credit may be reduced (in part or in whole) if the taxpayer is not compliant with IRC §42 requirements. The taxpayer may also be subject to the recapture of credit claimed in prior years under IRC §42(j).
6. If a taxpayer disposes of a low-income building (or interest therein), no credit is allowable in the year of the disposition and the taxpayer is subject to recapture unless the taxpayer reasonably expects that the building will continue to be operated as a low-income building for the remaining compliance period.
7. The program is jointly administered by the IRS and state-authorized tax credit allocating agencies. Each state receives tax credits annually. The agencies are responsible for identifying the state's housing needs, allocating credit to qualifying projects that meet the state's QAP criteria, and monitoring the operating project for on-going compliance with IRC §42. Noncompliance is reported to the IRS.
8. The IRS' compliance responsibilities include the processing of forms submitted by state agencies and taxpayers, and ensuring compliance through activities such as auditing taxpayers' federal income tax returns.

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## Chapter 2 Precontact Analysis

**Introduction** This chapter provides guidelines for analyzing tax returns before contacting the taxpayer to determine which items related to the IRC §42 credit should be examined.

- Topics**
- Form 8609, Low-Income Housing Credit Allocation and Certification
  - Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
  - Form 8609-A, Annual Statement for Low-Income Housing Credit
  - Balance Sheet
  - Schedule K and Schedule K-1
  - Ownership By Individuals
  - Prior and Subsequent Year Returns
  - Related Returns
  - Risk Analysis
  - Initial Information Document Request
  - Summary

### **Form 8609, Low-Income Housing Credit Allocation and Certification**

Form 8609 documents the state agency's allocation of credit (Part I) and the taxpayer's certification for the first year of the credit period (Part II). It provides basic information about the low-income building, the terms of the credit allocation, and the taxpayer's elections.

Without a Form 8609 completed and signed by the state agency, the taxpayer cannot complete the first-year certification required under IRC §42(l)(1) and, therefore, may not be entitled to claim IRC §42 credits. If Forms 8609 are not included in the case file, determine whether the forms were received from the taxpayer after the tax return was selected for audit by contacting the LIHC Compliance Unit. If completion of the first-year certification cannot be confirmed, refer to Chapter 4.

**Amount of Credit Allocated** Compare the amount of credit claimed on the tax return to the amount allocated on Form 8609. The taxpayer is not entitled to claim more IRC §42 credit than the dollar amount reflected on Form 8609, line 1b. Form 8586, Low-Income Housing Credit, is filed with the tax return; line 1 indicates the total number of Forms 8609-A attached and line 3 indicates the total amount of credit from all the attached Forms 8609-A.

**Eligible Basis and Qualified Basis** Compare the Maximum Qualified Basis identified on line 3a by the state agency and the eligible basis identified on line 7 by the taxpayer.

1. If the numbers are the same, then (1) the building was intended to be a 100% low-income building and (2) the state agency determined that it was necessary to allocate the maximum amount of credit possible to assure that the project would remain feasible throughout the 15-year compliance period.
2. If the eligible basis is more than the qualified basis, then either the building is a mixed-use building (both low-income and market-rate units) or the state agency determined that it was not necessary to allocate the maximum amount of credit

possible to assure that the project would remain feasible throughout the 15-year compliance period.

3. If the eligible basis is less than the maximum qualified basis, the issue should be addressed during the audit.

If the percentage on line 3b is larger than 100%, then the eligible basis identified on line 7 has been artificially increased above the actual costs because the building is in a location that is considered difficult to develop; e.g., the costs of construction, land, and utilities are high compared to the location's Area Median Gross Income or there is a particularly high concentration of low-income individuals. The increased eligible basis increases the amount of credit available to subsidize costs that cannot be supported by debt or future cash flow from rents.

There should be a one-to-one match of Forms 8609 to Forms 8609-A filed with the tax return. Compare the eligible basis on Form 8609, line 7, to the eligible basis identified on Form 8609-A, line 1. The numbers should be the same. If the eligible basis on Form 8609-A, line 1, is less than reported on Form 8609, then a recapture event may have occurred and the issue needs to be addressed during the audit. The eligible basis on Form 8609-A, line 1, should never be larger than the eligible basis reported on Form 8609, line 7.

**Applicable Percentage**

Compare the applicable percentage reported by the taxpayer on Form 8609-A, line 5, to the applicable percentage identified on the matching Form 8609, line 2. Since this applicable percentage is fixed and identified by the state agency, the applicable percentage is seldom an audit issue.

**Type of Allocation**

The type of credit allocated to a building is dependent on two factors:

1. Whether the housing is newly constructed, an existing building, or an existing building that has been rehabilitated, and
2. Whether federal subsidies were used to construct or rehabilitate the building.

The possible combinations of the two characteristics are presented on Form 8609, lines 6a-e. The options are mutually exclusive so only one of the boxes should be marked on any one form. A building can receive more than one type of allocation, which requires the preparation of multiple Forms 8609.

**Tax-Exempt Bonds**

Projects financed with tax-exempt bonds under the IRC §146 Volume Cap and as defined in IRC §142(d) can also qualify for IRC §42 credits, but are limited to the 30% credit. The percentage of the aggregate basis financed by the tax-exempt bonds is identified on Form 8609, line 4, and the type of building is identified on line 6a or 6d. Note: the aggregate basis used for the percentage computation is different than eligible basis or qualified basis.

**Nonprofit Set-Aside**

A portion of a state's credit ceiling is set-aside for allocation to projects involving qualified nonprofit organizations. These allocations are identified on Form 8609, line 6g, starting with the November 2003 revision of the form. If an earlier revision was used, then the state agency should be asked to confirm whether the allocation was from the nonprofit set-aside. The nonprofit entity must (1) own an interest in the



property and (2) materially participate in both the development and on-going operation of the low-income project throughout the 15-year compliance period. See Chapter 6.

**Credit Period:  
BINs, Dates,  
and Elections**

Form 8609, line 1a, date of allocation, identifies the date (1) the taxpayer and state agency entered into a carryover allocation, or (2) the state agency signed the completed Form 8609, Part I, if the taxpayer was able to receive the allocation and place the building in service all within one calendar year. However, because of the complexity of real estate development, most IRC §42 projects are developed using a carryover allocation under IRC §42(h)(1)(E) or (F). If the IRC §42 project is a qualified residential rental project under IRC §142(a)(7), line 1a is left blank.

Form 8609, line E, identifies the unique Building Identification Number (BIN) assigned to the low-income building and should consist of the two letter state abbreviation, a two-digit year for the year the allocation was made, and a five-digit number assigned by the state agency. The BIN is helpful in determining the lifecycle of buildings financed with tax-exempt bonds. However, once the BIN is assigned, it will also be the BIN for all subsequent allocations of credit.

Form 8609, line 5, date the building was placed in service, is the date the first unit in the building is ready and available for occupancy under state or local law. For taxpayers receiving carryover allocations of credit, the placed in service date should be no later than the close of the second calendar year following the calendar year in which the allocation was made. For example, if the allocation date is June 14, 2009, the placed in service date should be no later than December 31, 2011.

Form 8609, line 10a, documents the taxpayer's election to begin the credit period the first year after the building is placed in service. Based on the information on lines 5 and 10a, the first year of the credit period can be determined, which is important because:

1. Generally, the applicable fraction is determined as of the last day of the taxable year. For the first year of the credit period, however, the applicable fraction is computed using an averaging methodology described in IRC §42(f)(2).
2. If an adjustment to the credit is made and the recapture provisions under IRC §42(j) are triggered, a portion of the credit claimed for each prior year of the 15-year compliance period is recaptured. The recapture percentage is also dependent on the year of the compliance period for which the recapture provisions are triggered.

**Multi-Building  
Projects**

Form 8609, line 8b, documents the taxpayer's election to treat the building as part of a multi-building project. If the election is made (the "Yes" box is checked), the taxpayer must identify all the buildings to be included in the project on an attachment to the Form 8609. The buildings should be identified by name, address, BIN, and the amount of credit allocated to each building. Under IRC §42(g)(7) and Treas. Reg. §1.103-8(b)(4)(ii), two or more qualified low-income buildings can be included in a project only if the buildings:

1. are located on the same tract of land (including contiguous parcels), unless all of the dwelling units in all the buildings are rent restricted,
2. are owned by the same person for federal tax purposes,
3. are financed under a common plan of financing, and
4. have similarly constructed housing units.

Identifying which buildings are included in the project is important for determining whether the project met the minimum set-aside requirement under IRC §42(g)(1).

**Minimum Set-Aside**

Form 8609, line 10c, documents the taxpayer's election of a minimum set-aside, which establishes three criteria against which the taxpayer's compliance will be evaluated:

1. The minimum number of low-income units the taxpayer must provide to be a qualified low-income project,
2. The income limit used to identify income-qualified households, and
3. The maximum rent the taxpayer may charge for a low-income rental unit.

The minimum set-aside must be the same for all low-income buildings included in a project.

If the project is financed with tax-exempt bonds, the taxpayer may elect, on Form 8609, line 10d, to be a deep rent skewed project under IRC §142(d)(4)(B). At least 15% of the low-income units in the project must be occupied by households whose income is 40% or less than the applicable income limit. This election is in addition to the minimum set-aside election.

**Property Address**

Using the building address (Form 8609, line A), research the local property records. Recorded documents provide information regarding:

1. the value of the land and buildings,
2. changes in ownership during the life of the project that may have triggered the credit recapture requirements,
3. debt financing used to finance the low-income project,
4. contracts imposing additional restrictions on the use of the property, and
5. the extended use agreement. If an extended use agreement is not recorded, then the project may not be a low-income project qualifying for the credit. Local courthouse records can be reviewed.

## **Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition**

The Forms 8823 submitted by the state agency provide information about the building to supplement what is known from the Forms 8609 and can help identify issues that should be addressed during an audit.

Form 8823 is considered an information return. The state agency's conclusions are accepted as correct unless otherwise proven to be incorrect (see IRM 4.10.7.6.1.2). The IRS can use the information to make adjustments to the IRC §42 credit. However, the IRS cannot project the state agency sample's results to the entire population of low-income units.

### **Reconciliation to Forms 8609**

The Forms 8609 and the Forms 8823 should be matched up by BIN and reconciled:

1. Reconcile the amount of credit allocated on the Form 8609, line 1b, to the amount of credit on Form 8823, line 5; there may be more than one Form 8609 for a building. If Form 8823, line 5, is blank or zero, then the taxpayer had not received the Forms 8609 at the time the state agency filed the Form 8823 with the IRS. Compare the dates the Forms 8609 and Forms 8823 were signed by the state agency.
2. Compare the owner's name and EIN; different owners indicate a prior sale of the building.

### **Rental Units**

Forms 8823, lines 7a-d, provide information about the rental units:

1. Line 7a identifies the total number of rental units in the building and line 7b identifies the total number of low-income units in the building. If line 7b is less than line 7a, then the building has a mix of low-income and market-rate rental units. For "mixed-use" buildings, audit issues should include consideration of the taxpayer's compliance with the Available Unit Rule, the Vacant Unit Rule, and the requirement to perform annual income recertifications for all low-income households. Noncompliance with any of these rules may result in failure to meet the minimum set-aside requirement.
2. Line 7c identifies the total number of rental units in a building for which noncompliance issues were identified by the state agency. The extent of known noncompliance can be estimated by comparing this number to line 7a.
3. Line 7d identifies the total number of low-income units reviewed by the state agency. By regulation, the state agency is required to review at least 20% of the low-income units on a "project" basis. If line 7d is more than 20% of line 7a, then the state agency may have expanded the sample size because extensive noncompliance was identified; e.g., poor internal controls (significant risk of error), multiple problems, a significant number of noncompliant units, or the state agency had credible information from a reliable source.

### **Period of Noncompliance**

The time period during which the taxpayer was noncompliant can be determined by comparing the dates on Form 8823, lines 8 and 9. The length of time will indicate whether the noncompliance possibly impacts more than one tax year. Line 9 will be

left blank if the noncompliance had not been corrected by the time the Form 8823 was filed.

**Categories of Noncompliance**

Form 8823 identifies 16 specific categories of noncompliance, as well as a catch-all category for other noncompliance issues. The IRS has provided the state agencies with a guide for completing Form 8823. The guide includes a separate chapter for each category of noncompliance which explains the underlying law and its application to specific fact patterns. The Guide is available on [www.irs.gov](http://www.irs.gov); the catalogue number is Training 23092-001.

The relevant chapters should be reviewed to understand the issues of noncompliance reported by the state agency. Note, however, that the scope of the guide is limited to identifying, correcting, and reporting noncompliance issues to the IRS. It does not address how noncompliance affects the amount of credit a taxpayer may claim.

**Dispositions**

State agencies report dispositions of low-income buildings, or interests therein, on Form 8823, line 13a-d. Information includes how the property was disposed of and who purchased the property (or interest therein). The disposition (gain or loss) should be reflected on the tax return.

**Form 8609-A, Annual Statement for Low-Income Housing Credit**

Form 8609-A is filed by the taxpayer owning the low-income building to complete the annual certification of on-going compliance under IRC §42(1)(2) and to compute the allowable credit for that tax year. The form is filed with the taxpayer's tax return for each year in the 15-year compliance period that begins after December 31, 2004. A separate Form 8609-A is filed for each allocation, so there should be a one-to-one match of Forms 8609 and Forms 8609-A.

**Part I, Compliance Information**

Based on the responses to questions A and B, the Form 8609-A can be associated with the correct Form 8609.

As noted earlier, the taxpayer cannot complete the certification for the first year of the credit period under IRC §42(1)(1) without receiving the executed Form 8609 from the state agency. Question C puts the taxpayer on notice that any building owner claiming credits without receiving a completed Form 8609 that is signed and dated by a state agency is subject to disallowance of the credit.

Questions D and E allow for self-reporting of events that may require a recapture of credit under IRC §42(j).

**Part II, Computation of Credit**

The second part of Form 8609-A is the computation of the allowable credit for the taxable year. The computation involves a number of steps needed to account for various types of low-income housing and circumstances. At this point, it is not necessary to analyze the whole equation, but note the following:

1. The eligible basis entered on Form 8609-A, line 1, should be the same as disclosed on Form 8609. Differences should be addressed during the audit. The amount entered on Form 8609-A, line 1, is the "per return" amount and the starting point for any adjustment made to the eligible basis.

2. The applicable percentage on Form 8609-A, line 5, should be the same as disclosed on Form 8609, line 2. If the applicable percentages are not the same, the taxpayer should be asked to provide an explanation.
3. Form 8609-A, line 15, is the allowable credit, but cannot be higher than the amount of credit identified on Form 8609, line 1b.
4. If credit is claimed on Form 8609-A, line 17, then the tax return is for the eleventh year of the credit period. Any credit not allowed in the first year of the credit period because of the special rule for computing the applicable fraction is allowable in the 11<sup>th</sup> year of the 15-year compliance period under IRC §42(f)(2)(B).

## **Balance Sheet**

The balance sheet included with the tax return provides financial information about the property. All large, unusual, or questionable items should be addressed during the audit.

### **Land Values**

Determine whether the land value reported on the balance sheet is reasonable and comparable to the valuation in the land records. Extremely low values should be audited. Land costs are not included in the eligible basis and the issue will be whether the taxpayer has allocated costs to the low-income buildings that should be allocated to the land.

### **Buildings and Other Depreciable Assets**

Most IRC §42 projects are owned by single-asset entities; i.e., the only business activity is the IRC §42 project. The eligible basis used to compute the credit should also appear on the balance sheet as depreciable property.

The depreciable asset figure should approximate the eligible basis reported collectively on the Forms 8609, line 7, and on Forms 8609-A, line 1, filed with the tax return. For low-income buildings in an area that is difficult to develop, multiply the depreciable assets by the percentage on Form 8609 line 3b, and then compare to the eligible basis.

Compare the balances of depreciable assets at the end of the year to the beginning of the year. Any significant decrease may be an indication of a sale or disposition of part (or all) of the IRC §42 project. For any such decrease in assets, there may be an IRC §42(j) credit recapture issue.

### **Accounts Receivable and Payable**

Receivables and payables need to be reviewed. Large, unusual, or questionable amounts may be indicative of related party transactions or transactions that should be reviewed during the audit.

## **Schedule K and Schedule K-1**

For a partnership, Schedule K and Schedules K-1 should be inspected to identify the type of financing involved, including nonrecourse financing. This information is good to know up front as the state agency records and taxpayer records will fully clarify the types and extent of financing used to develop and operate the IRC §42 project.

A comparison of the Schedules K-1 from year to year will identify changes in ownership percentages.

## Ownership By Individuals

Individuals also own IRC §42 projects directly, and the requirements are exactly the same. The Form 8609 should identify the individual as the owner in box C of Part I. As with business entities, ensure that the Form 8609 was completed and signed by the state agency and that the taxpayer completed the IRC §42(l)(1) certification. The taxpayer should be maintaining financial statements and summaries (including balance sheets, depreciation schedules, and income statements) regarding the operation of the IRC §42 project.

## Prior and Subsequent Year Returns

The taxpayer's prior and subsequent year returns should be reviewed to verify filing, address issues related to the year under audit, and identify any large, unusual, or questionable items. Also review the Schedules K-1 filed each year to identify changes in the partnership ownership. Partners selling their interest in the partnership are subject to the recapture provisions under IRC §42(j).

## Related Returns

Related returns are tax returns that have a relationship to the tax return under audit. Returns are considered related if an adjustment to one return requires adjustment to the other return so that the issue is treated consistently on both returns. Returns are also considered related for audit purposes if the returns are for entities that a taxpayer controls and can manipulate to divert income or camouflage transactions.

### Partners: Consistent Treatment

If the entity under audit is claiming the credit as a result of an interest in a flow-through entity, identify the name and EIN for the related partnership owning the IRC §42 project. Tax returns often include a schedule listing partnership interests and accumulating the flow-through income, loss, or credits. See Chapter 19 for a complete discussion.

### General Partner: Additional IRC §42 Projects

If the entity under audit owns the IRC §42 project, it is likely that it is a flow-through entity and the general partner is the project's developer. Determine whether the general partner is also the general partner for additional IRC §42 projects. If significant noncompliance is identified, the examination may need to be expanded to include the related entities.

## Risk Analysis

A reasonable projection of the potential additional tax should be estimated based on all current year adjustments, recapture of credit from prior years, and future year revenue protection. Any examination adjustments that propose to decrease the applicable fraction or eligible basis will result in changes not only to the taxable year under audit, but also in the recapture of a portion of the credit allowable in prior years and will possibly limit the amount of allowable credit in the remaining years of the credit period. A single potential adjustment can significantly impact the allowable credit when projected over the entire 10-year credit period.

### Example 1: Estimating Potential Tax

A taxpayer was allocated a credit of \$30,000 for one low-income building. During 2007, the fifth year of the credit period, the state agency determined that the project was no longer in compliance nor participating in the IRC §42 program, and reported its finding to the IRS on Form 8823. The taxpayer, however, disregarded the state agency's determination and claimed the credit.

The taxpayer's tax return for the fifth year was audited. For purposes of quickly estimating the potential adjustment, the examiner identified the following:

1. The \$30,000 credit claimed for 2007 was not allowable.
2. The taxpayer claimed \$30,000 for the 2003, 2004, 2005, and 2006 tax years. The credits are subject to recapture under IRC 42(j). The credit portion of the recapture amount is  $\$30,000 \times .333 \times 4 \text{ years} = \$39,960$ . See page 16-2 for explanation of the recapture percentage (.333). Note: The recapture amount also includes an interest portion calculated separately for each year. The computation is complex and should not be attempted for purposes of the risk analysis.
3. The taxpayer will not be able to claim credit in any of the remaining years of the 10-year credit period.  $5 \times \$30,000 = \$150,000$ .

### Initial Information Document Request

Under Treas. Reg. §1.42-5(b), taxpayers are subject to recordkeeping and record retention provisions specific to IRC §42. 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. The records for the first year of the credit period, however, must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

The following records and documents are necessary for the examination of specific issues related to the IRC §42 credit and should be requested at the beginning of the audit. However, as every case is different, the list should be tailored for the taxpayer under audit.

#### **General Information about the Taxpayer**

The following documents should be analyzed early in the audit to assist in setting the scope and depth of the audit.

1. Partnership Agreement,
2. Prospectus/Offering Memorandum related to the organization or syndication of the partnership,

3. Documentation pertaining to the partners' capital contributions including all notes,
4. Credit Allocation Application,
5. Market Study,
6. Credit Allocation Award/Contract or Carryover Allocation,
7. Extended Use Agreement,
8. All Forms 8609 issued to the taxpayer, and
9. Internal audit reports.

**Tax Returns**

The following documents will be needed to ensure consistent treatment from year to year:

1. Copies of tax returns for the tax year prior to the earliest year under audit and all tax returns for years subsequent to the tax years under audit.
2. Trial balance and any workpapers used to prepare the tax return under audit.
3. Depreciation schedules.

**Eligible Basis**

The audit of eligible basis will start with an analysis of the following documents to identify specific costs for in-depth consideration as large, unusual, or questionable items:

1. Final cost certification submitted to the state agency with supporting documentation; e.g., purchase agreements and construction contracts, or settlement documents if existing buildings were acquired.
2. Documentation of all financing sources; e.g., grants, loans, tax-exempt bonds, below market federal loans, and loans payable to the developer or any partner. The taxpayer should provide all debt instruments; e.g., mortgages and promissory notes. Identify outstanding balances and records for all loan repayments.
3. Financial reports; e.g., compilations, reviews, or audited financial statements.
4. Development contracts or agreements for the acquisition, construction, or rehabilitation of the IRC §42 project and related payments and/or notes.
5. Documentation of cost allocations between land, land improvements, and depreciable residential rental property included in eligible basis.

**Qualifying Low-Income Households**

While a review of the tenant files will be completed during the audit, the starting point will be an analysis of the tenant rolls. For the first document request, the taxpayer should provide:



1. For the years under audit, rent rolls identifying the households and family size for each low-income unit.
2. Documentation of internal controls in place to ensure that income-qualified households occupy the low-income units (e.g., copies of written procedures) and the taxpayer's policies (e.g., employment requirements and training).

**1<sup>st</sup> and 11<sup>th</sup>  
Year of the  
Credit Period**

If the first year of the compliance period is audited, the special rule for computing the applicable fraction under IRC §42(f)(2) is used. The taxpayer should provide:

1. Certificates of Occupancy, which will establish when the units were first available for occupancy. The taxpayer may provide alternative documentation. See Notice 1988-116.
2. A schedule indicating when each low-income unit was first occupied by an income-qualified household.
3. Computation of the applicable fraction, including the computation of the applicable fraction for each month.

If the eleventh year of the compliance period is audited and the taxpayer has claimed credit, the taxpayer should provide the information identified above as well as a copy of the tax return for the first year of the credit period.

**Additions to  
Qualified Basis**

Units first occupied by qualifying households after the end of the first year of the credit period will result in an increase in qualified basis. The units qualify for the credit, but the applicable percentage applied to the additional qualified basis is 2/3 of the applicable percentage shown on Form 8609, line 2. See IRC §42(f)(3). The taxpayer should:

1. Provide a list of units first occupied by qualifying tenants after the end of the first year of the credit period and identify when a qualifying household first occupied the unit, or
2. Confirm that all units were occupied by qualifying households by the end of the first year of the credit period.

**Examination of  
Income:  
Rents & Other  
Sources of  
Income**

Gross income is to be considered and the minimum income probes completed. See Chapter 20. Generally, taxpayers owning IRC §42 projects are single-purpose entities and the rents from leasing residential rental units will be the primary source of income. In addition to the records needed to complete the examination of income, the taxpayer should also provide:

1. Description of residential rental units, including total number of units, total number of low-income units, size (number of bedrooms) and rents charged for low-income and market-rate units. Also identify units for on-site managers or security personnel.
2. Documentation that rents are correctly restricted, including computations of the maximum allowable gross rent based on unit size.

3. Sources of rent subsidies; e.g., HUD section 8 payments.
4. Utility allowances and documentation of the computation.
5. Fees for services provided to tenants in addition to housing; e.g., providing meals or cleaning services in assisted living housing.
6. Other income from related activities; e.g., vending machines, laundry facilities, or charges for cable/satellite television.
7. Other income sources such as from the commercial use of a portion of the property; e.g., the taxpayer may receive income for a cell phone tower installed on the roof of a building.
8. Documentation of funds received from other sources; e.g., federal grants or subsidies received during the year, additional capital contributions, or loan proceeds.

**Noncompliance** If Forms 8823 were filed by the state agency, the taxpayer should provide documentation for corrective actions taken to restore the project to compliance.

**Dispositions** If the project was sold, documentation regarding the sale should be provided. Particularly, the sales contract and settlement documents, computation of the capital gain/loss, how the gain/loss was distributed among the partners, and whether the sale required the new owner to operate the project as a qualified low-income project for the remainder of the 15-year compliance period.

**IDR & Crosswalk to Issues** Exhibit 2-1, following this chapter, provide a discussion of documents that should be requested during the audit with reference to the relevant chapters in this guide

## Summary

1. Before beginning the examination, the file should be reviewed and information analyzed to determine the scope and depth of the examination. For audits of the IRC §42 credit, the analysis should also include consideration of information presented on IRS forms, as well as on the tax return itself, including:
  - Form 8609, Low-Income Housing Credit Allocation and Certification
  - Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
  - Form 8609-A, Annual Statement for Low-Income Housing Credit
  - Balance Sheet
  - Schedule K and Schedules K-1
2. Based on the analysis of available information, a reasonable projection of the potential additional tax can be made. The estimate should include the current year adjustment, credit recapture under IRC §42(j) from prior years, and revenue protection if the potential adjustment affects future years of the 15-year compliance period.

3. An Information Document Request (IDR) should be prepared and sent to the taxpayer with the initial contact letter as specific information will be needed to audit IRC §42 issues. See Exhibit 2-1, IDR & Crosswalk to Issues

## **Exhibit 2-1 IDR & Crosswalk to Issues**

The following records and documents are necessary for the examination of specific issues related to the IRC §42 credit and should be requested at the beginning of the audit. However, as every case is different, the IDR should be tailored for the taxpayer under audit.

### **General Information about the Credit Allocation**

The following documents should be analyzed early in the audit to provide an overview of the credit allocation.

1. All Forms 8609 issued to the taxpayer (see Chapter 2 for analysis and Chapter 4 for possible issues).
2. Extended Use Agreement (see Chapter 5).
3. If the credit allocation is from the nonprofit set-aside (see Chapter 6), the taxpayer should provide a copy of the IRS determination letter to confirm the nonprofit was granted nonprofit status.
4. Copies of tax returns for the tax year prior to the earliest year under audit, and all tax returns for years subsequent to the tax years under audit, will be needed to ensure consistent treatment from year to year.

### **Eligible Basis**

The audit of eligible basis (see Chapter 8) will start with an analysis of the following documents to identify specific costs for in-depth consideration as a large, unusual, or questionable item.

1. Final cost certification submitted to the state agency with supporting documentation; e.g., purchase agreements and construction contracts, or settlement documents if existing buildings were acquired.
2. Documentation of cost allocations between land, nonqualifying land improvements and depreciable residential rental property included in eligible basis.
3. Development contracts, agreements or other documents related to a developer's involvement in the acquisition, construction, or rehabilitation of the IRC §42 project. Also request documentation of payments for the services provided and/or deferment of payment.
4. Documentation of all financing sources; e.g., grants, loans, tax-exempt bonds, below market federal loans, and loans payable to the developer or any partner. Provide all debt instruments; e.g., mortgages and promissory notes. Identify the outstanding balances and records for all loan repayments. (See Chapter 10.)

**Qualifying Low-Income Households**

While a review of the tenant files will be completed during the audit, the starting point will be an analysis of the tenant rolls. See Chapter 12. The taxpayer should provide:

1. For the years under audit, rent rolls identifying the households and family size for each low-income unit.
2. Documentation of internal controls in place to ensure that income-qualified households occupy the low-income units (e.g., copies of written procedures) and the taxpayer's policies (e.g., employment requirements and providing training).

**1<sup>st</sup> and 11<sup>th</sup> Year of the Credit Period**

If the first year of the compliance period is audited, the special rule for computing the Applicable Fraction under IRC §42(f)(2) is used (see Chapter 12). The taxpayer should provide:

1. Certificates of Occupancy, which will establish when the units were first available for occupancy.
2. A schedule indicating when each low-income unit was first occupied by an income-qualified household.
3. Computation of First Year Applicable Fraction, including the computation of the Applicable Fraction on a monthly basis.

If the eleventh year of the compliance period is audited and the taxpayer has claimed credit, the taxpayer should provide the information identified above as well as a copy of the tax return for the first year of the credit period.

**Additions to Qualified Basis**

Units first occupied by qualifying households after the end of the first year of the credit period will result in an increase in qualified basis. The units qualify for the credit, but the applicable percentage applied to the additional qualified basis is 2/3 of the applicable percentage shown on Form 8609, line 2. The computation of the credit allowable for increases to qualified basis is included on line 7 of the Form 8609-A filed with the tax return.

If the taxpayer is claiming credit for additions to qualified basis, then the taxpayer should provide a list of units first occupied by qualifying tenants after the end of the first year of the credit period and identify when qualifying households first occupied the units. See Chapter 13.

**Rents & Other Sources of Income (Minimum Income Probes)**

Gross income is to be considered and the minimum income probes completed (see Chapter 20). Generally, taxpayers owning IRC §42 projects are single purpose entities and the rents from leasing residential rental units will be the primary source of income. In addition to the routine records needed to complete the examination of gross income, the taxpayer should also provide:

1. Description of residential rental units, including total number of units, total number of low-income units, size (bedrooms) and rents charged for low-income and market units. Also identify units for on-site managers or security personnel.

2. Documentation that rents are correctly restricted, include HUD schedules of Area Median Gross Income (AMGI) and computations of the maximum allowable gross rent for the year under audit.
3. Sources of rent subsidies; e.g., HUD section 8 payments.
4. Utility Allowances and documentation of the computation.
5. Fees for services provided to tenants in addition to housing; e.g., providing meals or cleaning services in assisted living housing.
6. Other income from related activities; i.e., vending machines, laundry facilities, charges for cable/satellite television, etc.
7. Other income sources such as from the commercial use of a portion of the property; e.g., the taxpayer may receive income for a cell phone tower installed on the roof of one building.
8. Documentation of funds received from other sources; e.g., federal grants or subsidies received during the year, additional capital contributions, or loan proceeds.

See Chapter 12 for discussion of these topics.

**Noncompliance** If the audit resulted from the filing of Forms 8823 by the state agency, the taxpayer should provide documentation for corrective actions taken to restore the project to compliance. Refer to the Guide for Completing Form 8823 for explanations of the individual noncompliance issues identified on the form.

**Dispositions** If the property was disposed of (e.g., a sale), documentation regarding the disposition should be requested. Particularly, the sales contract and settlement documents, computation of the capital gain/loss, how the gain/loss was distributed among the partners, and whether the sale required the new owner to operate property as a qualified low-income project for the remainder of the 15-year compliance period. See Chapter 13.

## **Chapter 3**

### **Audit Techniques**

#### **Introduction**

Auditing includes the accumulation of evidence for evaluating the accuracy of a taxpayer's tax return. Evidence takes many forms, including a taxpayer's testimony, a taxpayer's books and records, an examiner's own observations, and documents from third parties.

Audit techniques should be selected based on the information and evidence needed and the burdens placed upon both the examiner and taxpayer. If evidence is not directly available, alternative sources should be considered.

#### **Topics**

- Interviewing Taxpayers
- Touring IRC §42 Projects
- Evaluating Internal Controls
- Third Party Contacts
- Summary

See Chapter 20 for additional audit techniques for conducting the examination of income.

#### **Interviewing Taxpayers**

The purpose of an interview with the taxpayer is to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records in order to evaluate the accuracy of such information.

1. The interview should be held with the person(s) most knowledgeable about the development and on-going operation of the IRC §42 project. It may be necessary to interview more than one person.
2. The interview should be held early in the examination because the interview is an opportunity to gather information that can help establish, and possibly limit, the scope and depth of the examination.
3. Generally, interviews should be conducted after reviewing the documents requested in the first Information Document Request (IDR).

IRC §7521(c) authorizes a representative to represent a taxpayer at any interview. However, the taxpayer's voluntary presence should be requested if the representative cannot provide:

1. firsthand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices, and daily operations,
2. factual and reliable responses to questions,
3. timely follow-up information for any questions that could not be answered at the time of the initial interview, or

4. a properly authorized Form 2848, Power of Attorney and Declaration of Representative (POA), or Form 8821, Tax Information Authorization from the taxpayer.

## **Background and Financial History**

The taxpayer should provide background and financial information regarding the formation of the ownership entity and development of the project. The taxpayer should specifically discuss the development of the IRC §42 project, including:

1. The people and entities responsible for the planning and construction phases of the project, including the disclosure of related parties.
2. The services provided by the developer, the terms of the development contract, and to what extent the fee has been paid.
3. How the project was acquired; i.e., undeveloped land or land with improvements and existing buildings. The taxpayer should also explain how costs were allocated between land, nonqualifying land improvements, and depreciable residential rental property included in eligible basis.
4. The financial resources such as construction loans, permanent financing, grants, and funding from local, state, or federal programs.
5. The terms of the IRC §42 credit allocation and any additional requirements imposed on the taxpayer by the state agency as part of the extended use agreement.
6. How the final cost certification was prepared.

The interview is also an opportunity for the taxpayer to answer any questions arising from a review of documents such as the partnership agreement, the prospectus or offering memorandum, the credit allocation application, market study, credit allocation award, final cost certification, or depreciation schedules. For example, if the depreciable basis on the depreciation schedules is substantially different than what is reflected on the final cost certification, the taxpayer needs to explain the differences in costs.

## **Business Practices**

The taxpayer should explain how the IRC §42 project is managed and identify the people and organizations responsible for the project's day-to-day operations during the tax years under audit, including personnel responsible for determining whether households were income-qualified, preparing and maintaining the tenant files, receiving rents, making bank deposits, paying expenses, and accumulating financial information used to prepare the tax return.

The taxpayer should explain to what extent it is involved with the on-going operation of the project, how often the project is physically inspected, and whether the financial records are reviewed. If a management company is involved, how often does the taxpayer receive updates, reports, or financial summaries for the IRC §42 project? How and when does the management company notify the taxpayer of any irregularities? Does the taxpayer approve expenditures or to what extent does the taxpayer delegate responsibilities and to whom?



Does the taxpayer maintain written policies and procedures for the operation of the IRC §42 project describing how the project is intended to operate? Who opens the mail? Who receives rents from the tenants? Who deposits the rents in the bank? Who has authority to write checks? Who approves expenditures? Who reconciles bank statements? Are there periodic reviews by independent third parties?

**Internal Controls**

Ask the taxpayer to describe the books and records created as part of the day-to-day operation of the IRC §42 project. What are the common transactions? What books and records are maintained? Does the taxpayer review the books to ensure transactions are timely recorded and how often?

Does the taxpayer separate the duties of on-site personnel? The taxpayer should explain what checks and balances are in place to establish that all income is properly accounted for from the time the rents are received by the site manager. For expenses, the taxpayer should illustrate the review and approval process for approving expenditures, especially any large or unusual expenditure.

Does the taxpayer conduct internal audits? If so, why and what were the results? Does the general partner report to a representative for the limited partners? Do the limited partners conduct their own independent audits?

**Compliance with IRC §42**

The taxpayer should explain what policies and procedures are in place to ensure that the project is operated in compliance with IRC §42.

**Physical Maintenance**

The taxpayer will need to expend resources to make repairs and maintain the project in a manner suitable for occupancy. Does the taxpayer maintain reserves for this purpose? Who decides when maintenance is needed? How often does the taxpayer conduct physical inspections of the project?

**Tenant Qualifications**

How does the taxpayer ensure that new tenants are income-qualified at move-in? Does the taxpayer train employees? Does the taxpayer review tenant files? Is the taxpayer using an independent management company? Is the taxpayer frequently changing management companies? Does the taxpayer conduct internal audits or review of the tenant files?

**Tenant Files**

Who prepares the files? How are they maintained? Where are they stored?

**Rents**

How does the taxpayer determine the maximum allowable rent? Are utility costs included in the rent, or does the tenant pay utility costs based on actual use? If the tenant pays utilities, how does the taxpayer compute the utility allowance? In addition to housing, does the taxpayer provide services for which the taxpayer charges fees in addition to rent? Does the taxpayer charge pet fees? Does the taxpayer charge for the use of a laundry facility? Are there vending machines on

site? Does the taxpayer provide cable or satellite for a fee in addition to rent? Does the taxpayer receive rent subsidies from programs such as HUD's section 8 voucher program?

### **Cash Flows**

Generally, it is expected that the rents generated from the operation of the low-income project will be sufficient to pay on-going operating expenses and retire debt. Did that expectation hold true? If not, it is important to understand why cash flows were insufficient and how the taxpayer responded. Did the taxpayer forgo maintenance or otherwise limit costs? Did the taxpayer find additional sources of revenue? Did the taxpayer stop servicing the debt, incur additional debt, or find alternative financing such as a grant? Did the partners make supplementary capital contributions?

### **Community Service Facilities**

The taxpayer should be asked whether the project included a community service facility. If so, what services were provided, and were they provided throughout the taxable year? How did the taxpayer determine that the facility was used primarily to provide services for individuals whose income is 60% or less than the area's median gross income as required by IRC §42(d)(4)(C)?

### **Forms 8823**

If the state agency filed any Forms 8823 for the low-income building with the IRS, the circumstances of the noncompliance and subsequent correction should be explained. The taxpayer should also explain how the noncompliance was accounted for when computing the allowable credit for the affected tax year.

### **Prior and Subsequent Year Tax Returns**

If the analysis of the prior and subsequent year returns indicates that the amount of credit claimed varies from the credit claimed for the years under audit, the taxpayer should be asked to explain why.

### **Large, Unusual, or Questionable Items**

If any item on the return is a large, unusual, or questionable item (LUQ), inquiries should be made about such items during the initial interview.

### **Related Parties or Returns**

Related returns are tax returns that have a relationship to the tax return under audit because (1) any adjustment to one return will require a corresponding adjustment to the other return to ensure consistent treatment, or (2) the returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

Does the taxpayer own more than one IRC §42 project? While this taxpayer may be a single asset partnership, did the general partner and limited partner form additional partnerships owning IRC §42 projects? If so, how are the books and records for the different entities kept separate? Does the same management company operate all the IRC §42 projects?

Is the project developer or management company also a general partner or related to a general partner? The interrelationships of the parties involved in the development and operation of an IRC §42 project can facilitate the efficient production and management of low-income housing. However, these relationships may have tax implications if proper controls are not in place.

## **Touring IRC §42 Projects**

The IRC §42 project should be toured to ensure the housing exists and is suitable for occupancy. The tour is also an opportunity to observe the taxpayer's compliance with IRC §42 requirements and test internal controls. Treas. Reg. §301.7605-1(d)(3)(iii) states that "regardless of where an examination takes place, the Service may visit the taxpayer's place of business or residence to establish facts that can only be established by direct visit...The Service generally will visit for these purposes on a normal workday of the Service during the Service's normal tour of duty."

### **Preparing for Tour of an IRC §42 Project**

Examiners should review the credit allocation documents and extended use agreement before touring an IRC §42 project. These documents will identify the terms and conditions of the credit allocation that may be observable during the tour; e.g., providing services, income restrictions lower than the minimum set-aside election, rent skewing, housing types, etc.

### **Physical Characteristics to Observe When Touring IRC §42 Projects**

Touring an IRC §42 project can provide insight and understanding needed to identify and address IRC §42 issues. Characteristics to consider include:

1. **Signage and Advertising:** Signs posted around the project provide insight as to how the owner is representing this project; i.e., are there any indications that the project is low-income housing?
2. **Site:** Particularly if housing is new construction, try to envision the amount of land grading, clearing, grubbing, cutting, filling, and rough grading costs the developer might have incurred to prepare the land for construction.
3. **Buildings and Assets:** Identify garages, picnic areas, gazebos, laundry rooms, community rooms, and other buildings on the project site that could be classified as: (1) a facility for the tenants' exclusive use as part of the leasing of a low-income unit, or (2) a facility necessary for the operation of the project.
4. **Additional Income-Producing Activities:** Look for potential uses of the assets that might generate additional income for the taxpayer, such as renting the roof for commercial advertising or as a radio tower.
5. **On-Site Management or Security:** The taxpayer may require the site manager or maintenance personnel to live on the premises. Similarly, to deter crime in and around the project, the taxpayer may lease a rental unit to a security officer. How many rental units are occupied by employees and security officers?
6. **Physical Maintenance:** Look at the buildings, windows, grounds, sidewalks, parking lot, dumpsters, common areas, and landscaping to observe the owner's diligence in providing low-income housing. This is particularly important if the state agency reported that the project was not suitable for occupancy. See Chapter 12.

7. Landscaping: How much landscaping is there? Is it maintained? Is it trimmed? Is it overgrown or weedy? Is there a pond or lake on the property? Would the landscaping be destroyed if the low-income housing was destroyed?
8. Educational Institutions: Is the project located near a school? Compliance with the rules for households composed entirely of full-time students will be an issue if the IRC §42 project is in close proximity to post-high school educational institutions.
9. Duplication or Diversion of Costs: If the owner or general partner owns more than one project, is the construction similar? Are the construction material and designs similar for all the projects? If the taxpayer or general partner buys building materials and supplies in bulk, ensure that the appropriate materials (and appropriate amounts) were delivered and used at the intended site. In addition, consider whether internal controls were in place to ensure all costs are properly attributed to the appropriate project.
10. Building Interiors: What does the project look like on the inside? Tour the interiors of structures. Look for any common areas or non-rental areas that may not have been visible during the tour of the grounds. Look for additional sources of income, such as laundry facilities, access to cable television (the taxpayer may wire the entire building and provide access at a discount), or services provided for the residents in addition to housing. Due to privacy issues and the intrusiveness of such inspections, currently occupied units should not be inspected unless a specific reason is identified.

#### **Rents**

The internal controls should be tested for consistency with the taxpayer's description of how rents are collected, recorded, and deposited. Trace or "walk through" common business transactions and original entries throughout the accounting system. Is there a difference between what should happen and what actually happens? Look for weaknesses in the taxpayer's internal controls. Test the books against charges to individual tenant records. Are there points in the process where the internal controls could be compromised?

#### **Income Qualifying New Tenants**

Observe how the taxpayer determines whether new tenants are income-qualified.

1. Does the potential tenant fill out applications? Did the taxpayer charge an application fee? Are all applicants charged a fee?
2. How does the taxpayer determine the income limits used to evaluate a potential tenant's income?
3. How does the taxpayer verify the information provided by the potential tenant? Acceptable methods include third party verifications, reviews of documents submitted by the tenant (such as check stubs), and tenant certifications made under penalties of perjury.

Randomly select and review a few tenant files on site. Do they reflect the income-verification process observed? Are the files organized?

**Mixed-Use Projects**

If the project is a mixed-use project with both low-income and market-rate rental units, then:

1. Inspect and analyze any structural differences between market-rate units and low-income units. Are there noticeable differences between the size, cost, or upgrades in the market-rate and low-income units? If there are disproportionate standards, the issue will need to be addressed during the audit. See Chapter 11.
2. Ask the on-site manager to demonstrate how over-income units are tracked to ensure the Available Unit Rule is not violated. See Chapter 12.

If the project also includes commercial space, then inspect the commercial space. Are there any shared assets, such as a parking lot used by customers and low-income residents?

**Community Service Facilities**

If the project includes a community service facility, then the facility should be inspected.

**Analyzing Results**

Collectively, observations made during the tour of the project should be consistent with what the taxpayer explained during the interview and what was recorded in the books and records. What was observed and what wasn't? What was different than expected? Does it make sense?

1. Confirm that assets represented on the tax return were physically observed. If not, what happened to the asset? Was the asset something that could have been included in eligible basis? Were assets observed during the tour that are not represented on the tax return?
2. Were additional sources of income identified during the tour?
3. Were internal controls functioning? Can the books and records be relied upon?
4. Is the project operating in compliance with IRC §42 requirements?

**Case File Documentation**

The case file should include documentation that the project was inspected and describe the results, including observations and resolution of any questions.

**Evaluating Internal Controls**

Examiners need to understand how a taxpayer has delegated or separated duties related to the operation of the low-income housing to ensure that the project is in compliance with IRC §42 requirements. In other words, does the taxpayer have sufficient internal controls in place that allow an examiner to rely on the records and information presented by the taxpayer?

Information about the taxpayer's internal controls can be obtained by interviewing the taxpayer, observing the internal controls in place during the tour of the project, and by testing the taxpayer's books and records.

<b>Control Environment</b>	<p>The control environment is composed of the factors that affect the taxpayer’s policies and procedures; e.g., management philosophy and style, personnel policies, and organization structures.</p> <p>Prepare a diagram of the ownership structure and identify entities and individuals who are responsible for or participated in the development and/or on-going operation of the IRC §42 project. Once all the entities are identified, determine each entity’s responsibilities and whether there are sufficient controls between the entities to allow for the compiling and maintaining of reliable information with respect to the project.</p> <p>Generally, IRC §42 projects are owned by partnerships. It is not uncommon for a general partner to own a financial interest in the entity that develops the project, the entity that manages the project, or some other entity within the partnership structure. The presence of related entities can defeat the validity of many internal controls that appear to be in place, as the related entities are in a position to exert influence on the business decisions of the related entities. If related parties are identified, analyze all transactions between the parties.</p>
<b>Accounting System</b>	<p>Examiners need to know how the IRC §42 project operates on a day-to-day basis with respect to tenants occupying the housing, on-site personnel, and management oversight. What are the common transactions? What books and records are maintained? Examiners should be familiar with the normal flow of each type of transaction, including (1) what records are created, (2) how the transaction is recorded, and (3) how the funds flow into and out of the business.</p> <p>Create a diagram of the business operation depicting transactions and identifying who completes the transaction, when and where it is transacted, and who records it.</p>
<b>Control Procedures</b>	<p>Control procedures are the policies and procedures established by the taxpayer to ensure that the project operates as intended and that the assets are protected. Separation of duties is the primary control procedure used to limit the opportunity for any one person or entity to both perpetrate and conceal irregularities in the operation of the IRC §42 project. Other specific procedures include:</p> <ol style="list-style-type: none"> <li>1. Documentation of procedures and transactions,</li> <li>2. Supervision by management,</li> <li>3. Periodic review by independent third parties, and</li> <li>4. Timely recording of transactions.</li> </ol>
<b>Testing Internal Controls</b>	<p>The taxpayer’s internal controls should be tested by “walking through” representative transactions, including physical observation when transactions are recorded:</p> <ol style="list-style-type: none"> <li>1. Select different types of transactions,</li> <li>2. Look for consistency in recording similar or repetitive transactions, and</li> <li>3. Identify points where existing internal controls could be compromised.</li> </ol>
<b>Establishing Scope and Depth of the Audit</b>	<p>The taxpayer’s internal controls should be evaluated to determine the accuracy and reliability of the taxpayer’s books and records. Based on that determination:</p>

1. Establish the scope of the audit; i.e., identify issues requiring further examination and eliminate issues with little risk of material misstatement.
2. Establish the depth of the audit; i.e., select appropriate method for the examination of IRC §42 issues and determine the extent to which they should be used.

### **Third Party Contacts**

Third party contacts may be necessary to validate or corroborate information and documentation submitted by a taxpayer during an audit. Third party contacts can also provide information unavailable to the taxpayer.

#### **Contacting State Agencies**

The state agencies maintain complete project histories and are the best source for information (other than the taxpayer) about the project. State agency contact information can be identified on Form 8823 (lines 14 and 15) or at the website for the National Council of State Housing Agencies, [www.ncsha.org](http://www.ncsha.org).

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. State agencies should not be contacted about specific taxpayers until the decision to proceed with the examination has been made and only after providing notice to the taxpayer.

The state agency will be able to provide:

1. The credit allocation application,
2. The credit carry-over agreement,
3. The final cost certification submitted by the taxpayer,
4. The state agency's gap analysis,
5. Results of physical inspections,
6. Notices of noncompliance, and
7. Correspondence between the state agency and the taxpayer.

The state agency may be contacted to provide additional information and clarifications. Documentation of a state agency's reviews of the project may be available and can provide insight regarding specific instances of noncompliance and the taxpayer's overall ability to maintain the project in compliance.

#### **Other Third Party Contacts**

When making third party contacts, consider the source and quality of the information received. When making third party contacts, it is important to make multiple contacts to help establish a pattern or frequency of noncompliance (if such exists).

1. Former site managers and employees may have information about the taxpayer's books and records, as well as insight into the taxpayer's business practices and policies.
2. Former tenants can provide information regarding the operation of an IRC §42 project. For example, did the taxpayer allow households to rent units significantly larger than needed based on the household's size? Did the taxpayer try to keep the project in good condition?

3. When there are questions about a tenant income certification, it is important to verify the accuracy of the information. This is especially true where there is a pattern of incomplete or questionable information in the tenant files.

## Summary

A determination of a taxpayer's tax liability must be made based on all available information, including facts that support the taxpayer's position. In this chapter, the following audit techniques used to gather information and how these techniques can be used when auditing IRC §42 issues have been discussed.

1. Interviews with the taxpayer provide an opportunity to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records.
2. IRC §42 projects are toured to ensure the housing exists, includes the assets described in the records, and is suitable for occupancy. The tour is also an opportunity to observe the taxpayer's compliance with IRC §42 requirements and test internal controls.
3. The taxpayer's internal controls are evaluated to determine the reliability of the taxpayer's books and records. Consideration is given to the control environment, accounting system, and control procedures. The scope and depth of the audit will be established based on this evaluation. Information about the taxpayer's internal controls can be obtained by interviewing the taxpayer, observing the internal controls in place during the tour of the project, and by testing the taxpayer's books and records.
4. Third party contacts should be made if information cannot be provided by the taxpayer, or it becomes necessary to validate or corroborate information or documentation.



## **Chapter 4**

### **First Year Certification**

#### **Introduction**

Under IRC §42(l)(1), taxpayers are required to complete a certification with respect to the first year of the credit period. The certification is made by completing Part II of the Form 8609 executed by the state agency to document the allocation of IRC §42 credit.

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) that received 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 claims credit using Form 8609-A, Annual Statement for Low-Income Housing Credit.
3. Taxpayers make the certification one time by filing the completed Form 8609, Low-Income Housing Credit Allocation and Certification, with the LIHC Compliance Unit.

Without a Form 8609 completed, signed, and dated by the state agency, the taxpayer cannot complete the first-year certification required under IRC §42(l)(1) and, therefore, may not be entitled to claim any IRC §42 credits. The IRC §42(l)(1) certification should be identified as an audit issue if:

1. as part of the precontact analysis, the completion of the certification cannot be confirmed (see Chapter 2), or
2. the taxpayer's operation of the project is inconsistent with the information and elections documented on Form 8609.

#### **Topics**

- Law
- Completing the Certification During the Audit
- Evaluating Taxpayer Compliance
- Taxpayer Arguments
- Failure to Complete Certification
- Audit Scope
- Penalties
- Administrative Requirement
- Summary

#### **Law**

IRC §42(l)(1) reads:

(1) Certification with respect to 1st year of credit period. Following the close of the 1st taxable year in the credit period with respect to any qualified low-income building, the taxpayer shall certify to the Secretary (at such time and in such form and in such manner as the Secretary prescribes)—

- (A) the taxable year, and calendar year, in which such building was placed in service,
- (B) the adjusted basis and eligible basis of such building as of the close of the 1st year of the credit period,
- (C) the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under subsection (h),
- (D) the election made under subsection (g) with respect to the qualified low-income housing project of which such building is a part, and
- (E) such other information as the Secretary may require.

The flush language following IRC §42(l)(1)(E) reads:

In the case of a failure to make the certification required by the preceding sentence on the date prescribed therefore, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable by reason of subsection (a) with respect to such building for any taxable year ending before such certification is made.

**Treas. Reg.  
§1.42-1(h)**

Treas. 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, Part I, line 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.

**Chief Counsel  
Advisory  
200137044**

CCA 200137044 provides guidance regarding the IRC §42(l)(1) certification (in a question (Q) and answer (A) format) including the following:

Q2: Once a Form 8609 is first issued by an applicable allocating authority, can the taxpayer file an amended return to claim credits for taxable years in a building's compliance period prior to the issuance of the Form 8609?

- A2: Once a Form 8609 is issued by the applicable allocation authority, the taxpayer can file an amended return to claim credits for taxable years in a building's compliance period prior to the year in which the Form 8609 is issued.
- Q3. If a taxpayer has claimed IRC §42 credits for any year prior to the issuance of the Form 8609, can all credits claimed prior to the issuance of the Form 8609 be disallowed?
- A3. Under certain circumstances, if a taxpayer claimed IRC §42 credits for a year prior to issuance of the Form 8609 by the applicable allocating authority, all credits claimed prior to issuance of the Form 8609 can be disallowed.

The CCA includes two examples:

1. If, in the case of an allocation from the state housing credit ceiling, the state agency has not completed Part 1, the form is incomplete. Since the first-year certification requirement of IRC §42(l)(1) is incorporated into Form 8609, an incomplete form would not satisfy the IRC §42(l)(1) first year certification requirement.
2. If the failure to meet the IRC §42(l)(1) certification requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years (assuming no fraud) in the compliance period until this requirement is met.

The CCA also includes a qualification that "...It is not clear what the result would be for a tax-exempt bond project." At the time CCA 200137044 was written, Treas. Reg. §1.42-1T(h)(2) provided that for tax-exempt bond financed projects for which no allocation is made, an owner was to obtain a blank copy of Form 8609 and fill in (for Part 1) the address of the building and the name and address of the owner. This inconsistency between IRC §42 credit allocations and credits associated with IRC §146 was resolved when Treas. Reg. §1.42-1(h) became effective on January 27, 2004 (see discussion of regulation above).

- Q4. Can a taxpayer satisfy the certification requirements of IRC §42(l)(1) during the examination process?
- A4. There is no prohibition against satisfying the certification requirements of IRC §42(l)(1) during the examination process.
- Q5. If a revenue agent finds that the first year certification requirements of IRC §42(l)(1) have not been met, can the entire credit amount for the first and all successive years be disallowed?
- A5. The answer to whether the entire credit amount for the first and all successive years can be disallowed if the first-year certification requirements of IRC §42(l)(1) have not been met is similar to that in A3. The flush language following IRC §42(l)(1)(E) provides that in the case of a failure to make the certification required by IRC §42(l)(1) on the date prescribed thereof, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable under IRC §42(a) for any taxable year before such certification is made. If the failure to meet the §42(l)(1) certification

requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years (assuming no fraud) in the compliance period until this requirement is met.

## Completing the Certification During the Audit

There is no prohibition against satisfying the certification requirements during the examination process. See CCA 200137044. The taxpayer should be given the opportunity to provide executed Forms 8609 (completed, signed, and dated by the state agency) and Part II completed and signed by the taxpayer. If the taxpayer presents completed Forms 8609, then the following four issues must be addressed:

### **Issue #1: Credit Claimed in Prior Years**

Determine whether the credit claimed by the taxpayers in years before the certification is more than the credit allocated and documented on the Forms 8609. The audit 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.

### **Issue #2: Elections and Prior Year Tax Returns are Consistent**

Verify that the taxpayer's elections and past filings are consistent. Under IRC §6001, the taxpayer must provide adequate proof of consistent behavior, which can include providing prior year federal tax returns.

#### Example 1: Inconsistent Elections

A taxpayer placed a newly constructed low-income building in service in February of 2005 and began claiming credits the same year. The state agency provided the completed Form 8609, Part I, in March of 2009. The taxpayer elected to begin the credit period the first year after the building was placed in service, 2006, even though credits were actually claimed the year the building was placed in service.

In this case, the taxpayer has created documentation to support claiming the credit for eleven years rather than the prescribed ten year credit period under IRC §42(f)(1). The IRC §42 program analyst should be contacted if this issue is identified.

### **Issue #3: Verification of First Year Credit**

Verify the eligible basis, the applicable fraction, and minimum set-aside for the first year of the credit period to ensure that the building was timely placed in service and that the credit has been correctly computed. Under Treas. Reg. §1.42-5(b)(2), the records for the first year of the credit period must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the 15-year compliance period of the building.

### **Issue #4: Reasons for Failure to Complete the Certification**

Determine why the taxpayer failed to timely complete the IRC §42(l) certification.

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 first year in the credit period (when the eligible basis is determined), but the forms were not received before filing tax returns. Factors to consider:

1. When was the request for the Forms 8609 made?
2. What follow-up efforts did the taxpayer make to secure the Forms 8609?
3. Why did the state agency delay executing the Forms 8609?

State agencies generally attempt to timely provide the completed forms. Failure to do so is indicative of problematic projects; e.g., the cost certifications may not be complete, the state agency may have determined that the project was built using sub-standard materials, or the project was not built according to the terms of the allocation. The state agency should be contacted to determine the cause of the delay. State agencies keep records of their contacts with project owners; determine if and why the taxpayer delayed in responding to the state agency's inquiries.

## Evaluating Taxpayer Compliance

In *United State v. Boyle, Executor of the Estate of Boyle* (see Appendix F), the Court addressed a delinquency penalty for failure to timely file a return and explained that the meaning of the phrase, "...failure is due to reasonable cause and not to willful neglect..." for purposes of assessing the IRC §6651 penalty for failure to timely file a tax return.

The Court explained Congress' purpose was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly. "...To escape the penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from "willful neglect," and (2) that the failure was "due to reasonable cause...Congress obviously intended to make absence of fault a prerequisite to avoidance of the late-filing penalty. A taxpayer ...must therefore prove that his failure to file on time was the result neither of carelessness, reckless indifference, nor intentional failure."

### Willful Neglect

As used by the Supreme Court in *United States v. Boyle*, 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.

**Reasonable Cause**

The term “reasonable cause” is not defined in the Code, but Treas. Reg. §301.6651-1(c)(1) provides that, to demonstrate "reasonable cause," a taxpayer filing a late return must show that he “exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time.” Similarly, in *United States v. Boyle*, “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. (See IRM 20.1.1.3.1)

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 from the state agency? How many years has the taxpayer claimed the credit without completing the certification? How did the taxpayer answer question C on Form 8609-A filed with the tax returns to complete the IRC §42(l)(2) annual certification requirement?
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 the problems 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.
6. Death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause. Consider the relationship of the responsible party to the partnership; 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.

**Taxpayer’s Arguments****Taxpayer’s Burden**

The taxpayer bears the burden of demonstrating that the failure did not result from willful neglect and 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.

**State Agency Caused Delays**

A taxpayer may argue that delays were caused by the state agency responsible for completing the Forms 8609.

A taxpayer is not subject credit disallowance or recapture because a state agency failed to timely provide executed Forms 8609. The evaluation should be made based on the individual facts and circumstances of the case and the taxpayer's actions. The issue is whether there is a reasonable cause for any delays caused by the taxpayer and whether the taxpayer's failure resulted from willful neglect.

### **Housing Policy**

A taxpayer may argue that consideration should be given to the underlying policy of IRC §42, which is to encourage the construction of low-income housing by providing tax credits to taxpayers who are willing to assume substantial economic risk. Any narrow interpretation of "reasonable cause" would operate to discourage the very activity IRC §42 was designed to promote. Therefore, the strict standard as explained in *United State v. Boyle* is not appropriate for IRC §42(l)(1). Rather, the facts and circumstances of each case and should be evaluated to determine whether the taxpayer was exercising ordinary business care and prudence and responding to circumstances that cause delays in a prudent manner.

First, the determination should not be limited to consideration of the taxpayer's due diligence or prudence in responding to circumstances causing delays. The nature and cause of the delays must also be considered.

Second, the flush language following IRC §42(l)(1) requires consideration of both "reasonable cause" and "willful neglect" when determining whether the IRC §42 credit is allowable before completing the first year certification. *United State v. Boyle* does not set the standard, but rather reinforces and explains how the concepts should be applied under similar circumstances; i.e., the failure to file a tax return.

Finally, an argument based on housing policy suggests that taxpayers investing in IRC §42 project should be treated differently, or more leniently than other taxpayers who fail to timely comply with filing requirements. This argument is contrary to the administration of tax law and results in an unfair and inequitable treatment of taxpayers. From *United States v. Boyle*, Chief Justice Burger wrote:

"...Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. Prompt payment of taxes is imperative to the Government, which should not have to assume the burden of unnecessary ad hoc determinations."

### **Failure to Complete Certification**

Without the completed certification, the IRS cannot determine whether the state agency has approved the completed project, the amount of credit the taxpayer is entitled to claim, or the terms of the allocation. As a result, if the taxpayer cannot complete the certification during the audit, then 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.

**Reasonable Cause Exists**

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.

**Reasonable Cause Not Identified**

If the failure to complete the certification process is not due to a reasonable cause, or is due to willful neglect, no credit is allowable for any tax year before the certification is completed. The entire credit should be disallowed in all years open by statute, and under IRC §42(j), a portion of credit can be recaptured in years closed by statute or otherwise not examined

**Audit Scope****Additional Audit Requirements**

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 and the certification completed. For these possible outcomes, the taxpayer will need to establish that the buildings are qualified low-income buildings under IRC §42(g)(1) and the costs includable in the buildings' eligible basis.

**Penalties**

Penalties should be considered if the credit is disallowed; i.e., a determination was made that the taxpayer could not establish a reasonable cause for the failure to timely complete the IRC §42(l)(1) certification or the taxpayer was willfully negligent. The responsible parties should be identified and consideration given to the penalty under IRC §6701. This penalty applies to persons who knowingly aid and abet in the understatement of the tax liability of another person.

**Administrative Requirement****Securing Completed Forms 8609**

Should the taxpayer be able to complete the certification during the audit, the original executed Forms 8609 (both Parts I and II completed, signed, and dated) should be secured from the taxpayer and forwarded to the LIHC Compliance Unit with a note explaining that the forms were secured during an audit. The mailing address is included with the instructions for Form 8609 for the current revision of the form.

**Summary**

The importance of the IRC §42(l)(1) certification cannot be overemphasized; it isn't simply "paperwork." There is a possibility that a taxpayer is fraudulently claiming the credit; i.e., the taxpayer does not have an allocation of credit from a state agency. Further, even if the taxpayer has entered into a contract with the state agency, the IRS cannot determine whether 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.



## Chapter 5 Extended Use Agreement

<b>Introduction</b>	For all buildings allocated credit after 1989, IRC §42(h)(6) requires taxpayers to enter into an extended use agreement with the state agency. The requirement also applies to buildings financed with tax-exempt bonds under IRC §142(d) and receiving credits associated with the volume cap under IRC §146. Taxpayers must agree to a long-term commitment beginning on the first day of the 15-year compliance period and ending on the later of (1) the date specified by the state agency in the agreement or (2) the date which is 15 years after the close of the 15-year compliance period. In other words, the taxpayer covenants to maintain the buildings as low-income housing for at least 30 years.
<b>Topics</b>	<ul style="list-style-type: none"><li>• Law</li><li>• Audit Issues</li><li>• Audit Techniques</li><li>• Disallowance of Credit</li><li>• Summary</li></ul>
<b>Law</b>	
<b>Requirement</b>	<p>IRC §42(h)(6)(A) provides that a building is eligible for credit only if there is a minimum long-term commitment to low-income housing.</p> <p>(A) In general. No credit shall be allowed by reason of this section with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year.</p>
<b>Content</b>	<p>IRC §42(h)(6)(B) identifies the terms of the agreement.</p> <p>(B) Extended low-income housing commitment. For purposes of this paragraph, the term "extended low-income housing commitment" means any agreement between the taxpayer and the housing credit agency—</p> <ul style="list-style-type: none"><li>(i) which requires that the applicable fraction (as defined in subsection (c)(1)) for the building for each taxable year in the extended use period will not be less than the applicable fraction specified in such agreement and which prohibits the actions described in subclauses (I) and (II) of subparagraph (E)(ii),</li><li>(ii) which allows individuals who meet the income limitation applicable to the building under subsection (g) (whether prospective, present, or former occupants of the building) the right to enforce in any State court the requirement and prohibitions of clause (i),</li><li>(iii) which prohibits the disposition to any person of any portion of the building to which such agreement applies unless all of the building to which such agreement applies is disposed of to such person,</li></ul>

- (iv) which prohibits the refusal to lease to a holder of a voucher or certificate of eligibility under section 8 of the United States Housing Act of 1937 because of the status of the prospective tenant as such a holder,
- (v) which is binding on all successors of the taxpayer, and
- (vi) which, with respect to the property, is recorded pursuant to State law as a restrictive covenant.

**Extended Use Period**

IRC §42(h)(6)(D) defines the extended use period.

(D) Extended use period. For purposes of this paragraph, the term "extended use period" means the period—

- (i) beginning on the 1st day in the compliance period on which such building is part of a qualified low-income housing project, and
- (ii) ending on the later of--
  - (I) the date specified by such agency in such agreement, or
  - (II) the date which is 15 years after the close of the compliance period.

**Tenant Protections & Exceptions**

IRC §42(h)(6)(B)(i), by cross referencing IRC §42(h)(6)(E)(ii), provides tenants with protection against eviction or the termination of tenancy (other than for good cause) from any low-income unit and any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period.

IRC §42(h)(6)(E)(ii) provides that the termination of an extended use agreement under clause (i) shall not be construed to permit before the close of the 3-year period following such termination –

- (I) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or
- (II) any increase in the gross rent with respect to such unit not otherwise permitted under this section.

Rev. Rul. 2004-82, Q&A #5 explains that under IRC §42(h)(6)(B)(i), an extended use commitment must include a specific prohibition against 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 any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period. Because the prohibition in Q&A #5 was made retroactive to existing extended use agreements, the Service established a safe harbor under which housing credit agencies and taxpayers could meet the requirements of IRC §42(h)(6)(B)(i) in lieu of an extended use agreement for agreements entered into before January 1, 2006. Under Rev. Proc. 2005-37, the safe harbor is met:

1. If the agreement contains general language requiring taxpayers to comply with IRC §42 requirements (catch-all language) and the state agency notifies the taxpayer in writing on or before December 31, 2005, that consistent with the interpretation in Rev. Rul. 2004-82, Q&A-#5, the catch-all language prohibits the

taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) throughout the entire commitment period and prohibits the taxpayer from making an increase in the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period, or

2. If the extended use agreement does not contain specific language on the IRC §42(h)(6)(B)(i) prohibition against the actions described in subclauses (I) and (II) of IRC §42(h)(6)(E)(ii) or catch-all language, then the agreement must be amended to clearly provide for the IRC §42(h)(6)(B)(i) prohibition against the actions described in subclauses (I) and (II) of IRC §42(h)(6)(E)(ii) by December 31, 2005.

**Early Termination (Foreclosures and Qualified Contracts)**

The extended used period may be terminated early if there is a foreclosure or the taxpayer requests that the state agency find a buyer and no buyer is willing to maintain the housing's low-income status under IRC §42(h)(6)(F).

(E) Exceptions if foreclosure or if no buyer willing to maintain low-income status.

(i) In general. The extended use period for any building shall terminate—

(I) on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure) unless the Secretary determines that such acquisition is part of an arrangement with the taxpayer a purpose of which is to terminate such period, or

(II) on the last day of the period specified in subparagraph (I) if the housing credit agency is unable to present during such period a qualified contract for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a qualified low-income building.

Subclause (II) shall not apply to the extent more stringent requirements are provided in the agreement or in State law.

**Purchase by Tenant**

IRC §42(g)(6) allows a low-income tenant to pay (on a voluntary basis) a de minimis amount to be held toward the purchase of the low-income unit after the end of the 15-year compliance. The existence of such agreements, which might be recorded in the land records, does not negate the extended use agreement.

To qualify, the agreement must meet two conditions:

1. All amounts paid are refunded to the tenant if the tenant ceases to occupy the unit, and
2. The purchase of the unit is not permitted until after the close of the building's 15-year compliance period.

Also, in flush language to IRC §42(g)(6), the Code provides that any amount paid by the tenant is included as rent for determining whether the unit is rent-restricted. Rev. Rul. 95-49 asks, "Does an extended low-income housing commitment satisfy §42(h)(6) if its provisions may be suspended or terminated after the compliance

period when a tenant exercises a right of first refusal to purchase a low-income building?”

Briefly, Chief Counsel responded that the extended use agreement ensures that a certain percentage of a low-income building's units will continue to be available for rental by low-income tenants after the close of the compliance period. Similarly, IRC §42(i)(7) provides that that no federal income tax benefit fails to be allowable to the owner of a qualified low-income building merely by reason of a right of first refusal held by the building's tenants to purchase the building after the close of the 15-year compliance period, thereby permitting low-income tenants to be homeowners instead of renters. Since the objectives of §§42(h)(6) and (i)(7) are similar in that both sections attempt to promote housing for low-income individuals beyond the compliance period, the extended use agreement satisfies IRC §42(h)(6) even if a tenant holds a right of first refusal to purchase a low-income unit after the end of the 15-year credit period. See PLR 200703024 for an example.

**Correction  
Period**

IRC §42(h)(6)(J) provides a correction period should there be a determination that an extended use agreement is not in effect.

(J) Effect of noncompliance. If, during a taxable year, there is a determination that an extended low-income housing agreement was not in effect as of the beginning of such year, such determination shall not apply to any period before such year and IRC §42(h)(6)(A) shall be applied without regard to such determination if the failure is corrected within 1 year from the date of the determination.

**Foreclosure or  
Instrument in  
Lieu of  
Foreclosure**

Under IRC §42(h)(6)(E)(i)(I), the extended use agreement terminates on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure) unless the Secretary determines that such acquisition is part of an arrangement with the taxpayer a purpose of which is to terminate such period. No credit is allowable for the taxable year if the taxpayer is subject to the IRC §42(j) credit recapture provisions as a result of the disposition by foreclosure or instrument in lieu of foreclosure.

**Additional  
Discussion**

Refer to Chapter 16, 23, and 26 of the Guide for Completing Form 8823 for additional discussion.

**Audit Issues**

1. Whether an extended use agreement was in effect at the end of the tax year under audit.
2. Whether an extended use agreement meets the IRC §42(h)(6)(B) requirements.
3. If a determination was made that an extended use agreement was not in effect, whether the taxpayer corrected the failure within one year of the determination.

## Audit Techniques

1. Confirm that the extended use agreement is recorded by reviewing the land records. Depending on the location of the project, the agreement should be recorded by the county or other similar local government entity according to state law. Also review mortgages and other restrictive covenants recorded against the property; these agreements may include conditions that are inconsistent with IRC §42 requirements.
2. The extended use agreement is a contract between the state agency allocating the IRC §42 credit and the taxpayer owning the IRC §42 project. Make sure the extended use agreement is executed by the taxpayer and reflects agreement between the taxpayer and the housing credit agency.
3. Evaluate whether the extended use agreement meets the IRC §42(h)(6)(B) requirements. Under IRC §42(m)(1)(B) and (C), state agencies can impose additional conditions upon the credit allocation to serve the lowest income tenants for the longest periods in specified locations. For example, the state agency may require a taxpayer to set-aside a percentage of low-income units for occupancy by households with income less than 30% of the area's median gross income, even though the taxpayer elects the 40-60 minimum set-aside under IRC §42(g)(1). These additional requirements will also be reflected in the extended use agreement, but are not enforced under IRC §42. Rather, it is the state agency's responsibility to address noncompliance under state law.
4. For extended use agreements executed before January 1, 2006, that include catch-all language requiring compliance with IRC §42 requirements, ask the taxpayer to provide the state agency's notification that the catch-all language prohibits the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period. If the original extended use agreement did not contain catch-all language or specific language on the IRC §42(h)(6)(B)(i) prohibitions, then the agreement should have been amended by December 31, 2005.
5. For extended use agreements executed after December 31, 2005, the agreement should include specific language prohibiting the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period.
6. If the state agency identified noncompliance, a Form 8823 should have been filed with the IRS. The report should have included an explanation and copy of the notification letter beginning the one-year correction period. Contact the state agency to determine whether the noncompliance issue was timely resolved.

## Disallowance of Credit

**Disallowance of Current Year Credit** Noncompliance occurs if:

1. The extended use agreement does not meet the IRC §42(h)(6) requirements, is not properly executed, or is not recorded according to state law, and
2. The taxpayer failed to correct noncompliance within the one-year correction period provided by IRC §42(h)(6)(J).

If noncompliance occurs, no IRC §42 credit is allowable for any building governed by the agreement until the taxable year in which the extended use agreement is in effect. If noncompliance is identified, the IRC §42 program analyst should be contacted.

**IRC §42(j), Recapture Amount**

While noncompliance with the requirements under IRC §42(h)(6) results in the loss of credit, the noncompliance does not result in a decrease in qualified basis. As a result, the credit recapture provisions under IRC §42(j) are not applicable when a taxpayer fails to meet the IRC §42(h)(6) requirements or fails to correct noncompliance within the 1-year correction period. See Chapters 13 and 16.

## Summary

1. For all buildings allocated tax credits after 1989, IRC §42(h)(6) requires taxpayers owning IRC §42 buildings to enter into an extended use agreement with the state agency that allocated the credits to the buildings. The requirement also applies to buildings financed with tax-exempt bonds under IRC §142(d) and receiving credits associated with the volume cap under IRC §146.
2. The extended use agreement must be in effect for at least 30 years beginning on the first day of the building's 15-year compliance period and ending on the later of the date specified by the state agency in the agreement or 15 years after the close of the 15-year compliance period.
3. The extended use agreement is a contract between the taxpayer and state agency which can be enforced by low-income individuals (prospective, present or former occupants of the buildings) in state court and prohibits the refusal to lease to a holder of a voucher or certificate of eligibility under section 8 because of the status of the prospective tenant as such a holder.
4. The extended use agreement provides tenants with protection against eviction or the termination of tenancy (other than for good cause) from any low-income unit and any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period. However, there is an exception if there is a foreclosure or no buyer is willing to maintain the housing's low-income status, in which case tenants have these protections for three years following the termination of the extended use agreement.
5. The extended use agreement prohibits the disposition of any portion of a low-income building to which the agreement applies unless all of the buildings are disposed of to such person, and is binding on all successor owners of the project.

6. The extended use agreement must be recorded pursuant to State law as a restrictive covenant.
7. Noncompliance occurs if the extended use agreement does not meet the IRC §42(h)(6) requirements, is not properly executed, or is not recorded according to state law. However, if a taxpayer corrects the noncompliance within the one-year correction period, there is no disallowance of IRC §42 credit.
8. If noncompliance occurs, no IRC §42 credit is allowable for any building governed by the agreement until the taxable year in which the extended use agreement is in effect. The IRC §42(j) credit recapture provisions, however, are not applicable.

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## Chapter 6 Nonprofit Set-Aside

<b>Introduction</b>	<p>Congress, aware of the important role played by nonprofit organizations in the development of affordable housing, provided additional tax incentives for these entities to be involved in the development and management of IRC §42 projects.</p>
<b>Topics</b>	<ul style="list-style-type: none"><li>• Law</li><li>• Audit Issues</li><li>• Audit Techniques</li><li>• Audit Adjustments</li><li>• Related Issues</li><li>• Summary</li></ul>
<b>Law</b>	<p>IRC §42(h)(5) provides that a portion of each state's annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations. Specifically, IRC §42(h)(5) provides:</p>
<b>Nonprofit Set-Aside</b>	<p>(A) In general. Not more than 90% of the State housing credit ceiling for any State for any calendar year shall be allocated to projects other than qualified low-income housing projects described in subparagraph (B).</p>
<b>Qualified Low-Income Housing Projects</b>	<p>(B) Projects involving qualified nonprofit organizations. For purposes of subparagraph (A), a qualified low-income housing project is described in this subparagraph if a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.</p>
<b>Qualified Nonprofit Organizations</b>	<p>(C) Qualified nonprofit organization. For purposes of IRC §42(h)(5), the term "qualified nonprofit organization" means any organization if—</p> <ul style="list-style-type: none"><li>(i) such organization is described in paragraph (3) or (4) of IRC §501(c) and is exempt from tax under IRC §501(a),</li><li>(ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and</li><li>(iii) one of the exempt purposes of such organization includes the fostering of low-income housing.</li></ul> <p>(D) Treatment of certain subsidiaries.</p> <ul style="list-style-type: none"><li>(i) In general. For purposes of IRC §42(h)(5), a qualified nonprofit organization shall be treated as satisfying the ownership and material participation test of subparagraph (B) if any qualified corporation in which such organization holds stock satisfies such test.</li><li>(ii) Qualified corporation. For purposes of clause (i), the term "qualified corporation" means any corporation if 100% of the stock of such corporation is held by one or more qualified nonprofit organizations at all times during the period such corporation is in existence.</li></ul>

**Additional Discussion**

Refer to Chapter 22 of the Guide for Completing Form 8823 for additional discussion.

**Audit Issues**

1. Whether the taxpayer received an allocation from the nonprofit set-aside.
2. Whether the nonprofit is a qualifying nonprofit organization and satisfies the requirements for its tax exempt purpose.
3. Whether the nonprofit has maintained an ownership interest in the project.
4. Whether the nonprofit materially participated (within the meaning of IRC §469(h)) in both the project development and operation of the project throughout the building's 15-year compliance period.

**Audit Techniques****Step 1:  
Identify Credit Allocations from Nonprofit Set-Aside**

Allocations from the nonprofit set-aside are identified on Line 6g of Form 8609, Low-Income Housing Credit Allocation and Certification, starting with the November 2003 revision of the form. If an earlier revision was used, contact the state agency that made the allocation. Confirmation from the state agency is needed because:

1. Even though a nonprofit may be a partner in the partnership under audit, the taxpayer is not subject to the IRC §42(h)(5) requirements unless the taxpayer received the credit allocation from the nonprofit set-aside.
2. Although a nonprofit is not currently a partner in the partnership under audit, the taxpayer may have originally included a qualifying tax-exempt entity and received a credit allocation from the nonprofit set-aside.

If a determination is made that the taxpayer did not receive its credit allocation from the nonprofit set-aside, no further action is required.

**Step 2:  
Confirm Nonprofit's Status as a Qualified Tax-Exempt Organization**

IRC §42(h)(5)(C) defines a qualified nonprofit organization as any organization meeting the tax-exempt requirements of IRC §§ 501(c)(3) or 501(c)(4), and for which one of the exempt purposes includes the fostering of low-income housing. As low-income housing projects are typically owned by partnerships, allocations under the nonprofit set-aside are frequently made to partnerships for which the general partner is a qualifying nonprofit organization.

1. Ask the taxpayer for a copy of the IRS determination letter to confirm that the nonprofit was granted tax-exempt status.
2. Confirm that the nonprofit has filed required Forms 990, Return of Organization Exempt From Income Tax.
3. In the case of an IRC §501(c)(3) organization, determine whether the nonprofit is a tax exempt entity in good standing by using the IRS website ([www.irs.gov](http://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.

4. Determine whether one of the nonprofit's exempt purposes includes the fostering of low-income housing. IRC §501(c)(3) provides, in part, that an organization may be considered exempt if it is organized and operated exclusively for one or more of the following purposes; religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals. IRC §501(c)(4) provides, in part, that civic leagues or organizations satisfying certain criteria may be considered exempt if their net earnings are devoted exclusively to charitable, educational, or recreational purposes. Nonprofits participating in the IRC §42 program are usually designated as "charitable."

Treas. Reg. §1.501(c)(3)-1(d)(2) defines the term "charitable," as it relates to an organization's exempt purpose and provides that the term should be construed liberally. Notwithstanding, IRC §42(h)(C)(iii) requires that one of the exempt purposes of the organization must include the fostering of low-income housing. IRC §42(h)(5)(C)(i) also references IRC §501(c)(4), which relates to nonprofit civic leagues or organizations operated exclusively to promote social welfare, or local associations of employees, the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes. As is the case with an organization described in IRC §501(c)(3), one of the exempt purposes of such a league, organization, or association must include the fostering of low-income housing.

Rev. Proc. 96-32 provides guidance (including a safe harbor) for determining whether a qualified nonprofit organization under IRC §501(c)(3) involved in low-income housing is pursuing a charitable purpose by fostering low-income housing. The safe harbor 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. Under the safe harbor, a qualified nonprofit organization must establish (for each project) that at least 75% of the units are occupied by residents whose incomes are 80% or less of the area's median income, and either:

1. 40% of the units are occupied by residents whose incomes are 60% or less of the area median income, or
2. 20% of the units are occupied by residents whose incomes are 50% or less of the area median income.

To coincide with IRC §42 requirements, this determination can be made based on the residents' income at the time the household moves into the low-income unit.

If the taxpayer does not satisfy the safe harbor requirements, the assistance of an Exempt Organization specialist should be requested. See IRM 4.10.2.6.5 for instructions.

See also Step 5 and Related Issues (below) for additional considerations impacting the exempt status of the nonprofit.

**Step 3:  
Ownership Test**

The nonprofit must have an ownership interest in the low-income housing project throughout the 15-year compliance period. A qualified nonprofit organization can own an interest directly, or through a partnership, or own stock in a qualified corporation that owns directly, or through a partnership, a low-income housing project. A qualified corporation must be a corporation that is 100% owned at all times during its existence by one or more qualified nonprofit organizations.

**Step 4:  
Material  
Participation**

A qualified nonprofit organization must materially participate (within the meaning of IRC §469(h)) in both the development and operation of the project throughout the 15-year compliance period. IRC §469(h) defines material participation as activity that is regular, continuous, and substantial. Treas. Reg. §1.469-5T provides rules for determining the material participation for individuals and Treas. Reg. §1.469-5T(g)(3) provides rules for determining the material participation of certain corporations. Because neither of these provisions applies to nonprofit organizations, they should be reviewed for illustrative purposes only. The general facts and circumstances test of IRC §469(h)(1) is the test applicable to nonprofit organizations. The legislative history suggests the following guidelines in defining material participation in a business activity:

1. Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer,
2. Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else's decisions or periodic consultation with respect to general management decisions is not sufficient.
3. Participation must be maintained throughout the year. Periodic consultation is not sufficient.
4. Regular on-site presence at operations is indicative of material participation.
5. Providing services as an independent contractor is not sufficient.

Accordingly, a nonprofit entity will be considered to materially participate where it is regularly, continuously, and substantially involved in providing services integral to the development and operations of a project.

Nonprofits play an important role in the IRC §42 program. With their expertise, nonprofits can focus on the on-going performance of the housing project and the provision of services. For-profit entities may also have an interest in promoting low-income housing, but are also interested in the financial aspects of a project and have the funds to make capital contributions to the project. The motivations of both, enhanced by the ability of the nonprofit entity to access the nonprofit set-aside credit, often results in the creation of a partnership that includes both a nonprofit entity and a for-profit entity.

The partnership is often structured so that the nonprofit is a general partner with a 1% or less interest in the partnership and the for-profit investor(s) are limited partners with a combined ownership interest of 99% or more. This structure allows the nonprofit to participate in the project to achieve its special housing objectives of

the credit, while providing the financial benefit of the credit to the for-profit investor partners.

If the partnership has one or more for-profit general partners, the nonprofit partner may have less participation in the partnership, which raises the issue of whether the nonprofit's participation in the project is substantial (and thus material).

**Step 5:  
Exempt Status  
and Private  
Inurement**

The nonprofit and for-profit general partner should not be related parties; i.e., share officers or board of directors. Such relationships may indicate that the primary purpose of the nonprofit organization is to access credit from the nonprofit set-aside. More importantly, such associations may call into question the exempt status of the nonprofit entity. The issue being whether the nonprofit entity acts exclusively in furtherance of a charitable purpose or to further the interests of private investors. Although there is no all-inclusive list, some indicators that the nonprofit entity is not acting exclusively to further a charitable purpose are identified here.

1. The nonprofit is not the only general partner,
2. The nonprofit's minority partnership interest provides for minimal participation in the IRC §42 project's operation,
3. The nonprofit makes guarantees to the limited partners against loss of low-income housing credits, and
4. Excessive private benefits result from real property sales, development fees, or management contracts.

If there are indicators that the nonprofit entity is being unduly influenced by a for-profit entity, then assistance of an Exempt Organization specialist should be requested for further development of this issue. See IRM 4.10.2.6.5 for instructions.

## **Audit Adjustments**

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h)(5)(B) requirements. Failure to comply with IRC §42(h)(5)(B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c)(1). Therefore, the IRC §42(j) credit recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA 201352009.

**Step 1:  
Determination  
"as of the  
Close of the  
Taxable Year"**

Determine whether the noncompliance was corrected before the close of the taxable year in which the noncompliance originally occurred. As explained by CCA 201352009, and consistent with IRC §42(c)(1)(A), compliance should be determined "as of the close of the taxable year." If a taxpayer is found to be compliant "as of the close of the taxable year" in which the noncompliance first occurred, then no disallowance of credit is required.

**Step 2:  
Noncompliance  
Corrected  
within a  
Reasonable  
Period**

If the noncompliance is not corrected “as of the end of the taxable year in which the noncompliance occurred,” then determine whether responsibility for the noncompliance rests solely with the qualified nonprofit organization.

- If responsibility does not rest solely with the qualified nonprofit organization, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).
- If responsibility rests solely with the qualified nonprofit organization, then the agent should determine whether the noncompliance was corrected within a “reasonable period.”

**“Reasonable  
Period”  
Quantified**

Under IRC §42(j)(4)(E), taxpayers are provided relief from the credit recapture provisions in the event of a casualty loss if the loss is restored within “a reasonable period established by the Secretary.” In CCA 200134006, Chief Counsel concurred that a reasonable period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties under IRC §165.

Therefore, to ensure fair and equitable treatment of taxpayers in comparable situations, the “reasonable period” provided in IRC §42(j)(4)(E) to restore a casualty loss should be used to determine whether a taxpayer corrected the IRC §42(h)(5)(B) noncompliance within a reasonable period of time when the cause of the noncompliance rests solely with the qualified nonprofit organization. That is, the reasonable period of time for correcting noncompliance with IRC §42(h)(5)(B) is no longer than 2 years following the end of the tax year in which the noncompliance first occurred.

- If the noncompliance was corrected within a reasonable period, then no disallowance of credit is required.
- If the noncompliance was not corrected within a reasonable period, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).

**Related Issues**

**Federal  
Financing**

Nonprofit organizations usually have access to federal funding sources, including federal grants and below-market rate loans. Typically, nonprofit organizations will secure the federal financing and then loan the proceeds to the taxpayer. Depending on the facts and repayment terms, the loans may not be bona fide debt or will be subject to limitations. See Chapter 10 for additional discussion.

**Developer Fee**

In addition to sponsoring the development of the low-income housing, a nonprofit entity may act as the project’s developer and earn a developer’s fee. The issue is whether the nonprofit entity had the expertise needed to develop an IRC §42 project and, in fact, did develop the project. See Chapter 8 for additional discussion.

**Tax-Exempt  
Status (Private  
Inurement &  
Taxable  
Income)**

If the nonprofit entity is earning a development fee, there are two issues that may affect the tax-exempt status of the entity.

1. Private Inurement. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) provides that an exempt entity must be organized and operated exclusively for an exempt purpose specified in IRC §501(c)(3). Because these purposes serve public rather than private interests, an exempt entity must establish that it is not organized for the benefit of private interests. A developer fee paid to a nonprofit entity that may be ascribed, in whole or in part, to the benefit of private persons may call into question whether the entity is being operated “exclusively” for an exempt purpose, which in turn, may jeopardize the tax-exempt status of the entity.
2. Unrelated Business Taxable Income. Nonprofit entities may generate income through activities not directly related to their tax-exempt purposes. The developer fee may be subject to taxation under IRC §512 and if the nonprofit entity has an excess of taxable income, the entities tax-exempt status could be jeopardized.

In *Housing Pioneers, Inc. v. Commissioner*, the Tax Court determined that private inurement existed where the founders of the nonprofit organization operated it to privately benefit an existing housing partnership. See Appendix J.

The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.

**Summary**

1. IRC §42(h)(5) provides that a portion of each state’s annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations.
2. The qualified nonprofit organization must own an interest in the project and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.
3. Once it has been determined that a taxpayer received a credit allocation from the nonprofit set-aside, audit issues include determining whether the nonprofit is a qualifying nonprofit entity and satisfies the requirements for its tax exempt purpose, whether the nonprofit has maintained an ownership interest, whether the nonprofit materially participated in the project development and is participating in the on-going operation of the project.
4. The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.
5. The taxpayer may be subject to disallowance of the entire annual credit if noncompliance with the IRC §42(h)(5)(B) occurs. However, the IRC §42(j) credit recapture provisions are not applicable.

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## Chapter 7

### No Longer Participating in the IRC §42 Program

**Introduction** IRC §42(c)(2) defines a “qualified low-income building” to mean any building which is part of a qualified low-income housing project at all times during the period beginning on the first day in the compliance period on which such building is part of such a project, and ending on the last day of the compliance period with respect to such building. However, a low-income building may not remain a qualified low-income building throughout the entire 15-year compliance period. In this chapter, audit issues resulting from a state agency’s determination that a building is entirely out of compliance and is no longer participating in the IRC §42 program are discussed.

- Topics**
- Law
  - Audit Issues
  - Audit Techniques
  - Building Reinstated in Program
  - Summary

#### **Law**

**State Agency’s Authority** Treas. Reg. §1.42-5(e)(3) provides authority for the state agency to report to the IRS that a building is “no longer in compliance nor participating in the IRC §42 program” on Form 8823 line 11p. Treas. Reg. §1.42-5(e)(3)(i) reads:

Notice to Internal Revenue Service -- (i) In general. The Agency must be required to file Form 8823, “Low-Income Housing Credit Agencies Report of Noncompliance,” with the Service... If an Agency reports on Form 8823 that a building is entirely out of compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building's noncompliance...”

As noted in the Form 8823 Guide (Chapter 21), when a state agency notifies the IRS that a building is no longer in compliance nor participating in the IRC §42 program, the state agency may cease compliance monitoring. Also note that Form 8823, line 11p, does not include a box for reporting “noncompliance corrected” when a state agency reports that a building is no longer participating in the IRC §42 program.

**Returned Credits** Under certain circumstances, previously allocated low-income housing credits may be returned to the state agency. Under Treas. Reg. §1.42-14(d)(2)(ii), these credits may be returned up to 180 days following the close of the first tax year of the credit period for the building that received the allocation. These credits are returned to the state’s credit ceiling and can be reallocated to another qualified low-income project. In the event the entire credit is returned and the Forms 8609, Low-Income Housing Credit Allocation and Certification, have been issued, Form 8823 is used to notify the IRS that the credit has been returned. Treas. Reg. §1.42-14(d)(2)(iv) specifies the reasons for the return of the entire amount of allocated credit:

1. The building is not placed in service within the required time period or fails to meet the minimum set-aside requirements of IRC §42(g)(1) by the close of the first year of the credit period.
2. The building does not comply with the terms of its credit allocation. The terms of an allocation are the written conditions agreed to by the state agency and the allocation recipient in the allocation document.
3. The owner and state agency mutually agree to cancel an allocation of credit by mutual consent.

Note: Treas. Reg. §1.42-14(d)(2)(iv) also provides that a state agency may determine under IRC §42(m)(2) that an amount of credit allocated to a project is not necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.

**Noncompliance During the 15-Year Compliance Period**

Typical issues that may justify a state agency's determination that a taxpayer is no longer participating in the program include:

1. The taxpayer's noncompliance is egregious; i.e., conspicuous, flagrant, and systemic in nature and includes the failure to make reasonable attempts to comply with the requirements of the program, or careless, reckless, or intentional disregard of program requirements.
2. The taxpayer has, during the 15-year compliance period, voluntarily withdrawn a low-income building from the IRC §42 program, but retained ownership. For example, all the rental units may have been converted to market-rate units or used for another purpose.
3. The taxpayer fails to respond to repeated notices for monitoring reviews. Under Treas. Reg. §1.42-5(c)(2)(ii)(B), at least once every three years, the state agency must conduct on-site inspections of all buildings in the project and, for at least 20% of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.
4. The taxpayer repeatedly fails to submit annual reports and owner certifications required under Treas. Reg. §1.42-5(c)(1) and (3). See Chapter 7 of the Guide for Completing Form 8823 for additional discussion.

**Additional Discussion**

Refer to Chapter 21 of the Guide for Completing Form 8823 for additional discussion.

**Audit Issues**

There are two primary issues:

1. Whether the taxpayer claimed credit for the taxable year in which the taxpayer ceased to participate in the IRC §42 program, or for any subsequent tax year of the credit period, and

2. Whether the taxpayer correctly recaptured credit as required under IRC §42(j).

## Audit Techniques

**Step 1:  
Identify Issue** The first step is to determine whether the taxpayer claimed credit for the taxable year in which participation in the IRC §42 program ceased or any subsequent tax year. Also determine whether the taxpayer recaptured credit under IRC §42(j); i.e., Form 8611 should be completed and filed with the tax return. If the taxpayer ceased claiming credit and correctly applied the IRC §42(j) credit recapture provisions, then no further action is needed.

**Step 2:  
Disallow Credit  
in the Year of  
Determination  
and All  
Subsequent  
Tax years** If credit was claimed for the taxable year in which the taxpayer ceased to participate in the program, then the credit associated with the low-income buildings that are no longer in compliance is disallowed. If necessary, subsequent year tax returns should also be audited to disallow any credit taken in those years.

**Step 3:  
Determine the  
Amount of  
Credit Claimed  
in Prior Years** A determination that a low-income building is no longer in compliance and is no longer participating in the IRC §42 program is also a credit recapture event under IRC §42(j). The amount of credit claimed for each taxable year prior to the year of the determination should be verified with the taxpayer.

1. The credit for the first year of the credit period is usually less than the total allowable credit because the applicable fraction is determined using the special rule under IRC §42(f)(2). Under this rule, credit not allowable in the first year is allowable in the eleventh year.
2. A portion of the credit claimed may be associated with increases in qualified basis after the end of the first year of the credit period. This credit is accounted for on Form 8609-A, Line 11. This portion of the credit is not subject to recapture.

In the event the taxpayer cannot verify that a lesser amount was claimed, the maximum allowable credit should be used to compute the recapture amount. See Chapter 16 for additional discussion and computation of the recapture amount.

## Building Reinstated in the Program

Only the state agency that allocated the credit to the taxpayer can reinstate a low-income building in the IRC §42 program and, as a result, resume compliance monitoring activities. For example:

1. A taxpayer may be able to bring the building back in compliance. No credit is allowable while the building is not in compliance and not participating in the program, but the taxpayer may resume claiming credit if the noncompliance is corrected and the credit is otherwise allowable.
2. The low-income building may be sold to a new owner who can bring the building back into compliance and wishes to participate in the program. Under IRC §42(d)(7), if a low-income building (or interest therein) is acquired before the end of the 15-year compliance period, then the credit allowable to the new owner is equal to the amount that would have been allowable to the prior owner.

## **Audit Issues and Techniques**

If a building has been reinstated in the program, the taxpayer needs to provide documentation indicating the date the building was reinstated. The date of reinstatement is important for determining whether credit should be disallowed and/or recaptured. Further, the taxpayer should demonstrate that:

1. The original noncompliance issues that resulted in the state agency's determination have been resolved.
2. The extended use agreement required under IRC §42(h)(6) is in effect and recorded pursuant to State law as a restrictive covenant. See Chapter 5 for additional discussion.
3. The taxpayer has timely filed certifications with the state agency for each taxable year beginning with the year the building was reinstated. The taxpayer should provide copies of the certifications, which can be verified with the state agency if necessary. See Treas. Reg. §1.42-5(c)(1).
4. The state agency has resumed compliance monitoring activities. State agencies are required to provide taxpayers with written notice if the state agency discovers by inspection, review, or some other manner that the project is not in compliance with IRC §42 requirements. Many state agencies will also provide a taxpayer with a notification letter if, as a result of a physical inspection or tenant file review, no noncompliance issues were identified. See Treas. Reg. §1.42-5(e)(2). These reports are clear evidence that the state agency has resumed responsibility for compliance monitoring. If the taxpayer cannot provide documentation that the project is subject to the state agency's compliance monitoring activities, the state agency should be contacted for confirmation.

## **Summary**

1. A state agency may determine that a low-income building is no longer in compliance nor participating in the IRC §42 program and report the noncompliance event to the IRS on Form 8823. A state agency is not required to continue compliance monitoring activities after reporting the noncompliance to the IRS.
2. Under certain circumstances, as identified in Treas. Reg. §1.42-14(d)(2)(ii), credits may be returned to the state agency.
3. A state agency may report that a low-income building ceased to be part of qualifying low-income project at any time during the 15-year compliance period.
4. The audit can be limited to determining if the taxpayer claimed credits for the taxable year in which the taxpayer ceased to participate in the IRC program, or for any subsequent year of the credit period, and whether the taxpayer correctly recaptured credit as required under IRC §42(j).
5. A state agency may reinstate a building in the IRC §42 program if a taxpayer (or successor owner of the property) is able to bring the building back into compliance. The taxpayer may resume claiming credit if the noncompliance is corrected and the credit is otherwise allowable, but no credit would be allowable during the period the building is not in compliance.

## Chapter 8 Eligible Basis: Includable Costs

**Introduction** The examination of eligible basis begins with an analysis of the actual qualifying costs incurred by the taxpayer. This chapter provides guidelines for determining the dollar value of assets includable in eligible basis.

**Topics**

- Defining Eligible Basis
- Reconciling Eligible Basis & Identifying Large, Unusual, or Questionable Items
- Verifying Assets Included in Eligible Basis
- Common Areas, Required Facilities, and Providing Services
- Development Fees
- Partnership Costs
- IRC §42 Credit Allocation Costs
- Cost of Securing Financing
- Computing Adjustments to Eligible Basis
- Summary

### Defining Eligible Basis

Eligible Basis is defined primarily by reference to IRC §§103 and 168. IRC §42 provides supplemental definitions and requirements.

### Residential Rental Project

Under IRC §42(d)(4)(A), the adjusted basis of any building is determined without regard to the adjusted basis of any property which is not residential rental property. The legislative history for IRC §42 explains that residential rental property, for purposes of the low-income housing credit, has the same meaning as residential rental property within IRC §103. Treas. Reg. §1.103-8(b)(4)(i) constructed units..." that meet certain requirements. states, in part, that "a residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly

Treas. Reg. §1.103-8(b)(8)(iv) defines a "building or structure" to mean, generally, a "discrete edifice or other man-made construction consisting of an independent foundation, outer walls, and roof. A single unit which is not an entire building but is merely a part of a building is not a building or structure within the meaning of this section. As such, while single townhouses are not buildings if their foundation, outer walls, and roof are not independent, detached houses and row houses are buildings."

Notice 88-91 explains, however, that the term "qualified low-income building" for IRC §42 purposes includes residential rental property that is either an apartment building, a single family dwelling, a townhouse, a rowhouse, a duplex, or a condominium. A qualified low-income building does not include residential rental property owned or leased by a cooperative housing corporation or a tenant-stockholder, as those terms are defined under IRC § 216(b)(1)( and (2).

Under IRC §42, the buildings qualifying for the credit are:

1. new buildings, the original use of which begins with the taxpayer (IRC §42(i)(4));
2. existing buildings, which means any buildings that are not new buildings (IRC §42(i)(5)); and
3. rehabilitated buildings; i.e., the expenditures connected with rehabilitating an existing building are treated as a separate new building and do not include the cost of acquiring the building (IRC §42(e)(1) and (2)).

**Depreciable Residential Rental Property**

IRC §42(c)(2)(B) refers to low-income buildings as any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply; e.g., costs includable in eligible basis must be depreciable property under IRC §168.

IRC §168(e)(2)(A) defines “residential rental property” to mean any building or structure if 80% or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. The term “dwelling unit” means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment if more than one-half of the units are used on a transient basis. Also, if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

**IRC §179, Election to Expense Assets**

Under IRC §179(d)(9), no credit is allowed under IRC §38 with respect to any amount for which a deduction is allowed under IRC §179(a). The IRC §42 credit is a general business credit under IRC §38(b)(5). Consequently, depreciable residential rental property expensed under IRC §179 is not includable in eligible basis.

**IRC 263A: Indirect Costs**

IRC §263A generally requires direct costs and an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer to be capitalized to the property produced. IRC §263A(g)(1) defines “produce” as including constructing, building, installing, manufacturing, developing, or improving. However, as explained in Treas. Reg. §1.263A-2(a)(1)(ii), a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. Under IRC §263A(g)(2), a taxpayer is treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying IRC §263A(a).

Indirect costs are defined in Treas. Reg. §1.263A-1(e)(3)(i) as “...all costs other than direct material costs and direct labor costs (in the case of property produced)... Indirect costs are properly allocable to property produced...when the costs directly benefit or are incurred by reason of the performance of production...”

**Residential Rental Unit Defined**

A “unit” is defined in Treas. Reg. §1.103-8(b)(8)(i) to mean “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. Thus, 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.

IRC §42(i)(3)(B)(iv) provides that certain single-room occupancy units also qualify as residential rental units even though such housing may provide eating, cooking and sanitation facilities on a shared basis. (See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.)

**Common Areas** IRC §42(d)(4)(B) provides that eligible basis includes the adjusted basis of property subject to the allowance for depreciation, used in common areas or provided as comparable amenities to all residential rental units in such building. As explained in the legislative history for the original enactment of IRC §42, residential rental property includes...facilities for use by the tenants, and other facilities reasonably required by the project.

**Community Service Facilities** Under IRC §42(d)(4)(C), eligible basis of any building located in a qualified census tract includes the adjusted basis of any property used to provide services for certain nontenants. A “community service facility” is any facility (1) located in a qualified census tract (see IRC §42(d)(5)(C)), (2) designed to serve primarily individuals whose income is 60% or less of area median income (see IRC §42(g)(1)(B) and (3)) used throughout the taxable year as a community service facility. The increase in the eligible basis of any building attributable to a community service facility is capped under IRC §42(d)(4)(C)(ii). See Chapter 11.

Rev. Rul. 2003-77 provides a description of a facility qualifying as a community service facility because the requirements of IRC §42(d)(4)(C) are met.

“A qualified low-income building (the Building) received a housing credit allocation on October 1, 2002, and was placed in service in 2003. The Building is located in a qualified census tract (as defined in IRC §42(d)(5)(B)(ii)). A portion of the Building (the Facility) is used throughout the year to provide services to residents of the Building as well as nonresidents. The Facility consists of a meeting room, an administrative office, a storage room, and several multi-purpose rooms. The services provided at the Facility include daycare, career counseling, literacy training, education (including tutorial services), recreation, and outpatient clinical health care. The services are provided free of charge or for a fee that is affordable to individuals whose income is 60% or less of area median income (within the meaning of in IRC §42(g)(1)(B)). The adjusted basis of the property comprising the Facility (of a character subject to the allowance for depreciation and not otherwise taken into account in the adjusted basis of the Building) does not exceed 10% of the eligible basis of the Building.

As required by IRC §42(m)(1)(A)(iii), prior to the allocation of housing credit to the Building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by the Building. The study found, among other things, that providing day care, career counseling, literacy training, education (including tutorial services), recreation, and outpatient clinical health care services would be appropriate and helpful to individuals in the area of the Building whose income is 60% or less of area median income.”

**Transitional Housing & Supportive Services for the Homeless**

IRC §42(c)(1)(E) provides that if the taxpayer is providing transitional housing for the homeless under IRC §42(i)(3)(iii), then the qualified basis of a building providing such housing includes the portion of the building used to provide supportive services designed to assist tenants in locating and retaining permanent housing. To qualify as transitional housing:

1. the building must be used exclusively to facilitate the transition of homeless individuals (within the meaning of section 103 of the Stewart B. McKinney Homeless Assistance Act [McKinney-Vento Homeless Assistance Act (42 U.S.C. 11302), as in effect on Nov. 5, 1990) to independent living within 24 months, and
2. a governmental entity or qualified nonprofit organization (as defined in IRC §42(h)(5)) provides such individuals with temporary housing and supportive services designed to assist such individuals in locating and retaining permanent housing.

IRC §42(c)(1)(E) also limits the portion of the building used to provide supportive services that can be included in qualified basis to the lesser of:

1. so much of the eligible basis of such building as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
2. 20% of the qualified basis of such building, determined without regard to the portion of the building used to provide supported services. See Chapter 13 for additional discussion.

If the building is 100% occupied by low-income tenants, then qualified basis equals eligible basis and costs of facilities used to provide supportive services is limited to 20% of the building's eligible basis, determined without regard to the portion of the building used to provide the services. If the building is not 100% low-income, then further consideration should be given to whether the building is being used exclusively to facilitate the transition of homeless individuals to independent living.

**Functionally Related Facilities**

Under Treas. Reg. §1.103-8(b)(4)(iii), facilities that are functionally related and subordinate to residential rental projects are also considered residential rental property and include facilities for use by the tenants, such as swimming pools and other recreational facilities, parking areas, and other facilities reasonably required for the project; e.g. heating and cooling equipment, trash disposal equipment, or units for resident managers or maintenance personnel.

**Landscaping and Land Improvements**

IRC §167(a) provides, as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business of a taxpayer, or of property held for the production of income.

Rev. Rul. 74-265 held that land preparation costs may be subject to a depreciation allowance if such costs are so closely associated with a depreciable asset so that it is possible to establish a determinable period over which the preparation will be useful in a particular trade or business. A useful life for land preparation is established if it



will be replaced contemporaneously with the related depreciable asset, which is a question of fact, but if the replacement of the depreciable asset will require the physical destruction of the land preparation, this test is considered satisfied. The balance of the landscaping that will be unaffected by the replacement of the depreciable asset is considered inextricably associated with the land and is not includable in eligible basis under IRC §42(d)(1).

A taxpayer may argue that all land preparation and improvement costs should be depreciable property because without construction of the buildings and other infrastructure for the project, none of these expenses would have been incurred. However, the court in *Eastwood Mall v. U.S.*, 95-1 USTC paragraph 50,236 (N.D. Ohio 1995), aff'd by unpublished disposition, 59 F.3d 170 (6th Cir. 1995), specifically denounced this argument as being incorrect. The Court noted that in almost every instance, some costs will be incurred in preparing the land for the construction of a building. The court further noted that under the taxpayer's argument, all costs incurred in preparing a site are depreciable and that the only situation where land preparation costs would not be depreciable is where nothing is constructed on the land. The court stated that “[t]his interpretation is illogical and contrary to the law.”

**Date of Determination**

For a new building, under IRC §42(d)(1), the eligible basis is its adjusted basis as of the close of the first taxable year of the credit period. Under IRC §42(d)(2), the same rule applies for existing (i.e., acquired) buildings, but additional requirements must also be met. And for rehabilitation expenses treated as a separate new building under IRC §42(h)(3)(C), the same rule applies, but only if criteria for minimum expenditure amounts have been met. See Chapter 9.

**Reconciling Eligible Basis & Identifying Large, Unusual, or Questionable Items**

The scope of the examination is determined after reviewing the tax return, the Forms 8609, and the taxpayer’s final cost certification.

**Step 1: Reconciliation of Eligible Basis**

The eligible basis reported on Form 8609, line 7, and Form 8609-A, line 1, should match. Any differences should be explained by the taxpayer.

Under IRC §42(m)(2), the credit allocated by a state agency to a project must not exceed the amount the agency determines is necessary for the financial feasibility of the project and viability as a qualified low-income housing project throughout the credit period. To make sure only the credit necessary is allocated, the state agency evaluates the sources and uses of funds at three critical points of the development process: (1) when the taxpayer applies for the credit, (2) when the credit allocation is made, and (3) when the building is placed in service. See IRC §42(m)(2)(B) and (C).

The final evaluation for when a building is placed in service must be made no later than the date the state agency issues the Form(s) 8609. As described in Treas. Reg. §1.42-17(a)(5), the taxpayer must submit a schedule of project costs. This schedule is commonly referred to as the final cost certification because it is to be prepared under the method of accounting used by the taxpayer for federal income tax purposes, and must detail the project’s total costs as well as those costs that may qualify for inclusion in eligible basis under IRC §42(d). In addition:

1. 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. The CPA's audit must be conducted in accordance with generally accepted auditing standards and the auditor's report must be unqualified.
2. For projects with less than 11 units, the state agency may require an audited schedule of project costs.

A copy of the schedule of costs and (if required) the auditor's report should be secured from the taxpayer or, if not available, from the state agency. The eligible basis reported on this final cost certification should be compared to the eligible basis reported on Form 8609 and Form 8609-A and any differences reconciled.

**Step 2:  
Review  
Taxpayer's  
Final Cost  
Certification**

The taxpayer's final cost certification should be reviewed for completeness. Treas. Reg. §1.42-17(a)(3)(i) lists the minimum information that should be included; i.e., the schedule should sufficiently detail the costs, whether or not includible in eligible basis, and should include (but not be limited to): site acquisition costs, construction contingency, general contractor's overhead and profit, architect's and engineer's fees, permits and survey fees, insurance premiums, real estate taxes during construction, title and recording fees, construction period interest, financing fees, organizational costs, rent-up and marketing costs, accounting and auditing costs, working capital and operating deficit reserves, syndication and legal fees, and developer fees. State agencies may require additional information and prescribe a format.

Generally, the schedule of costs is a one-page summary of total costs presented in a columnar format. The left column lists high-level categories, the second identifies the total costs incurred for that category, and the third column includes costs qualifying for eligible basis. If the taxpayer acquired and rehabilitated an existing building, then the acquisition costs for the building are stated separately from the rehabilitation costs, and are distinguished from the cost of the land.

**Step 3:  
Identify Large,  
Unusual, or  
Questionable  
Items (LUQs)**

Based on the review of the final cost certification, the audit scope for examining the dollar value of eligible basis can be determined. Specific costs should be identified as large, usual or questionable items. (See IRM 4.10.2.3.1.)

1. Consider the inherent character of the cost categories. Categories that are not includable in eligible basis can be eliminated from further consideration if the taxpayer did not include the costs in eligible basis. For example, the costs associated with the acquisition of land.
2. Consider the beneficial effects of how an item is reported. For example, there are some costs which should be allocated and only a portion of the cost included in eligible basis. A taxpayer may have purchased land with an existing building that the taxpayer then rehabilitated and now qualifies as low-income housing. In this case, there should be an allocation of the purchase price between the land and existing building. Another typical fact pattern is the allocation of costs when there is more than one low-income building. If actual costs associated with each building are not tracked during the developmental process, the total eligible basis for the entire low-income development should be allocated among the buildings

based on square footage.

3. Consider costs that should be identified in the final cost certification, but are missing, such as such partnership organizational costs, rent-up and marketing costs, and syndication fees. These costs need to be accounted for, even though they are not includable in eligible basis, to ensure they have not been accumulated with other costs for a line item on the certification.
4. Consider line items on the cost certification that are an accumulation of a larger number of separate costs. At a minimum, the taxpayer should explain what the underlying costs are.

It may be possible to exclude costs because the costs are not, by character, includable in eligible basis. For the remaining categories identified on the cost certification, two additional criteria should be used to identify large, unusual, or questionable items for audit consideration.

1. Consider the comparative size of the cost to total eligible basis. Small dollar values for line items that appear to be includable in eligible basis by character need not be further examined.
2. Consider the absolute size of the cost, even if comparably small, if the dollar value does not appear commensurate with the character of the cost.

At this point, identify those cost that the taxpayer has included in eligible basis which are:

1. possibly not includable in eligible basis,
2. allocated costs for which the method of allocation should be reviewed,
3. costs which should be, but are not, clearly identified in the cost certification and which might not be includable in eligible basis,
4. an accumulation of costs, for which the underlying individual costs might not be includable in eligible basis, or
5. individual line items selected because of their comparative or absolute size.

### **Verifying Assets Included in Eligible Basis**

Verifying the assets included in eligible basis requires consideration of five issues.

1. Character of the assets,
2. Cost of the assets,
3. When the cost was paid or incurred,
4. Whether costs were reasonably allocated among the assets, and
5. Whether the assets are in continuous use during the entire 15-year compliance period.

**Issue 1:  
Character of  
Asset**

The first issue is whether an asset is residential rental property qualifying for the credit. Consider the following:

1. IRC §§ 103 and 168 are the primary references for the definition of depreciable residential rental property. Depreciable basis includes costs capitalized to the property under IRC §§ 263(a) and 263A.
2. Under IRC §42, eligible basis includes not only the cost of residential rental units, but can also include common areas, community service facilities, facilities used to provide supportive services for the homeless, and functionally related facilities.
3. Eligible basis also includes the cost of some land improvements and preparation, but is generally limited to costs so closely associated with a depreciable asset includable in eligible basis that it is possible to establish a determinable period over which the land improvement or preparation will be useful. A useful life for land improvements or preparation is established if it will be replaced contemporaneously with the related depreciable asset.

Refer to Appendix C for a summary of specific costs and treatment.

**Issue 2:  
Cost of Asset**

The second issue is whether the dollar amount of the qualifying assets is accurately reported. Under IRC §42(d)(1), the eligible basis of a newly constructed building is the building's adjusted basis as of the close of the first taxable year of the building's ten-year credit period, without regard to any depreciation. See IRC §42(d)(4)(D).

The final cost certification provided to the state agency is insufficient evidence of the assets included in eligible basis. Documents available to support the computation of eligible basis include:

1. Closing Documents and Settlement Sheets - These documents specify such items as the purchase price and terms, various transfer and real estate taxes, professional fees, and other related expenses. These documents were not prepared to identify assets includable eligible basis and further analysis is needed to determine which assets have been, or should be, included in eligible basis.
2. American Institute of Architects (AIA) Statements or Construction Vouchers - These documents can provide details regarding the work done for specific addresses and units, the types and amounts of costs, and the related percentages of completion. These documents are helpful for reviewing eligible basis and identifying disproportionate standards. They provide a unit-to-unit comparison for construction and amenities.
3. Development Agreements – These agreements may provide detail for the intended eligible basis figure and its components.
4. Certificate of Occupancy – This document provides a description of the building and identifies when it was placed in service. In some areas it also describes zoning and the type of units offered, and whether commercial areas exist.

5. Local Property Records – These records can provide information such as a description of the real estate, mortgage information, recording of the extended use agreement, existence of any covenants, various sale terms, and the names of prior owners.

**Issue 3:  
When Paid or  
Incurred**

The third issue is determining when the cost was paid or incurred. Only those qualifying costs paid or incurred by the end of the first year of the credit period are includable in eligible basis.

**Costs Paid or Incurred**

Notice 88-116 explains that construction, reconstruction, or rehabilitation costs are incurred for purposes of IRC §42 on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer incurring the costs with respect to other items of income and expense; i.e., the amount must be fixed and determinable.

**Beginning of the Credit Period**

Under IRC §42(f)(1), the credit period starts with the taxable year in which the building is placed in service, or at the election of the taxpayer, the succeeding taxable year. The election is documented on Form 8609, line 10a.

Notice 88-116 defines the term “placed in service” for IRC §42 purposes.

1. 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. In general, a transfer of the building results in a new placed-in-service date if, on the date of the transfer, the building is occupied or ready for occupancy.
2. The placed-in-service date under IRC §42(e)(4)(A) for rehabilitation expenditures that are treated as a separate new building is the close of any 24-month period, over which the taxpayer has aggregated expenses for purposes of determining whether the minimum costs have been incurred to qualify for the credit. This calculated placed-in-service date applies even if the building is occupied during the rehabilitation period. At this point, the taxpayer should document compliance with the requirement for the selected 24-month period to establish when the rehabilitation costs were placed in service. See Chapter 9 for more detailed discussion.

Under IRC §42(f)(5)(A), the credit period for an existing building cannot begin before the first taxable year of the credit period for rehabilitation expenditures with respect to the building.

**Documentation**

Generally, certificates of occupancy issued by a local government agency after physically inspecting the buildings are used to document when a building was placed in service. The documented placed-in-service date should match the date identified

on Form 8609, line 5.

**Issue 4:  
Reasonable  
Method of  
Allocation**

The fourth issue is whether the costs have been reasonably allocated among the assets.

**Land and Depreciable Residential Rental Property**

The cost of the land upon which the IRC §42 project is located should be identified and reconciled to the amount reported on the balance sheet. If the taxpayer purchased land with improvements, then the purchase price should be allocated among the assets purchased. This is necessary because the cost of the land is not includable in eligible basis while the cost of the land improvement might be includable.

The taxpayer should document how the purchase price was allocated. In addition, a review of the local property records can provide information such as a description of the real estate and sales transactions.

A review of records from the tax assessor's office may provide a ratio of the value of the land to existing improvements, which can serve as a preliminary standard against which the land valuation by the taxpayer can be measured. However, while the ratio may be helpful, the actual tax assessment value may not provide the current market values.

There are instances where the land value is nominal or zero. For example:

1. The taxpayer may construct low-income housing as leasehold improvements on leased land. The lease period must be at least at least 30 years starting with the beginning of the credit period.
2. Ownership of existing housing may have transferred to the taxpayer from a city or local government entity for little or no cost based on an agreement for the taxpayer to construct and operate low-income housing.

If necessary, a referral should be made to request an engineer's assistance when determining land valuations. See IRM 4.10.2.6.5 for instructions.

**Acquisition and Rehabilitation of Existing Buildings**

When a building is acquired and rehabilitated as low-income housing, certain costs must be allocated among the acquisition of the land, the existing building, and the new rehabilitation. Under IRC §42(e)(5), rehabilitation expenditures may, at the election of the taxpayer, be taken into account either as an rehabilitation costs or as costs associated with the existing building under IRC §42(d)(2)(A)(i), but not under both.

**Multiple Low-Income Buildings**

Eligible basis is determined on a building-by-building basis. There are three additional considerations when determining eligible basis for projects with more than one low-income building.

1. Determine whether eligible basis is reasonably allocated among the low-income buildings.
2. Determine how the costs of common areas and facilities includable in eligible basis, but not directly associated with a specific low-income building, are allocated among the low-income buildings.
3. Determine how landscaping costs includable in eligible basis are allocated among the low-income buildings.

#### **Mixed Low-Income Residential Units and Commercial Property**

Mixed-use buildings, which contain commercial space as well as residential rental space, are not precluded from qualifying for the IRC §42 credit. However, the cost of the commercial portion of the building is not includable in eligible basis.

#### **Example 1: Excluding Costs of Commercial Property**

A taxpayer purchases a seven-story apartment house in an urban area for \$110,000, of which \$40,000 is allocated to land and \$70,000 to the building. The bottom floor consists of commercial space occupied by a convenience store and a dry cleaner. The taxpayer wants to develop the six upper stories as low-income residential rental units.

The commercial space does not preclude the building from being used for low-income housing. Based on square footage, only \$60,000 can be included in eligible basis ( $6/7 \times \$70,000$ ) of the acquired building.

#### **Direct and Indirect Costs**

As explained in Treas. Reg. § 1.263A-1(e)(3)(i), "...indirect costs are properly allocable to property produced...when the costs directly benefit or are incurred by reason of the performance of production... Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to IRC §263A. Taxpayers subject to IRC §263A must make a reasonable allocation of indirect costs between production, resale, and other activities."

Treas. Reg. §1.263A-1(f) discusses various cost allocation methods that can be used to allocate direct and indirect costs to produced property. For example, a taxpayer may use the specific identification method (Treas. Reg. §1.263A-1(f)(2)), the burden rate and standard cost methods (Treas. Reg. §1.263A-1(f)(3)(i) and (ii)) and any other reasonable method (Treas. Reg. §1.263A-1(f)(4)). Taxpayers may also allocate indirect costs using the simplified production method (Treas. Reg. §1.263A-2(b)) and allocate mixed service costs using the simplified service cost method (Treas. Reg. §1.263A-1(h)). If the taxpayer uses a burden rate method, standard cost method, or other reasonable method, the allocation method must be reasonable. An allocation method is reasonable if, with respect to the taxpayer's production activities taken as a whole:

1. the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in Treas. Reg. §§ 1.263A-1(f), 1.263A-2 or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;
2. the allocation method is applied consistently by the taxpayer; and
3. the allocation method is not used to circumvent the requirements of the simplified methods in Treas. Reg. §§ 1.263A-1, 1.263A-2, 1.263A-3, or the principles of IRC §263A.

**Issue 5:  
Continuous  
Service**

The fifth issue is whether the asset continues to be in service during the tax year under audit. While the eligible basis is initially determined at the end of the first year of the building's credit period, the asset must remain in service continuously throughout the entire 15-year compliance period. As a practical matter, assets will need maintenance, repairs, and even replacement over time. However, any asset that is no longer in service or that no longer exists will result in a reduction in eligible basis. The determination is made as of the last day of the taxable year.

Assets included in eligible basis should be observed when conducting the tour of the low-income project. Any differences between the assets observed and the assets included in eligible basis should be reconciled. See Chapter 3 for additional discussion.

## **Common Areas, Required Facilities, and Providing Services**

IRC §42(d)(4)(B), Basis of property in common areas, etc., included, reads:

The adjusted basis of any building shall be determined by taking into account the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in such building.

**Common Area**

Common areas are facilities expected to be used by the tenants and can be reasonably associated with residential rental property; e.g., a parking garage or swimming pool. To qualify, the facility must meet two requirements:

1. The common area must be made available on a comparable basis to the tenants of all residential rental units (not only low-income tenants) and,
2. No separate fee is required for the use of these facilities. As explained in the legislative history for the original enactment of IRC §42, "...the allocable cost of tenant facilities, such as swimming pools, other recreational facilities and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project."



Alternatively, a taxpayer may decide to exclude an allowable cost from eligible basis. In which case, IRC §42 does not control the taxpayer's use of the common area.

**Reasonably  
Required  
Facilities**

A facility reasonably required by the project is, under Treas. Reg. §1.103-8(b)(4)(iii), residential rental property that is functionally related and subordinate to the residential rental units.

For example, under Treas. Reg. §1.103-8(b)(4)(iii), units for resident managers or maintenance personnel are not classified as residential rental units, but rather as facilities reasonably required by a project that are functionally related and subordinate to residential rental units. As a result, the adjusted basis of a unit occupied by a full-time resident manager is included in the eligible basis of a qualified low-income building, but is not considered a rental unit included in the computation of the applicable fraction. See Chapter 12 and Rev. Rul. 92-61 for additional discussion.

Rev. Rul. 2004-82, Q&A #1 explains that units occupied by security officers are also treated as reasonably required facilities.

Q-1. A new qualified low-income building is located in an area in which owners of apartment buildings typically employ security officers due to the level of crime in the area. If a unit in a building is occupied by a full-time security officer for that building and the building's owner requires the security officer to live in the unit, is the adjusted basis of that unit includable in the building's eligible basis?

A-1. Yes. "...The unit occupied by a full-time security officer is similar to the units described in the examples contained in Treas. Reg. §1.103-8(b)(4)(iii), and is reasonably required by the project because of the level of crime in the area. Thus, the unit is functionally related and subordinate to the building. As a result, the unit is residential rental property for purposes of IRC §42 and its adjusted basis is includable in Building's eligible basis under IRC §42(d)(1)..."

**Facilities Used  
to Provide  
Services**

Eligible basis also includes facilities used by the taxpayer to provide tenants with services not normally associated with the leasing of residential rental property. See also Chapter 12.

Rev. Rul. 98-47 provides an example.

**FACTS:**

Complex M provides housing units on a non-transient basis for individuals who are of retirement age or older. All of the units in Complex M, which is comprised of Building X, Building Y, and Building Z, each of which is composed of similarly constructed housing units that have separate and complete facilities for living, sleeping, eating, cooking, bathing, and sanitation. The cooking and eating area contains a small refrigerator, a sink, a pull-down table, and a two-burner stove with an oven. Each unit is designed so that the stove can be replaced with a full-sized microwave oven if the physical or mental

frailties of the resident make it imprudent to provide a functioning cooking stove.

Each resident enters into a lease arrangement with Complex M. The amount of the monthly payment under the lease varies according to the level of care provided in the building in which the resident resides, with Building Z commanding the largest payment and Building X the smallest payment. The monthly payment is made in exchange for use of an individual unit, basic services and, with respect to Buildings Y and Z, other services. Under a lifetime lease payment option, residents of Complex M may pay a fixed monthly amount for the time they reside in Complex M. The lifetime lease option guarantees a resident the right to move to a unit in Buildings Y or Z if the resident requires additional care.

The basic services available to the residents in all three buildings include: laundry; housekeeping; regular daily meals in the common dining areas; 24 hour monitored emergency call service using call buttons and two-way communication devices located in each room of a unit; planned social activities; and scheduled transportation to various sites in the vicinity including commercial areas, shopping centers, hospitals, and doctor's offices.

Building X, Building Y, and Building Z each contain a separate common dining area. The dining area in each building will be used exclusively by residents of Complex M and visitors of those residents. The size of the dining area in any building does not exceed that necessary to serve the residents of the building and their guests. The dining area serves the special needs of the residents and provides the staff of Complex M an opportunity to monitor the overall well-being, nutrition, and health of the residents.

Only the basic services are made available to residents of Building X. No other services are included in the monthly payment. Continual or frequent nursing, medical, or psychiatric services are not made available in Building X.

The basic services and the Building Y support services are made available to residents of Building Y. The Building Y support services are as follows: assistance by medication management technicians in medication management and intake; maintenance of detailed medication records; consultation with a nurse as needed about health concerns and medication plans; assistance by non-medically certified aides each day during waking hours in activities of daily living that include getting in and out of bed and chairs, walking, using the toilet, dressing, eating, and bathing; and routine checks by staff members of Building Y to insure the residents' general well-being. Some residents of Building Y have incapacitating infirmities that require continual assistance, but do not require continual or frequent nursing, medical, or psychiatric services. Continual or frequent nursing, medical, or psychiatric services are not made available in Building Y.

The basic services and the Building Y support services are made available to residents of Building Z. In addition, Building Z is staffed in the following manner: registered nurses are on duty for 12 hours each day; licensed practical

nurses are on duty for 24 hours each day; and licensed nurses' aides are available 24 hours each day. The nurses and nurses' aides are available to provide nursing care for residents' medical or psychiatric needs. Thus, continual or frequent nursing, medical, or psychiatric services are made available in Building Z.

Residents in Building X are required to move into Buildings Y or Z or another facility outside of Complex M if, because of physical or mental disability, they require additional care beyond that offered by Building X. Residents in Buildings X and Y are required to move into Building Z or another facility outside of Complex M if they require continual or frequent nursing, medical, or psychiatric services.

### ANALYSIS

As set forth in the facts above, Building X, Building Y, and Building Z each contains complete living units within the meaning of Treas. Reg. §1.103-8(b)(8), all of the living units within the respective buildings are available to the general public, and all of the living units are used on a non-transient basis. Since Complex M also provides significant non-housing services to residents of the three buildings (including continual or frequent nursing, medical, or psychiatric services to the residents of Building Z), the analysis must consider the nature and extent of the non-housing services. In the case of Complex M, the analysis must examine whether the buildings of Complex M are hospitals, nursing homes, sanitariums, or rest homes rather than residential rental property. ...The labels are not determinative. The focus .....is whether the facilities are, in substance, residences or health care facilities. Therefore, the nature and degree of the services provided by the facility controls.

Significant non-housing services are made available to residents of Building X and Building Y, including meals and various support services. The services available to residents of Building X and Building Y do not include continual or frequent nursing, medical, or psychiatric services although, under the lifetime lease option, certain residents are assured that they will receive continual or frequent nursing, medical, or psychiatric services in Building Z if required.

### HOLDING

Thus, under the principles set forth above, Buildings X and Y would be residential rental property [and qualified as residential rental units under IRC §42(d)]. Continual or frequent nursing, medical, or psychiatric services are made available to residents of Building Z in addition to the same non-housing services that are made available to residents of Building X and Building Y. Thus, under the principles set forth above, Building Z would not be a residential rental property.

## Development Fees

**Developer Fee Defined** Generally, a developer fee represents payment for the developer's services and is (at least in part) includable in eligible basis. There are three basic types of developer fees.

### **Turnkey Project Fee**

The taxpayer (usually a partnership) enters into a development agreement with a developer to pay an amount that includes all hard construction costs and the developer's fee. For example, the development agreement requires a payment of \$2 million with the estimated hard costs of the project budgeted at \$1,200,000. If the actual costs are consistent with the budgeted amounts, then the developer will have earned a fee of \$800,000. If the actual costs exceed the budget, the development fee would decrease.

### **Fixed Amount Development Fee**

A fixed amount developer fee occurs when the "hard costs" and the developer fee are separately stated line items in the contract. For example, \$1 million of estimated hard costs with a developer fee added in a fixed amount of \$150,000. Unlike a turnkey agreement, the developer fee does not decrease if the hard costs exceed the budgeted amount.

### **Completed Project Developer Fee**

A completed project developer fee is passed on to the ultimate purchaser of the building as a component of the purchase price. The purchase price includes all the components (land, new construction, acquisition of an existing building, rehabilitation costs, and development fee), but the individual components may not be separately stated.

**Related Parties** Typically, the developer will be the general partner (or managing general partner) of the partnership owning the project. The developer may also be related to the entity that actually constructed the project or the property management company operating the project. The inter-relationships need to be identified and understood, as these relationships will affect how transactions are conducted and documented.

While there are specific relationships noted throughout IRC §42, taxpayers are considered related for audit purposes if:

1. an adjustment made to one return requires corresponding adjustments to the other return to ensure consistent treatment (see also IRC §§ 1313(c) and 267), or
2. tax returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

### **Audit Issues & Techniques**

There are four basic issues to consider when examining the developer fee.

1. Character of the services to be provided,
2. Services actually provided,
3. Reasonableness of the fee amount, and
4. Method of payment.

To address these issues:

1. Review the development agreement or contract. Generally, the contract will outline all the anticipated responsibilities and remedies if the developer fails to perform according to the agreement. It should also disclose the payment terms. Typically, there will be payments at specific times during development and when development is completed. The developer may also have agreed to defer payment of a portion of the fee.
2. If the developer agreed to defer payment, review the developer fee note and/or other applicable documents(s) evidencing the debt. The note and/or applicable document(s) will outline the terms (amount, interest, payment schedule, etc.) for payment of the deferred fee.
3. Review the taxpayer's book and records to identify payment of the fee. If the developer agreed to defer a portion of the fee, determine whether payments been made and/or interest accrued according to the terms of the agreement.

**Issue 1:  
Character of  
the Services to  
be Provided**

The development services to be provided will be identified in the agreement entered into by the taxpayer and the developer. This contract, as well as any supporting documentation, should be reviewed to determine what services the developer expected to perform. Typically, the developer agrees to provide (or may have previously provided) services related to the acquisition, construction, and initial operating phases of development.

**Development Costs Includable in Eligible Basis**

Examples of services typically includable in eligible basis include, but are not limited to:

1. Negotiating agreements for architectural, engineering, and consulting services, the construction of the low-income housing (including interiors) or improvements includable in eligible basis, and the furnishing of the associated supplies, materials, machinery or equipment.
2. Applying for and maintaining all government permits and approvals necessary for the construction of the project and securing the certificates of occupancy (or other equivalent documents) when completed.
3. Complying with the requirements imposed by insurance providers during construction.
4. Providing oversight, including inspections during the course of construction and approving eventual payment for the services rendered.
5. Implementing the taxpayer's decisions made in connection with the design, development, and construction of the project.

See Appendix C for the treatment of specific costs not identified here.

### **Developmental Costs Not Includable in Eligible Basis**

Development of a low-income project involves services that are not associated with the low-income buildings and, therefore, the costs are not includable in eligible basis. Typical services include (but are not limited to):

1. Acquiring the project site. Specific activities may include locating suitable sites, performing economic and feasibility studies, market studies, and negotiating the purchase price. The developer may be involved in the purchase (settlement and closing) for a selected site and be responsible for holding and maintaining the site until construction begins. Note: a portion of the purchase price may be included in eligible basis if the purchase included the acquisition of a building that is subsequently rehabilitated for use as low-income residential rental property.
2. Maintaining contracts, books and records sufficient to establish the value of the completed project.

### **Negotiating Financing**

A developer may advise the taxpayer regarding available sources of financing, such as federal, state or local subsidy programs, as well as commercial financing. The developer may also negotiate the terms of the financing with lenders or secure financing. See “Cost of Securing Financing” on page 8-27.

### **Partnership Costs**

Services associated with the partnership’s organization, syndicating partnership interests, or securing an allocation of IRC §42 credit, are not includable in eligible basis. These costs are discussed in detailed later in this chapter.

### **Initial Lease-Up Costs**

Because of the developer’s expertise, the taxpayer may contract with the developer to complete the initial leasing of the rental units. Typical costs include (but are not limited to) hiring on-site managers and trained staff, advertising, and maintaining model units. These costs are not includable in eligible basis. Instead, the costs should be amortized over the life of the lease if long term. If the lease is for a short term, typically at least six months but no more than one year for low-income rental units, then the costs should be amortized over the period necessary for completing the initial leasing of all the rental units.

### **On-Going Management Costs**

The developer may also contract to provide on-going management of the day-to-day operations of the project after the initial lease-up. Typical services include providing qualified on-site project managers, physically maintaining the project site, resolving tenant issues, renewing leasing and securing new tenants, including the completion of income certifications for low-income households. The manager will have authority to collect rents, make deposits, and pay expenses below specified dollar criteria without the taxpayer’s approval. The management services may also provide for the creation of books and records sufficient to accurately report rental income and

period expenses on the taxpayer's federal income tax return. These costs should be expensed and matched against current rental income.

**Issue 2:  
Services  
Actually  
Provided**

The second issue to consider is whether the developer actually performed the services. While it is generally expected that one developer will initiate development and then provide services throughout the development process until the project is completed, there are instances where more than one developer is involved.

**Concurrent Developers**

Multiple developers may be involved at the same time. For example, a for-profit developer may work with a qualified nonprofit organization to develop a low-income project qualifying for a credit allocation under IRC §42(h)(5). When there are multiple developers, there are two basic questions:

1. How were developmental responsibilities divided among the developers? For example, responsibilities may be assigned based on the developers' areas of expertise.
2. Did the developer have the skills and expertise needed to provide developmental services and complete the project?

**Consecutive Developers**

A developer may not be able to complete a project and the taxpayer will hire a new developer. Under these circumstances, it is important to understand why the developer could not complete the project, what services each developer performed, and how the developers were paid.

**Issue 3:  
Reasonable  
Fee**

While the absolute value of the fee can be large, the developer bears the equally large financial risk of failure. As a best practice, the state agencies have limited the developer fee amount that can be supported by the credit. While the methodologies differ, the state agencies generally limit the fee to a percentage of total costs. The IRS is not compelled to accept the developer fee amount allowed by the state agency and may raise issues involving the reasonableness of the fee amount if the facts and circumstances warrant doing so.

**Issue 4:  
Method of  
Payment**

Developer fee payments made during development, or at the time development is completed, and which are identified in the taxpayer's books as payments of developer fees are (generally) not challenged. Deferred fees, however, require further consideration.

**Performance of Additional Services**

1. Because the developer may be (or is related to) the general partner, consider whether the payment is contingent upon providing services usually associated with the duties of a general partner.
2. Because the developer may be (or is related to) the entity operating the low-income project, consider whether payment of the developer fee is contingent on successfully operating the project, or maintaining the project in compliance with

IRC §42.

If the above fact patterns exist, separately or in combination, then the deferred portion of the developer fee is not includable in eligible basis because the developer is being paid for services unrelated to the development of the low-income building.

#### **Intent to Pay Deferred Developer Fee**

In some cases, the terms and conditions of the deferred developer fee note and/or other documents may suggest that the taxpayer does not intend to pay the deferred fee. This issue is particularly important to address if the parties to the transaction are related. Consider whether:

1. the note and/or other documentation bears no interest rate or no payment is required for extended periods of time, suggesting that the agreement is not an arm's length transaction,
2. payment is contingent on events unlikely to occur,
3. payment is subordinate to payment of other debt, and it is unclear that payment would ever be financially possible,
4. the developer holds a right of first refusal to purchase the property for a price equal to the outstanding debt, or
5. the general partner, who is (or is related to) the developer, is required to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date.

If the above fact patterns exist, separately or in combination, the deferred developer fee note may not be bona fide debt.

#### **Analysis of Debt**

An extended discussion of bona fide debt is included here. See also Chapter 10.

#### **Recourse or Nonrecourse Debt**

Generally, debt, whether recourse or nonrecourse, is includable in the basis of property. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1, 11 (1947). However, the obligation must represent genuine, noncontingent debt. Nonrecourse debt is not includable if the property securing the debt does not reasonably approximate the principal amount of the debt, or if the value of the underlying collateral is so uncertain or elusive that the purported indebtedness must be considered too contingent to be includable in basis.

Recourse liabilities are generally includable in basis because they represent a fixed, unconditional obligation to pay, with interest, a specified sum of money. However, the mere fact that a note is recourse on its face is not determinative. For example, an obligation, whether recourse or nonrecourse will not be treated as a true debt where payment, according to its terms, is too contingent or repayment is otherwise unlikely. A liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.



### **Genuine Indebtedness**

When considering whether transactions characterized as “loans” constitute genuine indebtedness for federal tax purposes, the courts have isolated a number of criteria from which to judge the true nature of an arrangement which in form appears to be debt. In *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3<sup>rd</sup> Cir. 1968), the court enumerated the following sixteen nonexclusive factors that bear on whether an instrument should be treated as debt for tax purposes:

1. The intent of the parties;
2. the identity between creditors and shareholders;
3. the extent of participation in management by the holder of the instrument;
4. the ability of the debtor to obtain funds from outside sources;
5. thinness of capital structure in relation to debt;
6. the risk involved;
7. the formal indicia of the arrangement;
8. the relative position of the obligees as to other creditors regarding the payment of interest and principal;
9. the voting power of the holder of the instrument;
10. the provision of a fixed rate of interest;
11. a contingency on the obligation to repay;
12. the source of the interest payments;
13. the presence or absence of a fixed maturity date;
14. a provision for redemption by the corporation;
15. a provision for redemption at the option of the holder; and
16. the timing of the advance with reference to when the taxpayer was organized.

As the *Fin Hay* court noted, “Neither any single criterion nor any particular series of criteria can provide an exclusive answer in the kaleidoscopic circumstances which individual cases present.” The Sixth Circuit cited *Fin Hay* with approval in *Indmar Products Co., Inc. v. Commissioner*, 444 F.3d 771, (6<sup>th</sup> Cir. 2006), confirming that “[t]he various factors...are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship.” The Tax Court has also held that the case-enumerated factors are merely aids to determining whether a given transaction represents genuine debt. *Nestle Holdings, Inc., v. Commissioner*, T.C. Memo, 1995-441.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that may be considered when making such a determination are:

1. whether there is an unconditional promise on the part of the taxpayer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonable foreseeable future,
2. whether the lender has the right to enforce the payment of principal and interest,
3. whether the lender's rights are subordinate to rights of general creditors,
4. whether the instruments give the lender the right to participate in the management of the issuer (in this case, the IRC §42 project),
5. whether the taxpayer is thinly capitalized,
6. whether the lender (stockholders or partners) is related to the taxpayer,
7. the label placed upon the instrument by the parties, and
8. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in *Goldstein v. Commissioner*, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

1. a note or other evidence of indebtedness exists,
2. interest is charged,
3. there is a fixed schedule for repayments,
4. any security or collateral is requested,
5. there is any written loan agreement,
6. a demand for repayment has been made,
7. the parties' records, if any, reflect the transaction as a loan any repayments have been made, and
8. the borrower was solvent at the time of the loan.

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction to be a loan.

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. See *Fisher v. Commissioner*, 54 TC 905 (1970).

In *Story v. Commissioner*, 38 TC 936 (1962) the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligation. However, the Commissioner, in C.B. 1965-1, 4, limited his acquiescence in this case to the factual nature of that particular case. See Rev. Proc. 65-4, C.B. 1965-1, 720.

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner*, 42 TC 936 (1964), in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will “continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor...where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received...” Action on Decision, 1976 A.O.D. LEXIS 364.

#### **Related Party Transactions**

In the typical fact pattern for IRC §42 projects, both the general partner of the taxpayer (the purported debtor) and the developer (the purported creditor) are controlled by the same entity (or may be the same entity). Where borrowing transactions occur between related entities rather than as arm’s length, they are “subject to particular scrutiny because the control element suggests the opportunity to contrive a fictional debt.” *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998). Stated another way, where “the same persons occupy both sides of the bargaining table,” the form of a transaction “does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will” in order “to create whatever appearance might be of...benefit to them despite the economic reality of the transaction.” *Geftman*, 54 F.3d 61 at 75, citing *Fin Hay Reality v. United States*, 398 F.2d 694, 697 (3d Cir. 1968). Accord, *Anchor Natl. Life Ins. Co. v. Commissioner*, 93 T.C. 382, 407 (1989).

As the *Geftman* Court explained, “[t]he rule in *Fin Hay* accords with the general principle that tax consequences must be determined not from the “form of the transaction,” but from its “true substance.” *Geftman*, 154 F.3d at 75. Thus, “a transaction must be measured against an objective test of economic reality and characterized as a bona fide loan only if its intrinsic economic nature is that of a genuine indebtedness.” Where the transaction is not the project of an arm’s length relationship, much less weight is accorded to the factors relating to the form of the transaction than to those factors that go to the substance of the arrangement. See *Laidlaw v. Commissioner*, T.C. Memo. 1998-232; 75 TCM (CCH) 2598, 2617.

## **Intrinsic Economic Nature**

In form, the deferred developer fee will be structured as a promissory note or other debt instrument. However, given the relationship between the parties, a court may accord little weight to the form of the transaction. Instead, the essential question is whether the instrument's "intrinsic economic nature is that of a genuine indebtedness."

### **1. Independent Creditor Test**

Consider the substantive terms of the alleged debt. For example, the note does not provide for installment payments; rather, the note is due and payable only after an extended period of time. It is only payable after all the taxpayer's operating expenses and all other sums due are paid. The debt is nonrecourse and unsecured. In the event of default, the note holder's sole remedy is a judgment against the taxpayer, to be collected against whatever assets (if any) the taxpayer has at the time of default. Despite these unusually generous terms, the debt is interest-free.

The acid test of the economic reality of a purported debt is whether an unrelated outside party would have advanced funds to the borrower under like circumstances. *Fischer v. U.S.*, 441 F.Supp. 32, 28 (1977). It is highly unlikely that an outside lender would have advanced funds to a taxpayer under the terms described above. Generally, creditors avoid subjecting funds to the risk of the borrower's business as much as possible and seek a reliable return. See *Laidlaw*, T.C. Memo 1998-232. Commercial lenders thus impose borrowing terms that ameliorate risks and charge interest rates that are reasonably calculated to compensate for those risks and provide a reasonable return on the lender's investment. As described above, none of the note terms suggest any effort to limit risks. The note is due and payable far in the future. There are no installment payments due in the interim. The note is subordinated to other debt and is only payable after all the taxpayer's operating expenses have been paid. The note is unsecured and nonrecourse. An economically motivated lender would charge significant interest to account for these risks, but the deferred developer fee note considered here is interest-free. Altogether, these features indicate that the debt instrument's "intrinsic economic nature" is not that of genuine debt.

### **2. Debt-Equity Ratios**

Another factor that can indicate an absence of substance to purported debt is thinness of the taxpayer's capital structure relative to accumulated debt. *Fin Hay*, 398 F.2d 694, 696; *Laidlaw*, 75 TCM (CCH) at 2620. Courts generally consider a borrower's debt to equity ratio and other financial data in deciding if it is thinly capitalized. *Tyler v Tomlinson*, 414 F.2d 844, 850 (5<sup>th</sup> Cir. 1969). A taxpayer's thin capitalization adds to the evidence that a deferred developer fee is not genuine debt. However, even if the taxpayer's capital structure were more robust, that alone, especially in light of the highly favorable terms of the debt, would not necessarily tip the balance in favor of treating a deferred developer fee as described above as genuine debt.

### 3. Potential Sources of Repayments

A related factor when considering the substance of the transaction is the taxpayer's ability to repay the advance and the reasonable expectation of the repayment. *Laidlaw*, 75 TCM (CCH) at 2624. Normally, there are four such possible sources: (1) liquidation of business assets, (2) profits, (3) cash flow, and (4) refinancing with another lender. "The burden is on the taxpayer to establish this, of course, and such a conclusion must be based on concrete facts and sound assumptions about the [taxpayer's] future." *Fischer v. United States*, 441 F.Supp 32, 39 (1977).

Consider the taxpayer described in TAM 200044004, which was a partnership formed to construct, develop, and operate a low-income housing tax credit property. The taxpayer's managing partner was related to other parties, including the developer. The other general partner was a nonprofit corporation. At completion of the construction, the taxpayer did not have sufficient funds to pay the entire development fee so it issued a note for the balance owing. The note was payable at maturity, 13 years from completion of the project. The note was unsecured and source-of-payment restrictions were in effect during the term of the note. Payment was subordinate to other debts. The note bore interest which was compounded annually and added to the unpaid principal during the term of the note. The taxpayer was obligated to pay off the note in full at maturity and the general partners were obligated to make additional capital contributions necessary to pay off the note at maturity. Financial statements also indicated that payments had been made on the note.

The TAM concluded that the amount of the developer fee note was includable in the building's eligible basis. The note was an obligation on the part of the taxpayer to pay a fixed amount, with interest, at maturity. Although payments were contingent on cash flow or receipts from capital transactions prior to maturity, all remaining principal and accrued interest were payable at maturity. Also, although sources of payment were contingent, and the developer could not foreclose on any security interest in any specific asset, the general partners were obligated, at maturity, to contribute an amount sufficient to pay off the note in full. Repayment of the note was also backed by the equity the taxpayer had in the assets beyond the general partners' guarantee. In other words, it appeared the taxpayer has sufficient equity and assets to repay the note.

Critical to the determination in the TAM was the fact that the note bore interest to compensate the lender for the various financial risks posed by the note. The TAM cites an excerpt from *Gibson Products v. United States*, 637 F.2d 1041 (5<sup>th</sup> Cir 1981), in which the court stated that, "the single most important factor dictating that the transaction...was not a true loan is the fact that the total combined assets....were not sufficient to pay the note on or before the maturity date...absent production from any of the leases." 637 F.2d at 1047.

**Court Case: Substantiation of Services Performed** In *Carp & Zuckerman v. Commissioner*, the Tax Court concluded that the taxpayers failed to prove that they performed the development services specified in the agreement. The Court explained that the taxpayer bears the burden of proving that the developer fee constituted a qualified expenditure and that it was inappropriate to apply the rule found in *Cohan v. Commissioner*. See Appendix I.

**Summary** Ultimately, the burden is on the taxpayer to demonstrate that the developer fee was earned and is includable in eligible basis. If the taxpayer has deferred payment, the taxpayer will also need to demonstrate the deferred fee is bona fide debt. For related party transactions, when a court may accord little weight to the form of the transaction, the intrinsic economic nature of the transaction must be considered; i.e., would an unrelated outside lender advanced funds to the taxpayer under like circumstances? Particularly when the absence of interest provisions (or very low interest rates), unsecured, nonrecourse, subordinated, balloon payment would normally dictate a significant interest rate in a commercial setting to compensate the lender for the associated risks.

## **Partnership Costs**

Partnership costs are not includable in eligible basis. Because the taxpayer may have included partnership costs in the development costs, the taxpayer's books and records should be reviewed.

**Organizing Costs** Generally, IRC §42 projects are owned by partnerships. The cost of organizing a partnership is amortized over a period of time not less than 60 months under IRC §709(b) and is not includable in eligible basis. Organizational costs include associated legal and accounting fees for preparing legal documents and contracts, making required regulatory filings, etc.

**Syndication Costs** Syndication costs are incurred for the marketing and selling of partnership interests. Expenses include the preparation of offering memorandums and promotional materials, broker fees and commissions, legal fees, and due diligence costs. None of these costs are includable in eligible basis. Under IRC §709, these costs are capital costs that are not currently expensed or amortized, nor includable in the basis of the property for purposes of depreciation.

## **IRC §42 Credit Allocation Costs**

Credit allocation costs are incurred to secure an allocation of IRC §42 credit. These costs are not capitalized to the low-income buildings' adjusted basis and, therefore, are not includable in eligible basis. Activities related to credit allocation costs include (but are not limited to):

1. Reviewing the state agency's qualified allocation plan, which identifies the state's housing priorities (IRC §42(m)(1)(B) and (C)) and locating qualifying sites.
2. Conducting 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) specifies that the market study is to be conducted before the credit allocation is made and at the developer's expense by a disinterested party approved by the

state agency.

3. Notifying the chief executive officer (or the equivalent) of the local jurisdiction where the project is to be located and providing the individual with a reasonable opportunity to comment on the project. The notification may also include town meetings with the community. IRC §42(m)(1)(A)(ii) requires state agencies to make this notification, but the requirement is often delegated to the developer.
4. Preparing and submitting a detailed proposal to the state agency describing the project, estimating costs, and identifying sources of financing (including federal, state and local subsidies). The amount of equity expected to be generated by reason of the IRC §42 credit must also be disclosed. See IRC §42(m)(2). In addition, the proposal will include information required by the state agency.
5. Paying application and/or allocation fees to the state agency. See Rev. Rul. 2004-82, Q&A #3.

Depending on the facts, all or a portion of these costs may be required to be capitalized as amounts paid to create an intangible asset. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections.

## Cost of Securing Financing

The IRC §42 project will most likely need additional funding in addition to the equity investment by limited partners. The sources may vary, but generally the cost of securing the funding is not includable in eligible basis. Instead, the cost is amortized over the life of the funding as an amortizable IRC §167 intangible. See TAM 200043015, which cites *Enoch v. Commissioner*, 57 T.C. 781, 794-5 (1972), acq. on this issue, 1974-2 C.B. 2. See also Rev. Rul. 70-360, 1970-2 C.B. 103, Rev. Rul. 75-172, 1975-1 C.B. 145, and Rev. Rul. 81-160, 1981-1 C.B. 312.

Common costs include:

1. Interest on bridge or construction loans,
2. Permanent loan credit enhancement,
3. Permanent loan origination fees and closing costs,
4. Recording and title insurance costs, and
5. Reserves required by lender.

Under IRC §263A, however, the allocable portion of indirect costs of real or tangible personal property produced by a taxpayer during the construction period are generally capitalized to the property produced; i.e., costs that directly benefit or are incurred by reason of the performance of production activities. To the extent the costs are allocated and capitalized under IRC §263A to property produced that qualifies for eligible basis, these capitalized costs are includable in eligible basis. For example, while the interest on a bridge or construction loan is generally not includable in eligible basis, the interest incurred during the construction period that is capitalized as an indirect cost under IRC §263A is includable in eligible basis.

**Cost of Issuing Tax-Exempt Bonds**

The costs associated with issuing tax-exempt bonds (bond issuance costs) are not includable in eligible basis, even if the same costs are capitalized under IRC §263A.

Bond costs include:

1. fees assessed by the state agency,
2. state board fees,
3. rating agency fees,
4. trustee fees,
5. underwriter fees,
6. investment fees,
7. legal counsel fees,
8. bank inspector fees, and
9. costs for photos, prints, and renderings.

TAM 200043015 provides the rationale for excluding all bond issuance costs from eligible basis. As explained in the TAM, Congress determined that bond issuance costs are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the bond offering. Characterizing a certain portion of bond issuance costs under IRC §263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Further, permitting an IRC §263A characterization of bond issuance costs to control for purposes of IRC §42 would result in the disparate treatment of the term “residential rental property” between IRC §§ 42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42 that requires that residential rental property have the same meaning for purposes of both IRC §§ 42 and 142.

**Computing Adjustments to Eligible Basis****Nonqualifying Costs**

The examination of eligible basis fundamentally requires consideration of five issues:

1. character of the assets,
2. cost of the assets,
3. when the cost was paid or incurred,
4. whether costs were reasonably allocated among the assets, and
5. whether the assets are in continuous use during the entire 15-year compliance period.

Based on the examination results, the dollar value of assets included in eligible basis should be adjusted.

**Example 1: Impermissible Costs Included in Eligible Basis**

A taxpayer claimed IRC §42 credit based on qualifying costs of \$10,000,000. The examiner made the following adjustments:

1. \$75,000 - the expense was paid to an accountant to prepare the application submitted to the state agency to secure an allocation of credit. The \$75,000 included the cost of the market study required under IRC §42(m)(1)(A)(iii) and preparing the three cost certifications required under IRC §42(m)(2)(A).



2. \$100,000 – the expense was a contingency fee included in the construction contract that was not paid during the period prescribed in the contract.
3. \$450,000 – the taxpayer included the entire \$1,500,000 developer fee in eligible basis. The adjustment was made to account for services provided by the developer to find and purchase the land, organize the partnership, and secure the allocation of credit.
4. \$35,000 – the expense was for the construction of a swimming pool, considered common area that was timely placed in service, but later proved to be too expensive to operate. The taxpayer filled in the pool.
5. \$40,000 – the taxpayer could not document that costs were associated with qualifying assets or that the expenses were actually incurred.

The total adjustment is \$700,000. The actual eligible basis is  
 $\$10,000,000 - \$700,000 = \$9,300,000$ .

### **Reductions and Limitations**

Once the actual costs includable in eligible basis are determined, specific reductions and limitation are considered. If the taxpayer acquired and rehabilitated an existing building, refer to Chapter 9. Otherwise, the next step in the examination of eligible basis is an analysis of the taxpayer's financial resources. See Chapter 10.

### **Summary**

This chapter focused on determining the dollar value of assets includable in eligible basis.

1. Eligible basis is defined, generally, as depreciable residential rental property. IRC §§ 103 and 168 are the primary Code references, as well as specific criteria provided by IRC §42. Depreciable basis includes costs capitalized to the property under IRC §§ 263(a) and 263A.
2. Eligible basis includes the costs associated with the residential rental units, common areas provided as amenities, functionally related facilities, community service facilities, facilities used to provide supportive services for the homeless, and land improvements (under limited circumstances).
3. A low-income building's eligible basis is its adjusted basis at the end of the first year of the building's credit period, not at the time the building is placed in service.
4. Eligible basis does not include costs expensed under IRC §179.
5. The analysis of eligible basis begins by reconciling the eligible basis reported on Forms 8609 and 8609-A, followed by a review of the final cost certification presented to the state agency. Based on this review, specific costs can be identified as large, unusual, or questionable items and the audit scope established.

6. Verification of the costs included in eligible basis includes consideration of the character and cost of the asset, as well as when the cost was paid or incurred. Consideration should also be given to whether costs were reasonably allocated among the qualifying assets and whether the assets were continuously in service during the building's 15-year compliance period.
7. The developer fee represents the developer's profit and may be includable in eligible basis. The four primary issues to consider are the character of the services provided, services actually provided, reasonableness of the fee amount, and the method of payment.
8. Certain costs are not includable in eligible basis; e.g., the cost of organizing a partnership and syndicating partnership interests. The cost of securing an allocation of IRC §42 credit is also excluded.
9. The costs of securing financing generally do not qualify as eligible basis; these costs are amortized over the life of the funding under IRC §167. To the extent these amortized costs are allocable to property produced during the construction period under IRC §263A, the allocable costs are includable in eligible basis. However, costs associated with issuing tax-exempt bonds are not includable in eligible basis, even if the same costs are capitalized under IRC §263A.

## Chapter 9

### Eligible Basis: Acquisition and Rehabilitation of Existing Buildings

**Introduction** If the taxpayer acquired an existing building and rehabilitated it for use as low-income housing, then additional criteria must be met to qualify for the IRC §42 credit. New buildings are defined in IRC §42(i)(4) as buildings for which the original use begins with the taxpayer. Existing buildings are defined in IRC §42(i)(5) as buildings that are not new buildings.

Under specific conditions, credit can be allocated for both the acquisition and rehabilitation of an existing building. Two separate allocations of credit will be made and documented on separate Forms 8609, Low-Income Housing Credit Allocation and Certification. The type of allocation will be identified on line 6.

- Topics**
- Acquisitions of Existing Buildings
  - Substantially Rehabilitated Buildings
  - Acquiring a Low-Income Building Before the End of the Compliance Period
  - Acquiring a Low-Income Building During the First Year of the Credit Period
  - Acquiring a Low-Income Building Before the Place in Service Date
  - Summary

#### Acquisition of Existing Buildings

**IRC §42(d)(2): Existing Buildings** Generally, the eligible basis of an existing building is its adjusted basis as of the close of the first taxable year of the building's credit period if the taxpayer's acquisition of the building meets all four requirements explained in this section. See IRC §42(d)(2)(B). If the acquisition does not meet all four requirements, then the eligible basis is zero. See IRC §42(d)(2)(A)(ii). The adjusted basis of an existing building does not include the basis of the building as determined by reference to the basis of other property held at any time by the person acquiring the building. See IRC §42(d)(2)(C).

**Requirement 1: Acquisition by Purchase** The building is acquired by purchase as defined in IRC §179(d)(2), which defines the term "purchase" as any acquisition of property, but only if:

1. The property is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under IRC §§ 267 or 707(b). However, when applying IRC §267(b) and (c) for purposes of IRC §179(d), IRC §267(c)(4) is treated as providing that the family of an individual shall include only his/her spouse, ancestors, and lineal descendants,
2. The property is not acquired by one component member of a controlled group from another component member of the same controlled group, and
3. The basis of the property in the hands of the person acquiring it is not determined (1) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (2) under IRC §1014(a) (relating to property acquired from a decedent).

**Requirement 2:  
Last Placed in  
Service**

For buildings acquired before July 31, 2008, IRC §179(d) is applied by substituting “10 percent” for “50 percent” in IRC §§179(d)(7), 267(b), and 707(b).

For buildings placed in service before July 31, 2008, there is a period of at least 10 years between the date of its acquisition by the taxpayer and the later of (1) the date the building was last placed in service, or (2) the date of the most recent nonqualified substantial improvement of the building,

A “substantial” improvement is an improvement added to the capital account of a building during any 24-month period, but only if the sum of the amounts added to the account during this period equals or exceeds 25% of the adjusted basis of the building (determined without regard to IRC §1016(a)(2) and (3)) as of the first day of such period. The date of a substantial improvement is the last day of the 24-month period.

A “nonqualified substantial improvement” is any substantial improvement if IRC §167(k), as in effect on November 4, 1990, the day before the date of enactment of the Revenue Reconciliation Act of 1990, was elected for the improvement or IRC §168, as in effect on October 22, 1986, the day before the enactment of the Tax Reform Act of 1986, applied to such improvement.

Consideration of the building’s most recent nonqualified substantial improvement was removed when IRC §42(d)(2)(B) was amended as part of the Housing Assistance Act of 2008. As a result, for buildings placed in service after July 30, 2008, the determination is limited to whether there is a period of at least 10 years between the date of its acquisition by the taxpayer and the date the building was last placed in service.

When determining when a building was last placed in service for purposes of the 10-year requirement, certain placed in service events taking place within the 10-year period are ignored. These include a placement in service:

1. in connection with the acquisition of a building in a transaction in which the basis of the building in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such building in the hands of the person from whom acquired;
2. of a building by a person whose basis in the building is determined under IRC §1014(a) (relating to property acquired from a decedent);
3. of a building by any governmental unit or qualified nonprofit organization (as defined in IRC §42(h)(5)) if the requirements of IRC §42(d)(2)(B)(ii) are met with respect to the placement in service by such unit or organization and all the income from such property is exempt from Federal income taxation;
4. of a building by any person who acquired the building by foreclosure (or by instrument in lieu of foreclosure) of any purchase-money security interest held by such person if the requirements of IRC §42(d)(2)(B)(ii) are met with respect to the placement in service by such person and such building is resold within 12 months after the date such building is placed in service by such person after such foreclosure; or

5. of a single-family residence by any individual who owned and used such residence for no other purpose than as the individual's principal residence.

In addition to the rules described above, IRC §42(d)(6) provides a special exception that makes the 10-year requirement under IRC §42(d)(2)(B)(ii) inapplicable. Qualifying buildings include:

1. Any "federally-assisted building" or "state-assisted building" placed in service after July 30, 2008. A federally-assisted building is any building substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3), 221(d)(4), or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture. A state-assisted building is any building substantially assisted, financed, or operated under any state law similar in purposes to any of the laws referred to above for federally-assisted buildings.
2. Buildings acquired from insured depository institutions in default. On application by the taxpayer, the IRS may waive the requirement for any building acquired from an insured depository institution in default, as defined in section 3 of the Federal Deposit Insurance Act [12 USCS §1813], or from a receiver or conservator of such an institution.

**Requirement 3:  
Previously  
Placed in  
Service by the  
Taxpayer**

The building was not previously placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer as of the time previously placed in service. A person (the "related person" for purposes of this sentence) is related to any person if the related person bears a relationship to such person specified in IRC §§ 267(b) or 707(b)(1), or the related person and such person are engaged in trades or businesses under common control (within the meaning of IRC §52(a) and (b)). See IRC §42(d)(2)(D)(ii). For buildings placed in service on or before July 30, 2008, "10%" is substituted for "50%" when applying IRC §§ 267(b) or 707(b)(1).

**Requirement 4:  
Substantial  
Rehabilitation**

IRC §42 credit is allowable under IRC §42(e) for costs associated with the substantial rehabilitation of a building; i.e., the taxpayer acquired and substantially rehabilitated an existing building. Substantial rehabilitations are discussed in the next section.

**Audit Issue:  
Artificially  
Inflated  
Purchase Price**

In an attempt to secure a larger allocation of credit, a taxpayer may attempt to artificially increase the adjusted basis of an acquired building. Consider the case of *Corbin West Limited Partnership*, in which the Tax Court reasoned that because there was no reasonable likelihood that Corbin West would pay off the note, the note lacked economic substance and was not includable in the property's basis. The taxpayer was not entitled to depreciation deductions or low-income housing credits related to the note. See Appendix G.

## Substantially Rehabilitated Buildings

Under IRC §42(e)(1), the costs paid or incurred by the taxpayer for rehabilitating a building are treated as a new building separate from the cost of acquiring the building.

### Rehabilitation Expenditures Defined

Under IRC §42(e)(2), “rehabilitation expenditures” are:

1. amounts chargeable to a capital account, and
2. incurred for property (or additions or improvements to property) that is depreciable, and
3. incurred in connection with the rehabilitation of a building.

Rehabilitation expenditures do not include the cost of acquisition.

### Substantial Improvements: Minimum Expenditures to Qualify

Under IRC §42(e)(3), a minimum amount of rehabilitation expenses must be incurred to be treated as a new building under IRC §42(e)(1).

First, the rehabilitation expenses must be allocable to one or more rental units, or substantially benefit the rental units; e.g., the common area or a facility necessary for the operation of the project.

Second, the rehabilitation expenditures incurred during any 24-month period must meet the greater amount of either:

1. Not less than 20% of the adjusted basis of the acquired building (determined as of the first day of the 24-month period), without regard to IRC §1016(a)(2) or (3), or
2. The qualified basis (applicable fraction x eligible basis) attributable to the rehabilitation costs, when divided by the number of low-income units in the building, is \$6,000 or more. In other words, the average rehabilitation cost associated with each low-income unit must be at least \$6,000.

The above expenditure values used to determine whether the minimum rehabilitation expenditure requirement is met were added by the Housing Assistance Tax Act of 2008. Substitute 10% for 20% and \$3,000 for \$6,000 if:

1. The taxpayer received the allocation of credit before July 31, 2008 (as documented on Form 8609, line 1a), or
2. The building was financed by tax-exempt bonds issued before July 31, 2008. Buildings financed with tax-exempt bonds are identified on Form 8609, line 4. Further documentation from the taxpayer is needed to determine when the bonds were issued.

The \$6,000 average rehabilitation cost is also adjusted for inflation if the 24-month period ends during any calendar year after 2009. Under IRC §42(e)(3)(D), the \$6,000 amount is increased by an amount equal to \$6,000 multiplied by the cost-of-

living adjustment under IRC §1(f)(3) for the calendar year by substituting “calendar year 2008” for “calendar year 1992” in IRC §1(f)(3)(B). Any increase which is not a multiple of \$100 is rounded to the nearest multiple of \$100.

**Buildings Acquired from a Government Unit**

Under IRC §42(e)(3)(B), there is an exception to the minimum rehabilitation expenditure requirement when the building is acquired from a government unit. The taxpayer can elect to satisfy the minimum rehabilitation requirement solely by reference to IRC §42(e)(3)(A)(ii)(II); i.e., the taxpayer must incur an average \$6,000 rehabilitation cost per low-income unit (subject to inflation). However, use of this exception requires that the 30% applicable percentage under IRC §42(b)(1)(B)(ii) be used to compute the credit for the rehabilitation expenditures.

**Placed in Service Date**

Under IRC §42(e)(4)(A), expenditure qualifying as “substantial rehabilitation” are treated as placed in service at the close of the 24-month period. The 24-month period is determined by the taxpayer.

**Costs Included in Eligible Basis**

Once a determination has been made that the taxpayer substantially rehabilitated an existing building, the taxpayer can treat all the rehabilitation costs as a separate new building. Under 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.

**Audit Issues and Techniques**

Compliance with the minimum expenditures requirement is determined on a building-by-building basis.

1. The taxpayer should be asked to demonstrate that the test was met for the 24-month selected by the taxpayer, and
2. After accounting for any adjustments to eligible basis, compliance with the minimum expenditure requirement should again be determined, using the same 24-month period selected by the taxpayer.

**Acquiring a Low-Income Building Before the End of the Compliance Period**

Under IRC §42(d)(7), a taxpayer acquiring an existing IRC §42 low-income building (or interest therein) during the 15-year compliance period steps into the place of the prior owner. As a result, the building is not eligible for a new allocation of credit for acquisition costs and the taxpayer is expected to maintain the building as an IRC §42 low-income building for the remainder of the compliance period. The taxpayer may, however, receive an allocation of credit to rehabilitate the building.

**Placed in Service**

In general, a transfer of the property results in a new placed in service date if, on the date of the transfer, the property is ready and available for its intended purpose. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4) C.B. 91. However, if IRC §42(d)(7) applies, the fact that the transfer results in a new placed in service date does not jeopardize the purchaser's eligibility to claim the low-income housing credit.

**Allocation of Credit**

Under IRC §42(f)(4), if a building is disposed of during the 10-year credit period and the new owner continues to operate the building as a qualified low-income building under IRC §42(c)(2), the credit is allocated between the prior owner and the new owner on the basis of the number of days during the year the building (or interest)

therein was held by each. Note, however, that the parties may allocate the credit according to the number of months each party held the property as provided in Rev. Rul. 91-38, Q&A #5.

**Allocation of Recapture Amount**

An acquisition of a low-income building during the credit period also requires allocation of the recapture amount should there be a recapture event under IRC §42(j) after the change in ownership.

**Audit Issues and Techniques**

The eligible basis remains the same, regardless of changes in ownership. One difficulty encountered when auditing the eligible basis of a building acquired during the compliance period is the taxpayer's inability to provide original documentation of the costs incurred by the original owner. See Appendix E for discussion of documentation and record retention requirements.

**Acquiring a Low-Income Building During the First Year of the Credit Period**

A taxpayer may prefer to acquire an interest in a completed low-income building to avoid the risks of development. It is not uncommon for an equity investor to postpone acquiring a limited partnership interest until after the low-income building is placed in service but before the end of the first year of the credit period.

**Application of IRC §42(d)(7)**

The credit need not actually have been claimed by a prior owner in order for a subsequent owner to claim the credit under IRC §42(d)(7). If a taxpayer transfers a qualified low-income building (or an interest therein) before actually claiming a credit, but after having received an allocation from a state agency or having qualified for the credit without an allocation (i.e., low-income buildings financed with tax-exempt bonds), the credit will be considered allowed to the prior owner.

In the case of buildings financed with tax-exempt bonds under IRC §42(h)(4)(B), therefore not requiring a credit allocation, the credit is considered allowed to the prior owner for purposes of IRC §42(d)(7)(B)(i) when the following conditions are met:

1. the tax-exempt obligations have been issued;
2. the building has met the requirements for allocation of a housing credit dollar amount under the state agency's qualified allocation plan;
3. the governmental unit issuing the bonds has determined the credit dollar amount necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period; and
4. the state agency has assigned a building identification number to the building as is done when an allocation of credit is made by the state agency.

For further information, see Rev. Rul. 91-38.



**Example**

On March 1, 2007, Developer D, a calendar year taxpayer, placed in service a low-income building that had received a \$20,000 allocation of IRC §42 credit in 2006. The building consisted of 10 low-income units and 2007 is the first year of the credit period. On July 20, 2007, D sold a 99% of its interest in the building to T. At the time of sale, D had not yet claimed any credit with respect to the building for the period before the sale.

Although D had not claimed any IRC §42 credit prior to the sale, the building had received an allocation of IRC §42 credit before the sale of D's interest to T and D would have been allowed to claim credit on the 99% portion of its interest sold if D had retained 100% ownership of the property and had otherwise complied with the requirements of IRC §42. Therefore, under IRC §42(d)(7), T "steps into the shoes" of D to the extent of the acquired 99% interest and may claim the IRC §42 credit that would have been allowable to D on that interest for the period after the acquisition, provided that T complies with the IRC §42 requirements.

For D, the credit is computed as:

$$[(200/365) \times \$20,000 \times 100\%] + [(165/365) \times \$20,000 \times 1\%] = \$11,049.31$$

T's share of the credit is computed as:

$$(165/365) \times \$20,000 \times 99\% = \$8,950.69$$

**Audit Issues and Techniques**

Since eligible basis is not determined until the end of the first year of the credit period, the acquisition of an interest in the building does not, of itself, affect the analysis of eligible basis. However, a transfer under IRC §42(d)(7) should be reviewed to ensure that the allowable credit reflects the period of time the seller and the buyer held an interest in the building and the amount of credit attributable to their respective interests.

**Acquiring a Low-Income Building Before the Placed in Service Date**

Under certain circumstances, a taxpayer willing to bear the risks of development will invest in a building before the building has been placed in service, but after the building has received an allocation of credit. For example, a developer receives a "carry-over" allocation of credit under IRC §42(h)(1)(E) and begins construction. When partially completed, the developer transfers the building to the partnership intended to own the building and for which the developer is the general partner. Later, at an agreed upon percentage of completion before the building is placed in service, an investor will secure a partnership interest.

**Eligible Basis**

When ownership of a newly constructed building is transferred before the building is placed in service, the purchaser's eligible basis in the building is equal to the transferor's eligible basis in the building at the time of transfer, regardless of the purchase price. When ownership of a rehabilitated building is transferred before the rehabilitation expenditures are placed in service, the purchaser's eligible basis in the rehabilitation expenditures is equal to the lesser of the rehabilitation expenditures at the time of transfer, or the purchaser's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before that date. See Rev. Rul. 91-38, Q&A #7.

Furthermore, should the purchaser incur additional qualifying costs after the date of transfer, the costs would be added to the purchaser's eligible basis. As a result, when the eligible basis is determined at the end of the first year of the credit period, the eligible basis will consist of the transferor's eligible basis at the time of transfer and any additional qualifying costs incurred by the purchaser after the transfer.

## **Audit Issues and Techniques**

The transferor may have provided a summary of costs qualifying for eligible basis without providing supporting documentation. See Appendix E for discussion of documentation and record retention requirements.

## **Summary**

1. The eligible basis of an acquired building is its adjusted basis as of the close of the first taxable year of the credit period if, the acquisition of the building meets four requirements:
  - The building is acquired by purchase,
  - For buildings placed in service before July 31, 2008, there is a period of at least 10 years between the date of its acquisition and the later of (1) the date the building was last placed in service, or (2) the date of the most recent nonqualified substantial improvement of the building. If placed in service after July 30, 2008, the determination is limited to whether there is a period of at least 10 years between the date the building was acquired and the date the building was last placed in service.
  - The building was not previously placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer as of the time previously placed in service, and
  - the taxpayer substantially rehabilitated the acquired building.
2. To qualify as "substantially rehabilitated" and have the related expenditures be treated as a separate new building, rehabilitation expenses must meet the greater of:
  - Not less than 20% of the adjusted basis of the acquired building (determined as of the first day of the identified 24-month period), or
  - The qualified basis attributable to the rehabilitation costs, when divided by the number of low-income units in the building, is \$6,000 or more. The required average rehabilitation cost is adjusted for inflation if the 24-month period ends during any calendar year after 2009.
3. A taxpayer acquiring an IRC §42 low-income building (or interest therein) during the 15-year compliance period steps into the shoes of the prior owner. The eligible basis remains the same, regardless of changes in ownership.

4. A taxpayer may prefer to acquire an interest in a completed low-income building during the first year of the credit period to avoid the risks of development. The credit need not actually have been claimed by a prior owner in order for a subsequent owner to claim the credit under IRC §42(d)(7).
5. When ownership of a newly constructed building is transferred before the building is placed in service, the purchaser's eligible basis in the building is equal to the transferor's eligible basis in the building at the time of transfer, regardless of the purchase price, plus any qualifying costs incurred by the purchaser.
6. When ownership of a rehabilitated building is transferred before the rehabilitation expenditures are placed in service, the purchaser's eligible basis in the rehabilitation expenditures is equal to the lesser of the rehabilitation expenditures at the time of transfer, or the purchaser's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before that date.

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## **Chapter 10**

### **Eligible Basis: Analysis of Financial Resources**

#### **Introduction**

The amount of credit allocated to a low-income building is not to exceed the amount necessary to assure the low-income project's financial feasibility throughout the credit period. However, the capital investment generated by the credit is seldom sufficient to cover all the costs of development, including costs not includable in eligible basis and anticipated operational costs.

To determine the amount of credit needed, the state agency will evaluate the taxpayer's financial resources at three critical points in the development of the project:

- When the taxpayer applies for the credit,
- When the credit is allocated (or when the taxpayer received a carryover allocation of credit under IRC §42(h)(1)(E) or (F)), and
- When the low-income buildings are placed in service. This final analysis is usually conducted immediately after the end of the first year of the credit period, when the building's eligible basis is fixed.

For each of these determinations, the taxpayer is required to certify to the state agency the full extent of all federal, state, and local subsidies, and all other sources of funds and development costs that apply (or which the taxpayer expects to apply) with respect to the building.

The final cost certification, which describes all financial resources and federal/state/local subsidies, should be reviewed as part of the audit of eligible basis. This review is necessary because some financing sources impose specific requirements or restrictions on the credit.

#### **Topics**

The following topics are discussed in this chapter:

- Federal Grants
- Low-Income Buildings Financed with Tax-Exempt Bonds
- Below Market Federal Loans
- Nonrecourse Financing and IRC §42(k)(1), At-Risk Rules
- Nonrecourse Financing from a Qualified Nonprofit Organization
- Right of First Refusal to Purchase
- Qualified Contracts
- Bona Fide Debt
- "Not-For-Profit" Rules and Economic Substance
- IRC §45D, New Markets Tax Credit
- Audit Techniques
- Summary

## Federal Grants

**IRC §42(d)(5)(A) Federal Grants** Under IRC §42(d)(5)(A), a building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant.

1. For buildings placed in service before July 31, 2008, all federal grants made to the building (including for the operation of the building) require a dollar-for-dollar reduction of eligible basis.
2. If the building was placed in service after July 30, 2008, eligible basis cannot include any costs financed with the proceeds of a federally funded grant.

See Chapter 11 for a detailed discussion.

## Low-Income Buildings Financed with Tax-Exempt Bonds

IRC §42(i)(2) provides that a new building is treated as "federally subsidized" if the proceeds of a tax-exempt bond are used (directly or indirectly) with respect to the building or its operation. Federally subsidized buildings are identified on Line 6a or 6d of Form 8609, Low-Income Housing Credit Allocation and Certification. The applicable percentage for these buildings is limited to the 30% applicable percentage under IRC §42(b)(1)(B)(ii).

The percentage of the aggregate basis financed with tax-exempt bonds is identified on Form 8609, Line 4. Under IRC §42(h)(4)(B):

1. If 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds that are subject to the IRC §146 volume cap, then the allowable credit is based on the entire eligible basis.
2. If less than 50% of the aggregate basis of the building and land on which the building is located is financed with tax-exempt bonds that are subject to the IRC §146 volume cap, then the allowable credit is based on the eligible basis financed with the tax-exempt bonds.

See Chapter 14 for in-depth discussion of the Applicable Percentage.

## Below Market Federal Loans

New buildings placed in service before July 31, 2008, are also considered "federally subsidized" under former IRC §42(i)(2)(A) if the proceeds of a below market federal loan, are (or were) used (directly or indirectly) with respect to the building or its operation. Under former IRC §42(i)(2)(D), the term "below market federal loan" is defined as any loan funded in whole or in part with federal funds if the interest rate payable on the loan is less than the applicable federal rate in effect under IRC §1274(d)(1) as of the date that the loan was made.

If it can be established that:

1. funds loaned to the taxpayer are federally sourced and the interest rate is below the applicable Federal rate at the time the loan is made, and

2. costs included in eligible basis are financed with the loan proceeds,

then the tax treatment of the funds will be determined based on whether the future value of the IRC §42 project approximates the face value of the loan plus stated interest at the time the loan comes due.

1. If the value of the IRC §42 project is equal to, or greater than, the face value of the loan, plus stated interest on the loan, then the funds will be treated as a federal subsidy included in eligible basis and, under IRC §42(b)(1)(B)(ii), the applicable percentage will be reduced from the 70% value to the 30% value. See Chapter 14.
2. If the value of the IRC §42 project is less than the face value of the loan, plus stated interest on the loan, then the funds, to the extent they are less than the value of the project, will be treated as a federal grant. As a result, under former IRC §42(d)(5)(A), the eligible basis of the building will be reduced to the extent of the funds that is treated as a grant.

### **Nonrecourse Financing and IRC §42(k)(1), At-Risk Rules**

Under IRC §42(k)(1), "...rules similar to the rules of IRC §49(a)(1), other than subparagraphs (D)(ii)(II) and (D)(iv)(I), IRC §49(a)(2), and IRC §49(b)(1) shall apply in determining the qualified basis of any building in the same manner as such sections apply in determining the credit base of property." When applying IRC §49 to the IRC §42(k) at-risk rules, it is important to note that:

1. IRC §42 is not specifically referenced in IRC §49, and
2. the credit at-risk rules under IRC §42(k)(1) are "similar to," but not exactly the same as, the IRC §49 rules.

Generally, under IRC §49(a)(1), the "credit base" of property is reduced by the nonqualified nonrecourse financing, but the rules are applied differently for purposes of IRC §42(k).

1. Under IRC §49(a)(1)(E), if the taxpayer is a partnership, then the determination of whether a partner's allocable share of any financing is nonqualified nonrecourse financing is made at the partner level and in the same manner as the credit is allowable under IRC §38.
2. Under IRC §42(k)(1), the IRC §42 building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing on the building. See Chapter 13 for complete discussion of Qualified Basis.

### **"At Risk" and Nonrecourse Financing**

In general, IRC §465(b) provides that a taxpayer is considered "at risk" for the following:

1. capital contributions (money and the adjusted basis of any property contributed), and
2. amounts borrowed with respect to the activity for which the taxpayer has a personal liability or has pledged property as security (recourse financing).

IRC §49(a)(1)(D)(i) provides that nonqualified nonrecourse financing is any non-recourse financing that is not “qualified commercial financing.” IRC §49(a)(1)(D)(ii) defines qualified commercial financing, as financing with respect to any property if (1) such property is acquired by the taxpayer from a person who is not a related person, (2) the amount of nonrecourse financing does not exceed 80% of the credit base of the property being financed, and (3) the financing is borrowed from a “qualified person” or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government.

IRC §49(a)(1)(D)(iv) defines a qualified person as any person which is actively and regularly engaged in the business of lending money and which is not (1) a person related to the taxpayer, (2) a person from which the taxpayer acquired the property (or a related person to such person), or (3) a person who receives a fee relating to the taxpayer's investment in the property (or a related person to such person).

IRC §49(a)(1)(D)(iii) provides that “nonrecourse financing” includes (1) any amount by which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and (2) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to a person (other than the taxpayer) having such an interest.

IRC §49(a)(1)(D)(v) provides that the term “related person” has the same meaning as provided in IRC §465(b)(3)(C) and is determined as of the close of the taxable year in which the property is placed in service, unless regulations provide otherwise.

IRC §465(b)(3)(C) provides that a person is related to any person if:

1. the related person bears a relationship to such person specified in IRC §267(b) or IRC §707(b)(1), and substituting “10 percent” for “50 percent,” or
2. the related person and such person are engaged in trades or business under common control (within the meaning of IRC §52(a) and (b)).

IRC §§ 49(a)(2) and (b)(1) provide rules concerning net decreases and increases in nonqualified nonrecourse financing after the end of the taxable year in which the property is placed in service. As noted earlier, however, any reduction in the “credit basis” for IRC §49 purposes is equivalent to a reduction in the qualified basis of the IRC §42 low-income building.

## **Audit Techniques**

The application of the at-risk rules under IRC §42(k)(1) may result in a reductions of a low-income building's qualified basis. Therefore, the identification of any nonrecourse debt to which the at-risk rules apply must be made at the ownership level.

1. All documents, agreements, and debt instruments should be reviewed for debt associated with the financing of assets included in eligible basis. Regardless of how the taxpayer has classified the debt, consider whether the liability for repayment of the debt has been limited; e.g., guarantees, etc.



2. Review the partnership agreement to determine whether the agreement includes any guarantees that would limit liability for debt.

**Adjusting  
Qualified Basis**

Any reduction of qualified basis for nonqualified nonrecourse debt is made at the ownership level (usually a partnership) and will reduce the allowable IRC §42 credit allocable to the partners. See Chapter 13.

**Nonrecourse Financing from an Qualified Nonprofit Organization**

There is one exception to the general at-risk rules under IRC §42(k)(1) for non-recourse financing from a qualified nonprofit organization if certain criteria are met. If these requirements are met, the determination of whether such nonrecourse financing is qualified commercial financing with respect to any qualified low-income building is made without regard to whether such organization—

1. is actively and regularly engaged in the business of lending money, or
2. is a person described in IRC §49(a)(1)(D)(iv)(II); i.e., a person from which the taxpayer acquired the property (or a related person to such person).

**Qualified  
Nonprofit  
Organization  
Defined**

Under IRC §42(k)(2), the financing must be borrowed from a qualified nonprofit organization as defined in IRC §42(h)(5)(C):

1. the organization is described in IRC §501(c)(3) or (4) and is exempt from tax under IRC §501(a),
2. the organization is not affiliated with or controlled by a for-profit organization, and
3. one of its exempt purposes is the fostering of low-income housing.

This requirement is also met if the loan is made by a subsidiary (corporation) of a qualified nonprofit organization if 100% of the stock of such corporation is held by one or more qualified nonprofit organizations at all times during the period such corporation is in existence.

**Financing  
Secured by  
Property**

Under IRC §42(k)(2)(B), the financing must be secured by the qualified low-income building. This requirement does not apply, however, if the building is a federally assisted building as defined in IRC §42(d)(6)(B), and if:

1. a security interest in the building is not permitted by a federal agency holding or insuring the mortgage secured by the building, and
2. the proceeds from the financing (if any) are applied to acquire or improve the building.

Former IRC §42(d)(6)(B), which applies to buildings placed in service before July 31, 2008, defines a “federally-assisted building” as any building which is substantially assisted, financed, or operated under —

- section 8 of the United States Housing Act of 1937,
- section 221(d)(3) or 236 of the National Housing Act, or
- section 515 of the Housing Act of 1949.

For buildings placed in service after July 30, 2008, the Code section defining federally assisted buildings was moved to IRC §42(d)(6)(C)(i) and includes buildings substantially assisted, financed, or operated under the programs identified in former IRC §42(d)(6)(B), as well as “any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture.”

**Limited to 60% of Eligible Basis**

The requirement under IRC §42(k)(2)(C) is met if not more than 60% of the eligible basis of the qualified low-income building is attributable to such nonrecourse financing from the nonprofit organization at the end of any taxable year in the 15-year compliance period. The principal and interest of any governmental financing which is part of a wrap-around mortgage involving such financing is not included in the 60% limit.

**Repayment of Principal and Interest**

The requirement under IRC §42(k)(2)(D) is met if the financing is fully repaid on or before the earliest of:

1. the date on which the financing matures,
2. the 90<sup>th</sup> day after the close of the building’s 15-year compliance period, or
3. the date the building is refinanced or the building (to which such financing relates) is sold.

**Two Additional Requirements**

**Interest Rate**

Under IRC §42(k)(3), if the interest rate on the financing is less than the rate which is 1 percentage point below the applicable federal rate as of the time such financing is incurred, then the qualified basis (to which such financing relates) of the qualified low-income building shall be the present value of the amount of such financing, using as the discount rate such applicable federal rate.

For purposes of the preceding sentence, the rate of interest on any financing shall be determined by treating interest to the extent of government subsidies as not payable.

**Failure to Fully Repay**

Under IRC §42(k)(4), if the taxpayer fails to fully repay the financing as outlined in IRC §42(k)(2)(D), then the taxpayer’s tax for the year of such failure is increased by an amount defined as the “applicable portion of the credit.”

Under IRC §42(k)(4)(B) the applicable portion is the aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if the eligible basis of the building were reduced by the amount of financing that does not meet the requirements of IRC §42(k)(2)(D).

In addition, under IRC §42(k)(4)(A), interest on the applicable portion is assessed for the period beginning with the due date for the filing of the tax return for the first taxable year for which such credit was allowable, and ending with the due date for

the taxable year in which such failure occurs, determined by using the underpayment rate and method under IRC §6621.

IRC §42(k)(4)(C) makes rules similar to the rules of IRC §42(j)(4)(A) and (D) applicable for purposes of IRC §42(k)(4). The IRC §42(j) credit recapture rules are discussed in Chapter 16.

## **Right of First Refusal to Purchase**

Under IRC §42(i)(7)(A), tenants (in cooperative form or otherwise), a resident management corporation of a building, a qualified nonprofit organization as defined in IRC §42(h)(5)(C), or government agency may hold a right to purchase the building after the close of the building's 15-year compliance period for a price which is not less than the minimum purchase price.

### **Minimum Purchase Price**

Under IRC §42(i)(7)(B) the minimum purchase price is an amount equal to the sum of:

1. the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants), and
2. all federal, state, and local taxes attributable to the sale.

### **Purchase by Tenants**

Tenants may individually hold a right of first refusal to purchase their individual rental units.

For example, in PLR 200703024, the taxpayer owning the IRC §42 project wanted to amend the extended use agreement to provide tenants with a right of first refusal to purchase their units at the end of the compliance period. Under the right of first refusal, the purchase price for each unit would be affordable to the tenants because it would be based on the maximum applicable rents and would include a purchase discount. The IRS concluded that the right of first refusal granted to tenants as part of a condominium home ownership plan to purchase their units after the close of the compliance period applicable to each unit satisfied the IRC §42(i)(7)(A) requirements.

### **Impact on Federal Income Tax Benefits**

Under IRC §42(i)(7)(A), no federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal to purchase the building.

## **Qualified Contracts**

Under IRC §42(h)(6), a taxpayer must enter into a long-term agreement with the housing agency to provide housing for an "extended" time period after the end of the building's 15-year compliance period. Under IRC §42(h)(6)(E), the agreement terminates at any time if the building is acquired by foreclosure (or instrument in lieu of foreclosure) or, beginning after the 14<sup>th</sup> year of the building's compliance period, the housing agency is unable to present a "qualified contract" for the purchase of the low-income building by a person willing to maintain the building's low-income status. The state agency has one year beginning on the date the taxpayer submits a written request to the housing agency to find a person to acquire the taxpayer's

interest in the low-income portion of the building.

In summary, under IRC §42(h)(6)(F), a qualified contract is a bona fide contract to acquire (within a reasonable period after the contract is entered into) the non low-income portion of the building for fair market value and the low-income portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing agreement) of the sum of:

1. the outstanding indebtedness secured by, or with respect to, the building,
2. the adjusted investor equity in the building, plus
3. other capital contributions not reflected in the amounts described in (1) or (2) above, reduced by cash distributions from (or available for distribution from) the project.

A detailed description of the qualified contract is presented in Treas. Reg. §1.42-18. However, since the disposition of low-income buildings is anticipated to be after the end of the 15-year compliance period, the existence of a qualified contract does not impose any limit on any allowable credit during the 15-year compliance period or impose the credit recapture rules under IRC §42(j). See Chapter 16.

#### **Audit Issues**

There are two considerations as the taxpayer nears the end of the 15-year compliance period:

1. Is the taxpayer physically maintaining the IRC §42 project in a manner suitable for occupancy? See Chapter 12.
2. Is the taxpayer continuing to market and rent vacant low-income units to new low-income tenants? See Chapter 12.

If the answer to (1) or (2) above is “no,” then the taxpayer is subject to credit disallowance if the taxpayer is claiming credit for additions to qualified basis (see Chapter 15) and credit recapture under IRC §42(j). See Chapter 16.

#### **Bona Fide Debt**

A bona fide debt is one which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. See Treas. Reg. §1.166-1(c). To be a valid debt, the advance had to be made with a bona fide expectation that such amount would be repaid. In determining if there is a debtor-creditor relationship, the facts and circumstances pertinent to the advances is looked at along with the subjective intent of the parties.

Loan documents should be reviewed to determine whether the loans are bona fide debt. Supporting documents also include, but are not limited to, appraisal reports, historical and forecasted statements of operations and cash flows, guarantee agreements and balance sheets for guarantors.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument as debt or equity for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that

may be considered when making such a determination are the following:

1. whether there is an unconditional promise on the part of the issuer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonably foreseeable future,
2. whether the holder has the right to enforce the payment of principal and interest,
3. whether the holder's rights are subordinate to rights of general creditors,
4. whether the instruments give the holder the right to participate in the management of the issuer,
5. whether the issuer is thinly capitalized,
6. whether the holder of the instrument is related to the equity holder of the issuer,
7. the label placed upon the instrument by the parties, and
8. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in *Goldstein v. Commissioner*, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

1. a note or other evidence of indebtedness exists,
2. interest is charged,
3. there is a fixed schedule for repayments,
4. any security or collateral is requested to ensure payment,
5. there is any written loan agreement,
6. a demand for repayment has been made,
7. the parties' records, if any, reflect the transaction as a loan
8. any repayments have been made, and
9. the borrower was solvent at the time of the loan.

**Good Faith  
Intent**

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction to be a loan.

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. See *Fisher v. Commissioner*, 54 TC 905 (1970).

In *Story v. Commissioner*, 38 TC 936 (1962) acq., 1965-1 C.B. 5, the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligations. However, the Commissioner limited his acquiescence in this case to the factual nature of that particular case. Furthermore, the Commissioner stated that such acquiescence would not be considered the basis for issuing rulings in advance of the consummation of the transaction. See Rev. Proc. 65-4, 1965-1, C.B. 720.

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner*, 42 TC 936 (1964) in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will “continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor....where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received...” Action on Decision, 1976 A.O.D. LEXIS 364

See Chapter 8 for additional discussion of bona fide debt.

**Impact on Eligible Basis**

Costs financed with debt which is not bona fide debt are excluded from eligible basis.

**“Not-For-Profit” Rules and Economic Substance**

**IRC §183**

IRC §183 addresses activities not engaged in for profit. Under IRC §183(a), if an activity by an individual or S Corporation is not engaged in for profit, no deduction attributable to such activity shall be allowed except as otherwise provided in IRC §183.

IRC §183(c) defines an “activity not engaged in for profit” as any activity other than one with respect to which deductions are allowable for the taxable year under IRC §162 or under paragraph (1) or (2) of IRC §212.

**Treas. Reg. §1.42-4**

Treas. Reg. §1.42-4(a) specifically exempts ownership and operation of qualified low-income buildings under IRC §42 from the IRC §183 limitations. The regulation reads:

(a) Inapplicability to IRC §42. In the case of a qualified low-income building with respect to which the low-income housing credit under IRC §42 is allowable, IRC §183 does not apply to disallow losses, deductions, or credits attributable to the ownership and operation of the building.

The regulation, however, provides the following limitation.

(b) Limitation. Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under IRC §42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. See, e.g., IRC §§38(c), 163(d), 465, 469; *Knetsch v. United States*, 364 U.S. 361 (1960), 1961-1 C.B. 34 (“sham” or “economic substance” analysis); and *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978), 1978-1 C.B. 46 (“ownership” analysis).

**IRC §7701(o),  
Clarification of  
Economic  
Substance  
Doctrine**

Consistent with IRC §7701(o), a taxpayer’s investment in an IRC §42 project should not be challenged merely because the investment was made based on a tax incentive; i.e., the taxpayer made an investment (in form and substance) that the credit was intended to encourage. That does not mean, however, that all the transactions associated with the development and operation of IRC §42 projects are automatically safeguarded from the consideration of the economic substance doctrine.

IRC §7701(o) applies to transactions entered into after March 30, 2010, the date of enactment.

**Economic  
Substance  
Doctrine  
Implementation  
Procedures**

The decision to raise the codified economic substance doctrine must be made on a case-by-case basis and based on all the facts available. It is advisable that the factors outlined in LB&I Directive, LB&I-4-0711-015, be considered and analyzed in making this decision. Note that than individual transaction within an IRC §42 project, and not the entire project, may be considered to lack economic substance. Therefore, when determining whether to raise the codified economic substance doctrine in an IRC §42 project, all steps or transactions of the project must be considered.

**Impact on  
Eligible Basis**

Costs financed with debt which lacks economic substance and/or does not reflect a profit motive are excluded from eligible basis.

**IRC §45D, New Markets Tax Credit**

The IRC §45D, New Markets Tax Credit, provides a credit against federal income taxes for Qualified Equity Investments (QEIs) made in qualified community development entities (CDEs), which in turn invest the cash in one or more of the following “qualified low-income community investments” under IRC §45D(d)(1):

1. Any capital or equity investment in, or loan to, any qualified active low-income community business, the definition of which is dependent on the type of entity, the entity’s business activity, whether the entity is engaged in active conduct of the business and whether the entity’s income, activities, and assets qualify.
2. A loan purchased by a CDE from another CDE which is a qualified low-income community investment.
3. Financial counseling and other services to any qualified active low-income community business located in, or to any residents of, low-income communities.

4. Any equity investment in, or loan to, any CDEs.

The credit is 39% of the QEI and is claimed over the 7-year credit period. Under IRC §45D(a)(2), the applicable percentage is 5% for the first three years and 6% for the last four years. The IRC §45D credit is subject to recapture if, at any time during the 7-year credit period, there is a recapture event with respect to the investment.

Similar to IRC §42 investors, funds for investment as QEIs are often accumulated in “syndicated” partnerships, which then make QEIs in CDEs.

**Investment In  
IRC §42  
Projects Not  
Allowed**

If a CDE makes a capital or equity investment or a loan with respect to a qualified low-income building under IRC §42, the investment or loan is not a qualified low-income community investment to the extent the building’s eligible basis is financed by the proceeds of the investment or loan. See Treas. Reg. §1.45D-1(g)(3)(ii).

**Audit Issue:  
Loans from  
CDEs**

Since IRC §42 projects may be located in communities qualifying for IRC §45D investments, consideration should be given to whether:

1. A CDE made a direct equity or capital investment in the IRC §42 project; i.e., the CDE is a partner (directly or indirectly) in the taxpayer owning the IRC §42 project, or
2. Loan proceeds supporting assets in eligible basis are from a CDE,

And, if either (1) or (2) above is true, whether the investment or loan is treated as a qualified low-income community investment for purposes of IRC §45D.

**Step 1:  
Identify CDE**

To qualify as a CDE, an entity must be a domestic corporation or partnership that has a primary mission of serving, or providing investment capital for, low-income communities or low-income persons. Confirmation that an entity has current CDE status can be obtained at [www.cdfifund.gov](http://www.cdfifund.gov).

**Step 2:  
Capital or  
Equity  
Investments**

Determining whether a CDE’s investment in, or loan to, the IRC §42 project was treated as a qualified low-income community investment is beyond the scope of an audit of the IRC §42 credit. The IRC §45D program analyst should be contacted, as the IRC §45D credit may be subject to disallowance and/or recapture. Regardless of the outcome, the low-income building’s eligible basis will not be affected.

**Audit Techniques**

In addition to the capital investment by members of a partnership, financing may include temporary construction loans, permanent commercial debt, and federal subsidies such as tax-exempt bonds under IRC §146, federally-sourced below-market rate loans, and federal grants. Financing may also include “soft debt,” which is generally thought of as nonrecourse debt with favorable repayment terms. In addition, the deferred payment of costs included in eligible basis, such as a developer’s fee, should be examined to determine whether it is an indirect form of financing.



**Step 1:  
Identify  
Financial  
Sources**

1. The taxpayer's final cost certification should be reviewed to identify sources of financing the taxpayer disclosed to the state agency.
2. Analyze the liabilities disclosed on the balance sheet filed with the tax return.
3. Review the land records to determine whether debt instruments have been recorded as liens against the property.

**Step 2:  
Review Loan  
Documents**

Loan documents and repayment histories should be reviewed in detail.

1. What is the relationship between the taxpayer and the lender?
2. What are the terms of the debt instrument? Consider whether the debt reflects an arm's length transaction, particularly if the parties are related or one party is in a position to manipulate or camouflage a transaction.
3. What is the source of the funds? Are the funds federally sourced?
4. Is the debt bona fide debt?
5. Does the debt transaction have economic substance?

**Summary**

1. Federally sourced financing will limit the amount of credit that can be allocated to the building by either reducing eligible basis or restricting the applicable percentage to a 30% present value. Federal sourced financing includes tax-exempt bonds, federally sourced below-market rate loan (if the building was placed in service before July 31, 2008), and federal grants.
2. Nonrecourse financing is subject to at-risk rules, but there is an exception for financing from a qualified nonprofit entity under certain circumstances.
3. Neither a right of first refusal to purchase the low-income buildings nor the existence of a qualified contract to purchase the buildings affects whether the credit is allowable or the amount of the allowable credit.
4. A taxpayer's investment in an IRC §42 project is not subject to the IRC §183 limitations. However, consideration should be giving to whether debt is bona fide debt and whether a transaction reflects economic substance.
5. Costs financed with debt which is not bona fide debt are excluded from eligible basis.
6. Taxpayers owning IRC §42 projects are exempted from IRC §183 limitations. However, losses, deductions, or credits associated with the ownership and operation of a qualified low-income building under IRC §42 may be limited or disallowed under other provisions of the Code or principles of tax law.

7. For purposes of the IRC §45D, New Markets Tax Credit, if a CDE makes a capital or equity investments or a loan with respect to a qualified low-income building under IRC §42, the investment or loan is not a qualified low-income community investment to the extent the building's eligible basis is financed with the proceeds of the investment of loan.

## **Chapter 11**

### **Eligible Basis: Limitations and Adjustments**

**Introduction** Chapter 8 provided guidelines for analyzing the costs treated as eligible basis by the taxpayer. Chapter 9 addressed requirements specific to acquiring and/or rehabilitating an existing building. In Chapter 10, the taxpayer's financial resources were analyzed. Once the correct eligible basis is determined, adjustments are needed to account for limitations placed on the eligible basis. In this chapter, the following topics are addressed:

- Topics**
- Disproportionate Standards
  - Federal Grants
  - IRC §47, Rehabilitation Credit
  - IRC §48, Energy Credit
  - Supportive Services for the Homeless
  - Low-Income Buildings Financed with Tax-Exempt Bonds
  - Community Service Facilities
  - Low-Income Buildings in High Cost Areas
  - Summary

#### **Disproportionate Standards**

**IRC §42(d)(3):  
Dispropor-  
tionate  
Standards for  
Units**

A low-income building's eligible basis is reduced by the portion attributed to market-rate units and that are above the average quality standard of the low-income units. However, this basis reduction for disproportionate standards can be avoided to the extent the excess cost of the market-rate unit is not greater than 15% of the average cost per square foot of all the low-income units in the building and the taxpayer elects to exclude the excess cost of the market-rate unit from eligible basis. IRC §42(d)(3)(B)(ii) defines "excess" as the excess of the cost of a market-rate unit over the amount which would be the cost of the market-rate unit if the average cost per square foot of all low-income units in the building were substituted for the cost per square foot of the market-rate unit.

The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 9b.

#### **Example 1: Disproportionate Standards**

A mixed-use low-income building consists of 100 residential rental units. The 60 low-income units are 1,000 square feet on average and have an average cost of \$120,000 or \$120/sq. ft. The 40 market-rate units are also 1,000 square feet on average, but include upgraded appliances, granite counter tops, and hardwood floors which are not included in the low-income units. The cost of each market rate unit is \$156,000 or \$156/sq. ft. The taxpayer elected to exclude the excess cost of each market-rate unit from eligible basis and calculated eligible basis to be \$12,000,000 (100 units x \$120,000). Assuming the applicable percentage is 9%, the taxpayer computed the allowable credit as follows:

$$\$12,000,000 \times .60 \times .0900 = \$648,000$$

15% of the average cost per square foot for the low-income units is \$18/sq. ft. To be eligible for the IRC §42(d)(3)(B)(ii) election, the average cost of a market-rate unit cannot exceed (\$120 + \$18)/sq. ft. or \$138/sq. ft. Although the taxpayer made the election to reduce eligible basis on line 9b of Form 8609, the taxpayer does not qualify for the election for any of the market-rate units because the excess costs of these units is more the 15% of the average cost for the low-income units.

The eligible basis is limited to the cost of the low-income units, which is \$7,200,000, calculated as 60 units x \$120,000. The applicable fraction, however, remains 60%. Therefore, the allowable credit is computed as:

$$\$7,200,000 \times .60 \times .0900 = \$388,800$$

## Federal Grants

### IRC §42(d)(5)(A): Federal Grants

Under IRC §42(d)(5)(A), a building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant. The legislative history to the Tax Reform Act of 1986, which first implemented IRC §42 reads:

“Federal grants and other subsidies-Eligible basis may not include in any taxable year the amount of any Federal grant, regardless of whether such grant is included in gross income. A Federal grant includes any grant funded in whole or in part by the Federal government, to the extent funded with Federal funds. Examples of grants which may not be included in eligible basis include grants funded by Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.”

### Building Placed in Service Before July 31, 2008

Originally, IRC §42(d)(5)(A) considered all federal grants funding the development of a low-income building or used to operate the building once placed in service. The statute read:

“Eligible basis reduced by federal grants. 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.”

Issues to consider include:

1. Did the taxpayer receive federal grants before the beginning of the compliance period which (1) funded costs included in eligible basis, and (2) were outstanding at any time during the compliance period?
2. Did the taxpayer receive federal grants during the compliance period? If so, were the funds used for the building or its operation?

**Buildings  
Placed in  
Service After  
July 30, 2008**

IRC §42(d)(5)(A) was amended by section 3003(d) of the Housing Assistance Tax Act of 2008 to eliminate consideration of federal grants made to fund the operation of the low-income building. The Code now reads:

“Federal grants not taken into account in determining eligible basis. The eligible basis of a building shall not include any costs financed with the proceeds of a federally funded grant.”

**Federal Grants**

The following illustrate the types of federal grants, which, if used to fund costs otherwise allowable for eligible basis, prevent these costs from being included in eligible basis:

1. Housing Development Action Grants (HDAG) under the Housing and Urban-Rural Recovery Act of 1983.
2. Community Development Block Grants (CDBG) under Title I of the Housing and Community Development Act of 1974.
3. Urban Development Action Grants (UDAG) under Section 119 of the Housing and Community Development Act of 1974.
4. Rental Rehabilitation Grants under Section 17 of the U.S. Housing Act of 1937.
5. Grants made under the HOME program.

The above list is not intended to be all inclusive. Additional considerations involving federal grants include:

1. Grants may be received directly or indirectly from the Federal government. For example, a state or local government entity (or private source, such as a nonprofit entity) may receive federal grant funds directly from the Federal government and then make a grant of these funds to the project.
  - If the building was placed in service before July 31, 2008, the building’s eligible basis would be reduced by the amount of the grant.
  - If the building was placed in service after July 30, 2008, any costs funded by the grant cannot be included in the building’s eligible basis.
2. Eligible basis is reduced by the amount of the federally-sourced grant, regardless of whether the taxpayer includes the grant in gross income.
3. If the proceeds of a loan funded by a federal grant are used for a building and the loan is not reasonably expected to be repaid, then it is considered a federal grant.
4. If a federally-sourced grant is designated by the federal source for a specific purpose, then no portion of the funds can be redesignated for a different purpose.

**Federal Rental Assistance Payments**

Eligible basis is not reduced if the proceeds of a federal grant are used as a rental assistance payment under sections 8 or 9 of the United States Housing Act of 1937, or any rental assistance program designated by the IRS. See Treas. Reg. §1.42-16.

**Funds Not Considered Federal Grants**

As identified in the explanation of the Housing Assistance Tax Act of 2008 prepared by the Joint Committee on Taxation, none of the following is considered a grant made with respect to a building (eligible basis) or its operation:

1. Rental assistance under section 521 of the Housing Act of 1949,
2. Assistance under section 538(f)(5) of the Housing Act of 1949,
3. Interest reduction payments under section 236 of the National Housing Act,
4. Rental assistance under section 202 of the Housing Act of 1959,
5. Rental assistance under section 811 of the Cranston-Gonzalez National Affordable Housing Act,
6. Modernization, operating and rental assistance pursuant to section 202 of the Native American Housing Assistance and Self-Determination Action of 1996,
7. Assistance under title IV of the Stewart B. McKinney Homeless Assistance Act,
8. Tenant-based rental assistance under section 212 of the Cranston-Gonzalez National Affordable Housing Act,
9. Assistance under the AIDS Housing Opportunity Act,
10. Per diem payments under section 2012 of title 38, United State Code,
11. Rent supplements under section 101 of the Housing and Urban Development Act of 1965,
12. Assistance under section 542 of the Housing Act of 1949, and
13. Any other ongoing payment used to enable the property to be rented to low-income tenants.

**Section 1602 Grants**

Section 1602(a) of the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5) provides that the Department of the Treasury shall make a grant to the housing credit agency in an amount equal to the state's low-income housing grant election amount, which was limited to a percentage of the state's 2009 credit ceiling. The funds received by the agency in exchange for the credit were then used by the agency to make subawards to projects being developed.

Notice 2010-18 clarifies that the subawards are not federal grants. Specifically:

1. subawards are excluded from the gross income of recipients and are exempt from taxation, and
2. subawards used in a qualified low-income building are not federal grants for purposes of IRC §42(d)(5)(A) and do not otherwise reduce the depreciable or eligible basis of the building. See IRC §42(i)(9)(B).

**Tax Credit Assistance Program**

Enacted as part of the American Recovery and Reinvestment Tax Act of 2009, the Tax Credit Assistance Program (TCAP) administered by the Department of Housing and Urban Development (HUD) provides grant funding for capital investment in IRC §42 housing projects using a formula-based allocation of funds to state housing credit allocation agencies. The state housing agencies then distribute these funds through a competitive process according to their state's qualified allocation plan. Taxpayers receiving an allocation of IRC §42 credits in 2007, 2008, or 2009 are eligible for TCAP funding.

A taxpayer that received TCAP grants cannot include in eligible basis any costs financed with the proceeds of the grant. In addition, as clarified in CCA 201106008, taxpayers other than nonprofit or governmental entities generally include governmental grants in gross income under IRC §61(a) absent a specific exclusion. In this case, ARRA does not specifically exclude TCAP grants from gross income, and the Code does not contain any specific exclusion for such grants. Accordingly, TCAP grants are includible in a recipient's gross income for federal income tax purposes.

If the state agency distributed the grant funds as a bona fide loan, then it is a federal loan and is treated similarly to other federal loans.

## **Reporting Federal Grants**

### **Buildings Placed in Service Before July 31, 2008**

Taxpayer should reduce the total eligible basis of the building by the amount of any federal grants made to the building or for its operation. The reduction should be reflected in the eligible basis reported on Line 7 of Form 8609 Part II, First-Year Certification, and on Line 1 of Form 8609-A, Annual Statement for Low-Income Housing Credit.

If the federal grant was received after the end of the first year of the credit period, the taxpayer will use Form 8609-A line 14 to make the adjustment for the federal grant. This adjustment may result in (1) a reduction of the allowable annual credit amount and (2) application of the IRC §42(j) recapture provisions. See Chapter 16.

### **Buildings Placed in Service After July 30, 2008**

Determine whether any costs included in eligible basis as reported on Form 8609 line 7 were funded by federal grant funds. If so, eligible basis is reduced by the amount of these costs. Because eligible basis is determined at the close of the first year of the credit period, federal grants received after the first year of the credit period do not result in a reduction of a building's eligible basis.

## **Audit Issues**

Taxpayers may attempt to change the character of a federally-sourced grant by documenting the grant as a loan and then using the proceeds to construct low-income housing. Consider the following example.

### **Example 1: Changing the Character of Federal Grant**

A nonprofit entity applies for and receives a federal grant to construct affordable housing. The documentation identifies the name of the housing project, location, and characteristics of the housing. The nonprofit entity then applies for and receives an allocation of IRC §42 credit from a state agency, and subsequently forms a partnership with an investment group with the intention of constructing IRC §42 housing meeting specifications of both the federal grant and the credit allocation. The nonprofit entity serves as the general partner and intends to operate the housing project.

The nonprofit entity then loans the proceeds of the federal grant to the partnership to construct the housing. The loan period is longer than the extended use period (a minimum of 30 years under IRC §42(h)(6)(D)). The interest rate is zero or significantly lower than the applicable federal rate, and no payment of principal or interest is payable until the loan matures.

**Audit  
Techniques**

1. Review the balance sheet included with the tax return to identify loans and long-term debt.
2. For buildings placed in service before July 31, 2008, determine whether the taxpayer has elected, under IRC §42(i)(2), to exclude the principal amount of a federally subsidized loan from the building's eligible basis. The election is made on Form 8609 line 9a. If an election has been made, ensure that the taxpayer did not include the proceeds of the loan in eligible basis.
3. If a partner in the partnership is a nonprofit entity, further inquiry should be made to determine whether the nonprofit entity received any federal subsidies or grants, and whether such funds were loaned to the partnership and then used to construct IRC §42 housing.

Once a purported loan to the taxpayer has been identified, the following audit techniques should be used to establish the facts. See also Chapter 8.

1. Ask the taxpayer for the loan agreement and any other related loan documents. Consider whether the terms are particularly favorable; i.e., a low interest rate or no interest rate, no repayment required until the loan is due, or a loan period longer than the 15-year compliance period. Consider whether the lender realistically expects to receive payments. Also determine whether the loan is secured by the property, which establishes that the lender can receive the property in lieu of payment.
2. Interview the lender and determine the source of the funds used to make the loan. Also review documentation of the source of the funds. The documentation may identify the funds as a grant, loan, or other long-term payable. In addition, the documentation may identify the housing (by name, location, characteristics) for which the funds are to be used. This may indicate that the funds were originally intended by the federal source to be used for the low-income project and, if initially provided as a grant, could suggest that the funds should retain their original character as a federal grant.
3. Review the financial feasibility analysis completed by the state agency. The federal tax issue is resolved if the state agency reduced the eligible basis by the amount of the purported loan when determining how much credit to allocate to the building. Under IRC §42(m)(2), the state agency cannot allocate more credit to a project than is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. When the project is finished, the state agency evaluates the sources and uses of funds, and the total financing planned for the project. The owner must disclose the full extent of all federal, state and local grants and subsidies.



4. Determine whether the future value of the property securing the purported loan will equal or exceed the face value of the loan and accrued interest at the time the loan is due. Obtain an engineer's evaluation if the value of the property is in doubt.

**Conclusion**

If it can be established that (1) the funds loaned to the taxpayer are federally sourced, (2) the interest rate is below the applicable federal rate, and (3) the funds are included in eligible basis, then the tax treatment of the funds will be determined based on whether the future value of the property (reduced by any other debt on the property prior in right) equals or exceeds the face value of the loan plus interest at the time the loan comes due.

If the future value of the property (reduced by other debt on the property prior in right) does not equal, or is less than, the face value of the loan plus interest, then the purported loan will be deemed as not being able to be fully repaid and the funds, either fully or to the extent they cannot be repaid, will be treated as a federal grant and under IRC §42(d)(5)(A).

If the future value of the property (reduced by other debt on the property prior in right) is equal to, or greater than, the face value of the loan plus interest, then the funds will be treated as a federal loan and any cost paid from the loan proceeds may be includable in eligible basis. See Chapter 10 for additional discussion.

**IRC §47, Rehabilitation Credit****Law**

The IRC §47 Rehabilitation Credit provides a federal credit based on the cost of substantially rehabilitating qualifying buildings. The credit for any taxable year is computed as the sum of:

1. 10% of the qualified rehabilitation expenditures for any qualified rehabilitated building other than a certified historic structure, and
2. 20% of the qualified rehabilitation expenditures for an certified historic structure, as defined in IRC §47(c)(2)(B)(iv).

Under IRC §47(c)(2)(A)(i)(II), the IRC §47 qualified rehabilitation expenditures include amount properly chargeable to capital accounts for property for which depreciation is allowable under IRC §168 and which is residential rental property. The 10% credit is not allowable with respect to residential rental property under IRC §50(b)(2).

**Reduction of Adjusted Basis**

Under Treas. Reg. §1.48-12(e)(1) the basis of the rehabilitated property attributable to the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed.

## Example

### Example 1: Taxpayer Acquires Historic Structure

A taxpayer purchased an apartment building that has been designated a certified historic structure for \$3,000,000, \$500,000 of which is allocated to land. The taxpayer decided to rehabilitate the building for use as a 100% IRC §42 low-income building, and received an allocation of credit for both acquiring and rehabilitating the existing building. The taxpayer spent \$4,000,000 on expenses qualifying for the IRC §47 rehabilitation credit.

The taxpayer first computes the allowable IRC §47 credit:

$$\$4,000,000 \times 20\% = \$800,000$$

The taxpayer then reduces the adjusted basis of the rehabilitation costs by the amount of the IRC §47 credit.

$$\$4,000,000 - \$800,000 = \$3,200,000$$

The taxpayer computes the allowable annual IRC §42 credit for the cost of acquiring the building (less the \$500,000 cost of the land), using a 4% applicable percentage, as:

$$\$2,500,000 \times 100\% \times 4\% = \$100,000$$

The taxpayer computes the allowable annual IRC §42 credit for the rehabilitation costs, which are treated as a new building, using a 9% applicable percentage and the reduced adjusted basis, as:

$$\$3,200,000 \times 100\% \times 9\% = \$288,000$$

The adjusted basis of the rehabilitation expenses is also reduced by the amount of the IRC §47 credit for depreciation purposes. See Treas. Reg. §1.48-12(e)(1).

## IRC §48, Energy Credit

### Law

IRC §48(a)(2)(A)(i) provides a 30% credit for energy property (10% for some types of energy property) placed in service during the taxable year. IRC §48(a)(3)(A) defines “energy property” to mean:

- equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool (30% credit),
- equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight but only with respect to periods ending before January 1, 2017, (30% credit),

- equipment used to produce, distribute, or use energy derived from a geothermal deposit (within the meaning of IRC §613(e)(2), but only, in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission state (10% credit),
- qualified fuel cell property (30% credit), or qualified microturbine property (10% credit),
- combined heat and power system property (10% credit),
- qualified small wind energy property (30% credit), or
- equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, but only with respect to periods ending before January 1, 2017 (10% credit).

Under IRC §48(a)(3)(B), the construction, reconstruction, or erection of the “energy property” must be completed by the taxpayer, or if acquired by the taxpayer, original use of such property must commence with the taxpayer.

Under IRC §48(a)(3)(C), the “energy property” must be subject to depreciation (or amortization in lieu of depreciation).

IRC §48(a)(5) provides that a taxpayer may elect to treat certain property described in IRC §45(d) as “energy property” that is eligible for a 30% credit.

Under IRC §38(a)(3)(D), the “energy property” must meet the performance and quality standards (if any) which (1) have been prescribed by the Secretary by regulations (after consultation with the Secretary of Energy), and (2) are in effect at the time of the acquisition of the property.

The flush language following IRC §38(a)(3) further explains that “energy property” does not include any property which is part of a facility the production from which is allowed as a credit under IRC §45 for the taxable year or any prior taxable year.

**Reduction of Depreciable Basis Includible in Eligible Basis**

A taxpayer may include energy-producing systems as part of the IRC §42 project and include the cost in eligible basis. However, if the taxpayer claims the energy credit for the equipment under IRC §48, then the depreciable basis of the energy equipment must be reduced by 50% of the tax credits received. See IRC §50(c)(3).

For example, if a taxpayer constructs an IRC §42 project and includes qualifying solar panels with an adjusted basis of \$10,000, the taxpayer may claim an IRC §48 energy credit of \$3,000 and must reduce the eligible basis by \$1,500. For purposes of determining the eligible basis for the IRC §42 credit, the taxpayer would include \$8,500; i.e., \$10,000 - \$1,500.

**Section 1603 Grant Funds**

Under section 1603 of the American Recovery and Reinvestment Act, a taxpayer placing a qualifying renewable energy project in service may be eligible for a Section 1603 payment for 30% (or 10% for certain property). Under IRC §48(d)(3)(A), a Section 1603 payment is not includible in the taxpayer’s gross income but is taken into account in determining the basis of the property to which the payment relates. The Section 1603 payment is subject to rules similar to IRC §50; specifically, under

IRC §48(d)(3)(B), a taxpayer must reduce the basis of the property by 50% of the Section 1603 payment. This same basis reduction rule also applies for purposes of IRC §42.

For example, a taxpayer constructs an IRC §42 project, including solar panels with a depreciable (and eligible) basis of \$100,000. The taxpayer receives \$30,000 as a Section 1603 payment for the panels and reduces the \$100,000 depreciable and eligible basis of the panels by \$15,000, which represents 50% of the \$30,000 Section 1603 payment, to arrive at an IRC §42 eligible basis of \$85,000.

## **Supportive Services for the Homeless**

IRC §42(c)(1)(E) provides that if the taxpayer is providing transitional housing for the homeless under IRC 42(i)(3)(B)(iii), then a building's qualified basis shall be increased by the lesser of:

1. so much of the building's eligible basis as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
2. 20% of the buildings qualified basis (determined without regard to the portion of the building used to provide support services).

See Chapter 8 for additional discussion.

## **Low-Income Buildings Financed with Tax-Exempt Bonds**

IRC §103(a) provides that interest earned on state or local bonds is excluded from gross income if certain requirements are met. The maximum amount of bonds that can be issued under IRC §146 during any calendar year is referred to as the "volume cap" and is based on the population of the state or constitutional home rule city. The volume cap applies to tax-exempt multifamily housing bonds used to finance qualified residential rental projects under IRC §§ 142(a)(7) and 142(d), and can include low-income housing projects qualifying for the IRC §42 credit. That is, the low-income buildings can be financed with both tax-exempt bonds and equity investment.

One distinguishing feature of IRC §42 projects financed with tax-exempt bonds subject to the volume cap is that the credit assigned to the buildings is not "allocated" to the building from the state's housing credit ceiling as referenced in IRC §42(h)(1). Instead, under IRC §42(h)(4), the credit is associated with the IRC §146 volume cap. When the distinction is significant, projects financed with tax-exempt bonds are referred to as "buildings not subject to IRC §42(h)(1) by reason of IRC §42(h)(4)."

Credit allocations from the credit ceiling under IRC §42(h)(1) and credit associated with IRC §146 volume cap can be used together to finance a low-income housing project, in which case there will be two Forms 8609 to document the allowable credit from the different sources.

<b>Documentation of Bond Financing</b>	<p>Buildings financed with tax-exempt bonds are identified on Form 8609.</p> <ol style="list-style-type: none"> <li>1. If there is no allocation of IRC §42 credit, line 1a on Form 8609, the date of allocation, is left blank.</li> <li>2. Line 4 will reflect the percentage of the aggregate basis of the buildings and the land on which the buildings are located that is financed with tax-exempt bonds.</li> <li>3. Line 6a or 6d should be selected to note that the new construction or IRC §42(e) rehabilitation expenditure are federally subsidized.</li> </ol>
<b>Coordinating IRC §42 and IRC §142(d) Requirements</b>	<p>IRC §42 projects financed with tax-exempt bonds are subject to all the IRC §42 requirements, as well as requirements for the tax-exempt bond financing under IRC §142(d).</p>
<b>Eligible Basis Limitation</b>	<p>For purposes of examining the IRC §42 credit, there is only one limitation to consider. Under IRC §42(h)(4)(B), if 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds, then the credit is based on the entire eligible basis of the qualified low-income buildings, regardless of the source of funds used to finance the qualifying costs. If less than 50% of the aggregate basis of the building and land are financed with tax-exempt bonds, then only the eligible basis actually financed with the tax-exempt bonds is includable in eligible basis.</p>

**Example 1: Taxpayer Meets Requirement**

A state assigns \$500,000 of its volume cap under IRC §146 to an issue of exempt facility bonds designated for the development of a low-income residential project under IRC §142(d). The aggregate basis of the buildings and the land upon which the buildings are constructed is \$700,000. Under the terms of the bond indenture, \$490,000 of the proceeds will be used to finance costs includable in eligible basis of the buildings. The total eligible basis is \$575,000.

$$\$500,000 \div \$700,000 = 71.43\%$$

Since more than 50% of the aggregate basis of the buildings and land upon which the buildings are located is financed with tax-exempt bond proceeds, the taxpayer may:

1. Claim IRC §42 credit without an allocation under IRC §42(h)(1), and
2. The IRC §42 credit amount is based on the total \$575,000 eligible basis of the low-income buildings, regardless of whether the costs were financed with the proceeds of the tax-exempt bond.

## Example 2: Taxpayer Fails to Meet Requirement

A state assigns \$500,000 of its volume cap under IRC §146 to an issue of exempt facility bonds designated for the development of a low-income residential project under IRC §142(d). The aggregate basis of the buildings and the land upon which the buildings are constructed is \$1,100,000. The basis attributable to the buildings is \$850,000 and the basis attributable to the land is \$250,000. Under the terms of the bond indenture, \$490,000 of the proceeds will be used to finance costs includable in eligible basis of the buildings.

$$\$500,000 \div \$1,100,000 = 45.45\%.$$

Since less than 50% of the aggregate basis of the buildings and land on which the buildings are located is financed with tax-exempt bonds, only the qualifying costs financed with the proceeds of the tax-exempt bond can be included in eligible basis. In this case, eligible basis is limited to \$490,000.

### **Allocating Bond Proceeds**

Treas. Reg. §1.42-1T(f)(1)(ii) reads:

“(ii) Determining use of bond proceeds. For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in § 1.103-13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

### **Audit Techniques**

To verify the original allocation of costs, review the bond indenture and related documents, and then compare to the computation of eligible basis and the aggregate basis of buildings and land.

## Example 1: Costs Not Allowable in Eligible Basis Allocable to Land

A taxpayer received \$5,000,000 of tax-exempt bond financing which is used, with \$3,500,000 in capital contributions, to acquire and rehabilitate an existing residential rental building. The taxpayer made the following allocations:

Land: \$500,000  
Acquired Building: \$3,000,000  
Rehabilitation Cost: \$5,000,000

Since more than 50% of the cost of the combined land and building costs are financed with the tax-exempt bonds, the taxpayer computed the eligible based on the entire \$8,000,000; i.e.,

$$\$5,000,000 \div \$8,500,000 = 58.82\%$$

The examiner determined that the taxpayer had undervalued the cost of the land when allocating the purchase price between the land and existing building. The examiner determined that the correct value of the land was \$1,500,000 and the cost allocated to the acquired building was \$2,000,000. Accordingly, the examiner adjusted the eligible basis used to compute the credit for the acquisition of the building. However, when the cost of the land and buildings is totaled, the combined costs are still \$5,000,000 and 58.82% of costs are financed with the tax-exempt bond proceeds. No additional adjustment is needed.

#### Example 2: Allocating Tax-Exempt Bond Proceeds

A taxpayer received \$5,000,000 of tax-exempt bond financing which is used, with \$4,500,000 in capital contributions, to acquire and rehabilitate an existing residential rental building. The taxpayer made the following allocations:

Land: \$500,000  
Acquired Building: \$3,000,000  
Rehabilitation Cost: \$5,000,000

The taxpayer also incurred \$1,000,000 in costs that were not includable in eligible basis or the aggregate basis of the building and land.

The taxpayer has eligible basis of \$8,000,000

The taxpayer reported that all \$5,000,000 of the bond proceeds were used to finance the rehabilitation costs. Consequently, more than 50% of the cost of the combined land and building costs are financed with the tax-exempt bonds; i.e.,

$$\$5,000,000 \div \$8,500,000 = 58.82\%$$

Therefore, the taxpayer computed the eligible basis based on the entire \$8,000,000 and claimed credit under IRC §42(h)(4).

The examiner reviewed the tax-exempt bond indenture, which specified that \$1,000,000 of the proceeds must be used to finance certain costs of the project that are not includable in the aggregate basis of the building and the land or in the eligible basis. The indenture also requires that the remaining \$4,000,000 be used to finance the rehabilitation of the building. Applying the allocation in the indenture, the examiner determined that less than 50% of the aggregate basis of the building and land on which the building is located was financed by tax-exempt bonds:

$$\$4,000,000 \div \$8,500,000 = 47.06\%$$

Therefore, under IRC §42(h)(4)(A), only the portion of the IRC §42 credit attributable to the eligible basis financed by the tax-exempt bonds is exempt from the IRC §42(h)(1) credit allocation requirement. Because the state did not allocate any IRC §42 credit to the project from the state's credit ceiling under IRC §42(h)(1), the taxpayer will not be entitled to any amount of IRC §42 credit attributable to any portion of the eligible basis not financed by the tax-exempt bonds.

## Community Service Facilities

### IRC §42(d)(4)(C): Community Service Facility

Beginning with credit allocations after December 31, 2000, IRC §42(d)(4)(C) provides that the eligible basis of a qualified low-income building located in a qualified census tract can include a specified portion of a community service facility's adjusted basis. If financed with tax-exempt bonds, IRC §42(d)(4)(C) applies to buildings placed in service after December 31, 2000, but only with respect to bonds issued after December 31, 2000.

A "community service facility" is any facility:

1. Located in a qualified census tract (discussed later).
2. Designed to serve primarily individuals whose income is 60% or less of area median gross income (AMGI) within the meaning of IRC §42(g)(1)(B). Rev. Rul. 2003-77 provides that this requirement is satisfied if the following conditions are met. First, the facility must be used to provide services that will improve the quality of life for community residents. Second, the taxpayer must demonstrate that the services provided at the facility are appropriate and helpful to individuals in the area of the project whose income is 60% or less of AMGI. This may, for example, be demonstrated in the market study required under IRC §42(m)(1)(A)(iii), or another similar study. Third, the facility must be located on the same tract of land as one of the buildings that is part of the qualified low-income housing project. Finally, if fees are charged for services provided, they must be affordable for individuals whose income is 60% or less of AMGI.
3. Used throughout the taxable year as a community service facility.

### Adjusted Basis Limitation

In addition to the requirements above, the increase in the eligible basis of any low-income building attributable to the adjusted basis of any community service facility is limited. For purposes of limiting the costs included in eligible basis, all community service facilities associated with the same qualified low-income housing project are treated as one facility.

### Buildings Placed in Service Before July 31, 2008

The adjusted basis of any community service facility included in eligible basis cannot exceed 10% of the eligible basis of the qualified low-income housing project of which it is a part.



### **Buildings Placed in Service After July 30, 2008**

The adjusted basis of any community service facility included in eligible basis cannot exceed the sum of:

1. 25% of so much of the eligible basis of the qualified low-income housing project of which it is a part as does not exceed \$15,000,000, plus
2. 10% of so much of the eligible basis of such project as is not taken into account under (1) above.

#### **Example**

An example of a qualifying community service facility is described in Rev. Rul. 2004-82, Q&A #2.

A new qualified low-income building received a housing credit allocation on June 1, 2003, and was placed in service in 2004. The building is located in a qualified census tract (as defined by IRC §42(d)(5)(B)(ii), formerly IRC §42(d)(5)(C)). The neighborhood in which the building is located is an area with a high rate of crime. In 2004, the local police department leases a unit in the building to be used as a police substation. The substation is part of the police department's community outreach program and is intended to serve as a deterrent to crime in the community, assist the community with solving crime-related problems, reduce the response time to area calls for service, and provide the locally assigned police officers with a local office. The services provided by the police are free of charge. The substation's adjusted basis does not exceed 10% of the building's eligible basis.

As required by IRC §42(m)(1)(A)(iii), prior to the allocation of low-income housing credit to the building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by the building. The study found, among other items, that due to the high rate of crime in the community in which the building is located, providing a police substation would be appropriate and helpful to individuals in the area of the building whose income is 60% or less of AMGI.

The substation qualifies as a community service facility under IRC §42(d)(4)(C)(iii). Under the facts presented, the substation is designed to serve primarily individuals whose income is 60% or less than AMGI for the following reasons:

1. the services provided at the substation are services that will help improve the quality of life for community residents;
2. the market study found that the services provided at the substation would be appropriate and helpful;
3. the substation is located within the building; and
4. the services provided at the substation are affordable to low-income individuals.

Because the other requirements in IRC §42(d)(4)(C) are met, the building's adjusted basis will include the substation's adjusted basis; i.e., the substation's adjusted basis is includable in the building's eligible basis.

## Low-Income Buildings in High Cost Areas

After considering all the limitations to eligible basis discussed above, the modification for high cost areas is made. Under IRC §42(d)(5)(B), if a low-income building is located in a high cost area, then the eligible basis of a new building or the eligible basis associated the rehabilitation of an existing building can be increased to as much as 130% of the actual cost. Buildings receiving this increase in eligible basis are identified on Form 8609, Part I, line 3b. This increased eligible basis is often referred to as a “stepped up” eligible basis.

### **Qualified Census Tracts**

Certain census tracts qualify for the increase in eligible basis. The designation is made by Department of Housing and Urban Development (HUD) and is based on the character of the population; i.e., more individuals fitting the “low income” definition within a limited area. Under IRC §42(d)(5)(B)(ii)(I), a “qualified” census tract is any HUD-designated census tract in which 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%.

### **Difficult to Develop Areas (DDA)**

As defined in IRC §42(d)(5)(B)(iii)(I), “Difficult to Develop Areas” (DDAs) are areas designated by HUD where the costs of construction, land, and utilities are high compared to the area median gross income. In these locations, more credit is needed to subsidize costs that exceed the maximum costs otherwise allowable in eligible basis.

### **Gulf Opportunity Zone**

Under IRC §1400N(c)(3), the Gulf Opportunity (GO) Zone, Rita GO Zone, and Wilma GO Zone are treated as IRC §42(d)(5)(B)(iii)(I) difficult development areas. State agencies may increase the eligible basis of low-income buildings located in these areas if:

1. the building was placed in service after December 31, 2005 and before January 1, 2011, and
2. a credit allocation to the building was made after December 31, 2005, and before January 1, 2009, or, to the extent the building was financed with tax-exempt bonds, the bonds were issued after December 31, 2005.

### **State Agency Designation**

For buildings placed in service after July 30, 2008, state agencies can, under IRC §42(d)(5)(B)(v), designate buildings requiring an increase in credit in order for the building to be financially feasible and treat them as being located in a DDA. However, a state agency cannot designate buildings as requiring an increase in credit if any portion of the building’s eligible basis is financed with tax-exempt bonds under IRC §142(d).

### **Coordination with 40-50 Rule under Former IRC §42(i)(2)(E)**

If the building was placed in service before July 31, 2008, and is subject to the 40-50 Rule, then the building does not qualify for the increase in credit for buildings located in qualified census tracts or difficult development areas. Buildings subject to this rule are documented on Form 8609, line 6f. See former IRC §42(i)(2)(E) and Chapter 13.

## Audit Techniques

1. The taxpayer should provide documentation demonstrating that the low-income buildings are located in a qualifying area.
2. Lists of qualified census tracts designated by HUD and DDAs are available at [www.huduser.org/datasets/qct.html](http://www.huduser.org/datasets/qct.html).

## Example

### Example 1: Low-Income Building Located in Qualified Census Tract

A taxpayer claimed IRC §42 credit for a new building based on an eligible basis of \$10,000,000. The taxpayer also qualified for an increase in eligible basis to 130% of the actual costs. When reporting the building's eligible basis on Form 8609-A, line 1, the taxpayer entered \$13,000,000.

The examiner made adjustments to the actual costs included in eligible basis equaling \$700,000. The actual eligible basis is \$10,000,000 - \$700,000 = \$9,300,000. When multiplied by 130%, the corrected eligible basis is \$12,090,000. The adjustment to eligible basis is:

$$\$13,000,000 - \$12,090,000 = \$910,000.$$

## Summary

1. If the quality standards of a market-rate unit are above the average quality standards of the low-income units in the building, then the building's eligible basis is reduced by the eligible basis attributable to the market-rate unit. An exception applies if (1) the excess cost of the market-rate unit is not greater than 15% of the average cost per square foot of the low-income units, and (2) the taxpayer elects to exclude the excess cost from the building's eligible basis. The election is made on Form 8609, line 9b.
2. A building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant. Federal grants are funds which originate from a federal source and which do not require repayment.
3. Taxpayers providing transitional housing for the homeless can include a specified portion of the building used to provide supportive services designed to assist tenants in locating and retaining permanent housing in eligible basis.
4. IRC §42 projects financed with tax-exempt bonds are subject to all the IRC §42 requirements, as well as requirements for the tax-exempt bond financing under IRC §142(d). If 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds, then the credit is based on the entire eligible basis of the qualified low-income buildings, regardless of the source of funds used to finance the qualifying costs. If less than 50% of the aggregate basis of the building and land are financed with tax-exempt bonds, then only the eligible basis actually financed with the tax-exempt bonds is includable in eligible basis.

5. The IRC §47, Rehabilitation Credit, and IRC §48, Energy Credit, require reductions of the adjusted basis used to determine the eligible basis for IRC §42 purposes.
6. IRC §42 projects can include community service facilities designed to serve individuals with qualifying income in the qualified census tract in which the project is located. The adjusted basis of such facilities includable in eligible basis is limited to a specified percentage of eligible basis.
7. If a low-income building is located in a high cost area, the eligible basis of a new building or the eligible basis associated the rehabilitation of an existing building can be increased by as much as 130% of the actual cost.

## Chapter 12

### Applicable Fraction

**Introduction** The applicable fraction is the percentage of rental units in a building that qualify as low-income units. The taxpayer reports the applicable fraction on Form 8609-A, Annual Statement for Low-Income Housing Credit, line 2.

To qualify as a low-income unit under IRC §42(i)(3), a residential rental unit must meet three basic requirements:

1. the unit must be occupied by an income-qualified household,
2. the rent must be restricted, and
3. the unit must be suitable for occupancy.

In addition, there are four IRC §42 requirements that are also applied on a unit-by-unit basis: the Available Unit Rule, the Vacant Unit Rule, the General Public Use Requirement, and the Transient Use Rule. Consideration is also given to whether the low-income units are placed in service and whether the building is depreciable.

Finally, the taxpayer must provide a minimum amount of low-income housing, determined at the project level.

- Topics**
- Law
  - Income-Qualified Households
  - Rent Restrictions
  - Suitability for Occupancy
  - Available Unit Rule
  - Vacant Unit Rule
  - General Public Use and Transient Use
  - On-Going Business Activity
  - Computing the Applicable Fraction
  - Minimum Set-Aside
  - Deep Rent Skewing
  - Summary

**Additional Resources** The IRS maintains a Guide for Completing Form 8823 to assist state agencies in completing the compliance monitoring responsibilities and report noncompliance on Form 8823 consistently. References to specific chapters of the “Form 8823 Guide” are included in this chapter as a source of additional information. The Guide is available on [irs.gov](http://irs.gov) or by contacting the IRC §42 program analyst.

### Law

#### Applicable Fraction Defined

Under IRC §42(c)(1)(B), the applicable fraction is the smaller of the unit fraction or the floor space fraction.

- IRC §42(c)(1)(C) defines “unit fraction” as the fraction, the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units in such building.

- IRC §42(c)(1)(D) defines “floor space fraction” as the fraction, the numerator of which is the total floor space of the low-income units in such building, and the denominator of which is the total floor space of the residential rental units. Floor space includes the entire footprint of the unit, including closets within the unit and balconies attached to the unit for the sole use of the tenants occupying the unit.

The applicable fraction is carried out four decimal places on Form 8609-A, line 2.

**Bright Line Test**

Under IRC §42(c)(1)(A), the applicable fraction is determined on the last day of the taxable year.

**Special Rule for the First Year of the Credit Period**

Under IRC §42(f)(2)(A), there is a special rule for computing the applicable fraction 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 placed in service or available for occupancy. Examples are provided later in this chapter.

Under 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.

**Acquired and Rehabilitated Buildings**

If a building was acquired and then rehabilitated, there are two credit allocations and the taxpayer will file two Forms 8609-A with its tax return; one for the acquisition credit and another for the rehabilitation credit. The taxpayer, however, is not required to determine two applicable fractions. Under IRC §42(e)(4)(B), the applicable fraction for the substantial rehabilitation credit is the same as the applicable fraction for the acquisition credit.

**Owner-Occupied Buildings**

Under IRC §42(i)(3)(C), for buildings with four or fewer residential units, no unit in the building is treated as a low-income unit if the units in the building are owned by:

- any individual who occupies a residential unit in such building, or
- any person who is related to such individual (as defined in IRC §42(d)(2)(D)(ii)); i.e., a person is related to any person if the related person bears a relationship to such person specified in IRC §§267(b) or 707(b)(1), or the related person and such person are engaged in trades or businesses under common control (within the meaning of IRC §52(a) and (b)).

However, under IRC §42(i)(3)(E), for owner-occupied buildings having four or fewer units eligible for the credit, IRC §42(i)(3)(C) does not apply to the acquisition or rehabilitation of a building pursuant to a development plan of action sponsored by a state or local government or a qualified nonprofit organization (as defined in IRC §42(h)(5)(C)). Under this exception, the applicable fraction cannot exceed 80% of the unit fraction and any unit which is not rented for 90 days or more is treated as occupied by the owner of the building as of the first day it is not rented.

## Income-Qualified Households

### Area Median Gross Income (AMGI) Defined

Under IRC §42(g)(1), the taxpayer elects to provide low-income housing for individuals whose incomes is either (1) 50% or less of AMGI or (2), 60% or less of AMGI. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10c.

Under §142(d)(2)(B), the AMGI and an individual's income are determined in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937. The determinations are adjusted for family size and are specific to the IRC §42 project's location. IRC §42(g)(4) applies §142(d)(2)(B) to IRC §42 projects.

Notice 88-80 explains that AMGI (adjusted for family size) and individuals' income for purposes of IRC §42(g)(1) are determined using HUD's definitions of income for section 8 purposes and will not be made by reference to items of income used in determining gross income for purposes of computing federal income tax liabilities. In CCA 201046014, Chief Counsel confirmed that:

“..the published 50% or 60% income limitations for the HUD section 8 program should [be applied]...IRC §142(d)(2)(B)(i), through IRC §42(g)(4), controls income limits for IRC §42(g)(1) purposes. We read that section as Exam does that it is the Secretary of Treasury (not the Secretary of HUD) that makes the determination of what income limitations control for IRC §42 purposes in a manner consistent with determinations of lower income limits under HUD section 8...Ultimately, the issue comes down to how one interprets the first sentence of IRC §142(d)(2)(B)(i), particularly the words “in a manner consistent with.” We interpret this language, literally, to mean that the published HUD section 8 limits are used.”

### Alternative Income Limits

The National Nonmetropolitan Median Gross Income (NNMGI) is used instead of the AMGI, if:

1. IRC §1400N(c)(4), Special Rule for Applying Income Tests, is applicable. The IRC §42 project was (1) placed in service during 2006, 2007, or 2008, (2) is located in the Gulf Opportunity Zone, and (3) in a nonmetropolitan area as defined in IRC §42(d)(5)(B)(iv)(IV); i.e., the term “nonmetropolitan area” means any county (or portion thereof) which is not within a metropolitan statistical area.
2. IRC §42(i)(8) is applicable. The IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949) and the NNMGI is greater than the AMGI. IRC §42(i)(8) is not applicable if the low-income building is financed with tax-exempt bonds. IRC §42(g)(8) is applicable to determinations made after July 30, 2008.

Under the terms of an extended use agreement, a taxpayer may agree to provide housing for tenant populations at income levels lower than identified in IRC §42(g). Nonperformance of such state imposed requirements is not noncompliance resulting in loss of credit.

**Determining  
Income Limits  
Before 2009**

The AMGI amounts are determined by HUD. For years before 2009, HUD published three income limits for its housing programs; 30% of AMGI, 50% of AMGI (very low income) and 80% of AMGI (low-income). Taxpayers electing to provide low-income housing for household with income at 50% of AMGI or less, could use HUD's AMGI determination for very low income (50%) without further adjustments. However, HUD did not provide income at 60% of AMGI. As explained in Rev. Rul. 89-24, if the taxpayer elected to provide low-income housing for households with income at 60% or less than AMGI, the 50% AMGI value is multiplied by 120% to compute the 60% AMGI. The value is not rounded.

**Determining  
Income Limits  
After 2008**

Before 2009, HUD applied a general "hold harmless" policy when determining the income limits so that the income limits never decreased for any housing program relying on HUD's AMGI determinations.

In 2009, HUD began publishing separate income limits for 50% and 60% of AMGI for low-income housing provided under IRC §§ 42 and 142(d), which HUD refers to as "Multifamily Tax Subsidy Projects" (MTSP). It became necessary to separately determine income limits for MTSPs in order to apply a specific "hold harmless" rule under IRC § 142(d)(2)(E) for calendar years after 2008 that is not applicable to income limits used for HUD's housing programs. Effectively, the income limits used to determine whether a household is income qualified will never be less than the income limits the taxpayer initially used to determine whether a household was income-qualified. As a result:

1. the instructions in Rev. Rul. 89-24 to compute 60% AMGI are no longer needed.
2. the income limits used for HUD section 8 apply to IRC §42 projects placed in service after 2008 and the MTSP hold harmless rule apply.

For 2010 and later taxable years, "MTSP" income limits and AMGI are interchangeable terms.

**HERA Special  
Income Limits**

In areas where the income limits did not decrease in 2007 and 2008, the MTSP tables include a second set of income limits identified as "HERA Special 50%" and "HERA Special 60%." These income limits are applicable if the taxpayer relied on HUD's income limits in either 2007 or 2008.

1. If the project was in service, or placed in service during 2007 or 2008, the taxpayer relied on HUD's income limits to determine whether household were income-qualified.
2. The hold harmless rule is applied at the project level. Every low-income building is a separate project unless the taxpayer elects to include the building in a multi-building project as documented on Form 8609 line 8b.
3. If the taxpayer has grouped the buildings into multiple multi-building projects, then the HERA special income limits will apply to the projects placed in service before 2009 and the regular MTSP income limits will apply to projects placed in service after 2008.



4. 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.
5. If a taxpayer relied on Rev. Proc. 2003-82 to qualify tenants before 2009, then the taxpayer relied upon the HUD income limits and the project is subject to the HERA special income limits even though the rehabilitation was not placed in service until after 2008.
6. If the project is subject IRC §1400N(c)(4) because it 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), then the HERA special income limits are not applicable. The taxpayer continues to use the NNMGI to determine the income limits.
7. If the IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949), then the taxpayer will use the greater of the HERA special income limits or the NNMGI.
8. If a taxpayer placed an IRC §42 project in service in 2008, but did not begin the 10-year credit period until 2009, then the HERA special income limits should be used because the project was placed in service no later than 2008. Presumably, if the building and units are ready and available for occupancy in 2008, the taxpayer relied 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 period.
9. If the taxpayer is subject to the 40-50 rule under former IRC §42(i)(2)(E), then the MTSP income limits, AMGI, or the alternative HERA Special Income Limits should be used to determine the 50%. This rule is explained later in this chapter.
10. The "HERA Special" income limits are applicable to the project for the entire extended use period under IRC §42(h)(6). However, if the taxpayer (or a subsequent owner) receives a new allocation of credit and begins a new credit period in the future, the taxpayer would use the normal MTSP income limits because the taxpayer did not rely upon HUD's income limits in either 2007 or 2008 for the new allocation.

**Reliance on HUD Income Limits**

A taxpayer may rely on HUD's income limits until 45 days after the IRS publishes notice of such change in the Internal Revenue Bulletin, or a new effective date is published by HUD in connection with revised income limits. See Rev. Rul. 94-57.

During the 45-day implementation period, the outdated and new income limits "overlap" and a taxpayer can use either the old or new income limits.

Example 1: A taxpayer placed a new low-income building in service in July of 2014 and started renting units using the 2014 income limits to determine whether households are income-qualified. 2015 will be the first year of the credit period. The 2015 income limits, released by HUD on December 1, 2014, are lower than the 2014 income limits. The 45-day implementation period is December 1, 2014 through January 14, 2015.

- All of the tenants determined to be income-qualified using the 2014 income limits before the beginning of the credit period on January 1, 2015, continue to be qualified low-income households. Further, for purposes of “testing” income at the beginning of the credit period under Rev. Proc. 2003-82, the taxpayer may rely on the 2014 income limits to determine whether the Available Unit Rule is applicable.
- Since the taxpayer relied upon the 2014 income limits to determine whether tenants are income-qualified, the 2014 income limits are the “base” year for purposes of the hold harmless rule under IRC §142(d)(2)(E)(i). The taxpayer may continue to qualify new tenants using the 2014 income limits.

For buildings placed in service during the 45-day implementation period, the taxpayer can choose which income limits to use for all purposes (including elections), and may choose which income limits to use (outdated or new) based on which provides the greater tax benefit.

Example 2: The 2015 income limits are released by HUD on December 1, 2014. The 45-day implementation period is December 1, 2014 through January 14, 2015. The 2015 income limits are lower than the 2014 income limits for the location of a building, which the taxpayer places in service on January 3, 2015. The taxpayer decides to use the higher 2014 income limits.

- Beginning January 3, 2015, the taxpayer may use the higher 2014 income limit to determine whether a household is income-qualified.
- Since the taxpayer initially relied upon the 2014 income limits to determine whether tenants are income-qualified, the 2014 income limits are the “base” year for purposes of the hold harmless rule under IRC §142(d)(2)(E)(i). The taxpayer can continue to use the 2014 income limits after January 14, 2015.

**Household Defined**

As a general rule, a “household” consists of all individuals residing in a unit. See Chapter 4 of the Guide for Completing Form 8823 for an in-depth discussion.

**Household Income Defined**

A household’s income is determined using HUD’s definitions of income rather than using the definition of income for computing federal income taxes. See Notice 88-80. Generally, income is based on wages, business activities, and the use of assets. Refer to Chapter 4 of the Guide for Completing Form 8823 for complete discussion.

**Qualified Low-Income Household**

To determine whether a household is a qualified low-income household, the combined anticipated annual income of all occupants of the unit, whether or not legally related, is compared to the appropriate percentage of AMGI for a family with the same number of members. The household is a qualified low-income household if the household's income is equal to or less than the income limit for a family of equal size at the time the household moves into the unit.

**Increases in Household Size**

A household's size may increase during tenancy.

1. For mixed-use projects, with both market rate and low-income units, a new tenant's income is added to the income disclosed on the existing household's most recent tenant income certification, which is completed annually. The new household continues to be income qualified for purposes of the Available Unit Rule under IRC §42(g)(2)(D), which will be discussed later in this chapter.
2. For a 100% low-income project, the new tenant's income is added to the income disclosed on the existing household's original income certification because, beginning July 31, 2008, a taxpayer is no longer required to complete annual income certifications for 100% low-income project. The same rule applies for tax years ending before July 31, 2008, if the taxpayer received a waiver of the income recertification requirement under Rev. Proc. 2004-38 or Rev. Proc. 94-64. Otherwise, the treatment for mixed-use projects described in (1) above is applicable.

A household may continue to add members as long as at least one member of the original low-income household continues to live in the unit. Once all the original tenants have moved out of the unit, the remaining tenants must be certified as a new income-qualified household unless:

1. for mixed-used projects, the newly created household was income qualified, or the remaining tenants were independently income qualified at the time they moved into the unit, or
2. for 100% low-income buildings, the remaining tenants were independently income qualified at the time they moved into the unit.

**Decreases in Family Size**

Decreases in family size do not trigger the immediate income certification of a new household. Instead, subsequent annual income recertifications are based on the income of the remaining members of the household. If the remaining household's income is more than 140% (170% in deep rent skewed projects) of the income limit at the time of the annual income recertification, then the Available Unit Rule is applicable.

**40-50 Rule: Assistance Provided Under the HOME Investment Partnership Act or NAHASDA**

For buildings placed in service before July 31, 2008, former IRC §42(b)(2)(B)(ii) (now IRC §42(b)(1)(B)(ii)) provides that the applicable percentage for new buildings that are federally subsidized is the 30% present value percentage. Former IRC §42(i)(2)(A) provided that a new building is federally subsidized for any tax year if, at any time during such tax year or any prior tax year, there is or was any below market federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation, such as assistance provided under the HOME Investment Partnership Act or the Native American Housing and Assistance and Self-Determination Act of 1996.

For buildings placed in service on or before July 30, 2008, former IRC §42(i)(2)(E)(i) generally provided that assistance provided under either Act with respect to any building will not be treated as a below market federal loan if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of the AMGI. This is commonly referred to as the 40-50 rule.

Key points:

1. Buildings subject to this rule are identified on Form 8609, line 6f.
2. This requirement must be satisfied each taxable year of the extended use period described in IRC §42(h)(6)(D). The determination is based on the household occupying the unit at the end of the taxable year, or the last tenant if the unit is vacant and otherwise qualifying.
3. If a taxpayer fails to satisfy this requirement, then the applicable percentage for the year of the failure and all subsequent years of the compliance period is limited to the 30% present value credit under IRC §42(b)(1)(B)(ii). See Chapter 14.
4. For buildings placed in service after July 30, 2008, assistance under HOME and NAHASDA are not characterized as below market federal loans and IRC §42(i)(2)(E) was removed from the Code under section 3002(b) of the Housing Assistance Tax Act of 2008.

Refer to Rev. Rul. 2004-82, Section D, and Chapter 9 of the Guide for Completing Form 8823 for additional discussion.

**Deep Rent Skewing**

Under IRC §142(d)(4)(B)(i), a taxpayer can elect to provide housing to households with incomes of 40% or less of AMGI. The election is made on Form 8609, Low-Income Housing Certification, line 10d. The project qualifies if 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI. Taxpayer is also subject to specific rent limitations which will be discussed later in this chapter.

**Qualified Low-Income Student Households**

Residential rental units occupied by households composed entirely of full-time students are not considered low-income units unless at least one member of the household meets one of the exceptions under IRC §42(i)(3)(D), which provides that a unit shall not fail to be treated as a low-income unit merely because it is occupied:

1. by an individual who is:
  - a student receiving assistance under Title IV of the Social Security Act,
  - a student who was previously under the care and placement responsibility of the State agency responsible for administering a plan under part B or part E of title IV of the Social Security Act (as added by the Housing Assistance Tax Act of 2008, and applicable to determinations made after July 30, 2008), or
  - a student enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar federal, state or local laws.

2. entirely by full-time students if such students are

- single parents and their children and such parents are not dependents (as defined in IRC §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 or
- married and file a joint return. A married couple that is entitled to file a joint tax return, but has not filed one, satisfies the exception.

A unit is not a low-income unit if it is occupied entirely by full-time students at qualifying educational organizations for five or more months during a calendar year in which the taxable year of the taxpayer begins and who do not meet one of the exceptions identified in IRC §42(i)(3)(D). A unit is also considered nonqualifying if the taxpayer failed to verify the household's student status at the time of move in and on a continuous basis throughout the 15-year compliance period.

Refer to Chapter 17 of the Guide for Completing Form 8823 for additional discussion.

**Units Occupied by On-Site Managers, Maintenance Personnel, and Security Guards**

Treas. Reg. §1.103-8(b)(4) states that facilities functionally related and subordinate to residential rental units are considered residential rental property. Treas. Reg. §1.103-8(b)(4)(iii) provides that facilities that are functionally related and subordinate to residential rental units include facilities for use of the tenants and other facilities reasonably required for the project. The examples specified in the regulation include units for resident managers or maintenance personnel. Therefore, units occupied by resident managers or maintenance personnel are residential rental property for purposes of IRC §42.

Rev. Rul. 92-61 clarifies that (1) the cost of units occupied by full-time on-site property managers and maintenance personnel is included in the building's eligible basis. However, the units are "facilities" rather than "units" and are excluded from both numerator and denominator for purposes of determining a building's applicable fraction. Rev. Rul. 2004-82, Q&A #1, applies the same principle to include units occupied by full-time security officers.

**Emergency Housing Relief**

In the event of a federally declared disaster, a taxpayer may choose to provide emergency housing for displaced persons. If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act:

1. on or after July 2, 2007, and before August 21, 2014, see Rev. Proc. 2007-54.
2. on or after August 21, 2014, see Rev. Proc. 2014-49.

**Documenting Qualified Low-Income Households**

Under Treas. Reg. §1.42-5(b)(1)(vii), owners of IRC §42 projects must keep "documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation)." The regulation 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.

Taxpayers must retain these records for at least 6 years after the due date (with extensions) for filing the federal income tax return for the tax 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 building's 15-compliance period.

Under IRC §6001, every taxpayer is required to maintain records sufficiently detailed to prepare a proper tax return. This requires the maintenance of such permanent books and records sufficient to establish the amounts of gross income, deductions, credits, or other matters to be shown on the taxpayer's return. This requirement extends to the preparation and maintenance of tenant files sufficiently documented to support household eligibility for purposes of claiming the low-income housing credit under IRC §42.

A tenant income certification (TIC) and supporting documentation should include the following documentation:

1. Application/Income and Asset Questionnaire - A document completed by the household that the taxpayer uses to gather information about the household, such as household composition, income, income from assets, and student status.
2. Verification of Income and Assets - All sources of income and assets must be verified to establish move-in eligibility. The preferred verification method is through third party contact, and where applicable, written documentation such as copies of check stubs, Forms W-2, or self-certifications. The verification should be no older than 120 days before the household moved in. Under Rev. Proc. 94-65, a tenant (or prospective tenant) may provide a signed, sworn statement that includes (1) that the net family assets do not exceed \$ 5,000, and (2) the tenant's annual income from the family assets. Taxpayers may not rely on a low-income tenant's signed, sworn statement if a reasonable person would conclude that the tenant's income is higher than the tenant has represented. In such cases, the taxpayer must obtain other documentation to satisfy the documentation requirements. See Treas. Reg. §1.42-5(b)(1)(vii).
3. Student Status - Depending upon the student status of each household member, student verification may be required.
4. Tenant Income Certification – Documents must be signed by all the adult members of a household prior to move-in and at the time of the annual recertification, and must state the anticipated annual gross income of the household.

As explained in Rev. Rul. 2004-82, Q&A #11, a taxpayer may use an electronic storage system to maintain tenant files if it satisfies the requirements of Rev. Proc. 97-22.

**Additional Resources**

Refer to Chapters of 4, 5, 9, and 17 of the Guide for Completing Form 8823 for additional information.

**Audit  
Technique #1:  
Evaluate  
Internal  
Controls**

First, the taxpayer's internal controls and efforts to ensure that tenants are income-qualified at move-in should be analyzed to determine if a material control risk existed and may have allowed nonqualifying tenants to occupy low-income units during the tax year under audit.

1. As part of the interview with the taxpayer, determine who prepares the tenant files, how the files are maintained, and where the files are stored. Also determine whether the taxpayer is subject to the 40-50 rule or elected deep rent skewing.
2. Review the taxpayer's internal controls for ensuring that new tenants are qualified low-income households at move-in. Does the taxpayer train employees? Does the taxpayer review tenant files? Is an independent property management company operating the project? Is the taxpayer frequently changing management companies? Does the taxpayer conduct internal audits?
3. Review the on-site property manager's procedures for qualifying new tenants. Determine how the property manager conducts interviews, contacts third parties for verification, and maintains the files. How does the property manager handle certain fact patterns; e.g., what happens when the total anticipated income for the upcoming year is less than what it will cost to reside in the unit or a one-person household requests a three bedroom unit? How is the tenant's student status determined? How does the property manager know when it is time for the annual recertification (if required)?
4. Consider the property manager's internal controls. Does the manager use a standardized income certification document? Who reviews the property manager's work? Is the staff trained?
5. Contact the state housing agency and request information about any tenant file reviews the agency may have conducted during the tax year under audit.

Based on the analysis of the taxpayer's internal controls, consider:

1. Are the taxpayer's internal controls sufficient to minimize to opportunity for systemic misstatements of tenant income?
2. Can the tenant files be relied on?
3. Do some tenants represent a higher risk of not being qualified than others? For example, is there a significant risk that nonqualifying full-time student households are occupying the units?

The results of the analysis will determine the extent to which tenant files should be reviewed and the depth of that review.

**Audit  
Technique #2:  
Reviewing  
Tenant Files**

The taxpayer should provide documentation for the income limits used to identify qualified tenants throughout the year. Since the income limits are updated annually by HUD, the income limits may change during the year. The state housing agency can be contacted for confirmation if needed.

## **Sampling**

The initial sample of units can be selected by reviewing the rent roles. A statically valid sample may be appropriate for larger housing projects, or alternatively, judgment may be used to select a representative sample of units.

If the state housing agency reviewed the tenant files for the year under audit, the results can be relied upon for examination purposes, unless otherwise established, but only for the tenant files actually reviewed; i.e., the results cannot be projected to all the low-income units.

For example, a 100% low-income building consists of 50 units. The state agency reviews tenant files for 10 of the units and determined that three of the units were occupied by nonqualifying households. The IRS can rely on the state agency's determination for the 10 units, but cannot conclude that 30% of all of the units in the building were occupied by nonqualifying tenants solely because 30% of the units sampled by the state agency were occupied by nonqualified tenants.

## **High Risk of Error**

Units representing a higher risk for noncompliance should be reviewed. Examples include:

1. The number of individuals in the household is less than the number of bedrooms in the unit. Why did the tenant want or need more bedrooms? How does the tenant pay the higher rent for the larger unit? Is the household larger than reported?
2. The household size increased during the year. Why was an additional member added to the household? How long had the original household lived in the unit before additional members were added. Did the income of the resulting new household exceed the income limit? If the taxpayer or tenants manipulated the income limits, then the unit should not be treated as a low-income unit as of the date the household originally occupied the unit.
3. The tenant transferred to another unit. Why did the tenant transfer to another unit? Did the tenant move to another unit in the same building, or a unit in a different building? When a household moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit and the vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident. See Treas. Reg. §1.42-15(d). Under Rev. Rul. 2004-82, Q&A #8, a similar rule applies to households whose income is no greater than 140% of the income limit (or 170% for deep rent skewed projects) moves to a low-income unit in a different building within the project.

## **Contemporaneously Prepared Documentation**

Were the files prepared in a timely manner and concurrent to the events? Most likely, there will be some standardization between files (e.g.; use of forms) and individual notations explaining unusual circumstances.



## Evaluating Tenant Files

The primary purpose of the tenant file review is to determine whether the taxpayer reasonably estimated the income the household would receive in the year following the certification. The methods for estimating income includes (1) annualizing current sources of income, (2) identifying specific amounts from specific sources, (3) anticipated changes in income, and (4) using the prior year's income when the household's circumstances have not changed or are not expected to change.

Consider whether the household was income-qualified when the household initially moved into the unit.

1. Did the tenant disclose all taxable sources of income? Compare the information in the files with IRS records of income reported on the tax return; e.g., wages, alimony received, etc. Generally, if taxable income reported on the tax return is more than the income disclosed in the file, further inquiry is required.
2. Did the tenant disclose all sources of nontaxable income? Consider whether likely sources of nontaxable includes have been identified. For example, if the tenant is a senior and retired, it is reasonable to expect that is tenant was receiving income from social security, an insurance annuity, or another retirement plan.
3. Is the tenant's income as reported in the file sufficient to pay the rent and provide a reasonable amount for basic living expenses? If not, are there additional sources of funds that have not been disclosed? Does the tenant have a roommate, whose income should be included in the determination? Additional household members might be identified by securing a list of taxpayers who filed tax returns using the IRC §42 project's address as their residence and comparing the list of names to the rent records.
4. Is the income accurately reported and summarized?

Specific units may be identified as not occupied by income-qualified households. Units may be determined to be nonqualifying units as of the end of the taxable year, if, for example:

1. the taxpayer cannot provide documentation that the household was income-qualified,
2. the taxpayer did not make reasonable attempt to identify and verify all sources of income,
3. the taxpayer did not accurately determine the household's income, or
4. the household is a nonqualifying student household.

Based on the results, consider whether the review should be expanded to include more (or all) of the low-income units.

**Audit  
Technique #3:  
First Year of  
the Credit  
Period**

If the first year of the credit period is under audit, additional information is needed from the tenant files to compute the applicable fraction under IRC §42(f)(2)(A) for each full month of the taxable year that the building was placed in service, which will be discussed later.

1. Determine when the building containing the low-income units was placed in service.
2. Determine the month that the low-income units were first occupied by an income-qualified tenant.

**Audit  
Technique #4:  
40-50 Rule**

If the taxpayer is subject to the 40-50 Rule, follow the guideline above for Audit Technique #2, except review the tenant files for all the units rented to households with income at or below 50% of AMGI to confirm that at least 40% of all the units are occupied by households who had income at or below 50% AMGI at the time the household moved in. See Chapter 14 for additional information.

**Audit  
Technique #5:  
Deep Rent  
Skewing**

If the taxpayer is subject to the deep rent skewing requirement, follow the guideline above for Audit Technique #2, except review the tenant files for all the units rented to households with income at or below 40% of AMGI to confirm that at least 15% of all the units are occupied by households who had income at or below 40% AMGI at the time the household moved in.

**Audit  
Technique #6:  
Units Occupied  
by On-Site  
Managers,  
Maintenance  
Personnel and  
Security  
Guards**

A unit occupied by an on-site manager, maintenance personnel, or security guard should be treated as a facility reasonably required for the project and not treated as a residential rental unit if:

1. The services provided are required, given the character and size of the project,
2. The resident manager, maintenance personnel, or security officer is providing services required for the project that could not be properly provided unless the employee resides on the project premises. Revenue Rulings 92-61 and 2004-82, Q&A #1, presume that property managers, maintenance personnel, and security officers could not provide their service properly without occupying a unit on the premises, and
3. The resident manager, maintenance personnel, or security officer is working full time at the site.

The following fact patterns are not relevant to the determination:

1. Charging the resident managers, maintenance personnel, or security officers rent, utilities, or both for units in a qualified low-income building does not make the units residential rental units and not facilities reasonably required for the project under Treas. Reg. §1.103-8(b)(4)(iii). See Chief Counsel Advice dated June 2, 2014 (POSTN-111812-14).
2. The unit designated for a resident manager, maintenance personnel, or security officer can vary; e.g., to accommodate the resident manager's family size. When the designation is "switched" the units' character also switches.

For example, a vacant unit (A), last occupied by a nonqualified tenant, is “switched” with a unit (B) currently occupied by a resident manager to accommodate the resident manager’s family size. Unit A is treated as a facility required for the project and unit B is treated as a vacant residential rental unit not qualifying for the credit (included in the denominator of the applicable fraction, but not the numerator).

3. A unit designated for a resident manager, maintenance personnel, or security officer may be converted to a residential rental unit, in which case the unit will be included in the denominator of the applicable fraction for that year. The unit’s status will be its status immediately before being occupied by a resident manager, maintenance personnel, or security officer.

CAUTION: #2 and #3 above will not apply if the unit occupied by the resident manager, maintenance personnel, or security office is a single-family home. IRC §42 credit will not be allocated to the designated home and, therefore, it cannot be “switched” as described above.

Possible noncompliance issues include:

1. The unit is occupied by an employee that does not provide services required by the project. For example, the employee may be providing services for the building’s tenants. See Treas. Reg. §1.42-11 for additional information about the provision of services in addition to housing.
2. The unit is temporarily occupied by an employee not providing services specific to the project.

For example, an independent property management company operates ten IRC §42 projects within a 50-mile radius. To provide proper supervision for the managers living at the ten projects, a supervisor makes quarterly visits to each site. The supervisor travels from out of town, stays at the IRC §42 project nearest the airport in a unit held vacant for the supervisor, and then travels each day by car to a different project. Although the supervisor may be a full-time employee for the property management company, the supervisor is not working “full-time” on the premises where the employee has temporary lodgings.

3. The unit is occupied by an employee providing services at multiple IRC §42 project.

For example, a taxpayer contracts with an independent property management company to operate its IRC §42 project on a day-to-day basis. The management company has contracts with three taxpayers owning IRC §42 projects in close proximity and directs the property manager occupying a unit at the taxpayer’s project to manage all three projects. The property manager generally visits each site daily. The unit is not a “facility reasonably required for the project because the employee is not working full-time on the premises where the employee is occupying a unit. It may also be argued that it is not necessary to live on the project’s premises to perform the services.

In the event of noncompliance, the unit is considered a residential rental unit that is included in the denominator of the applicable fraction. The unit is not included in the applicable fraction's numerator, even if the employee is an income-qualified tenant, because a residential rental unit provided by an employer for its employees is not for use by the general public and is not eligible for credit under IRC §42. See Treas. Reg. §1.42-9(b).

## Rent Restrictions

### **Rent-Restricted Units, Gross Rent, and Imputed Income Limits**

To qualify as a low-income unit, the rent must be restricted as described in IRC §42(g)(2). In general, a unit is rent-restricted if the gross rent does not exceed 30% of the imputed income limit applicable to the unit.

Under IRC §42(g)(2)(A), the imputed income limit for any period is never less than the income limit applicable for the earliest period the building (which contains the unit) was included in the determination of whether the project is a qualified low-income housing project. As noted earlier, HUD applied a "hold harmless policy" when determining income limits so the income limits never decreased for any housing program relying on HUD's AMGI determinations for years before 2009. Beginning with 2009, HUD began publishing separate income limits for IRC §§ 42 and 142(d) project and now applies a "hold harmless" rule under IRC §142(d)(2)(E).

The imputed income limit is based on the number of bedrooms in the unit. Under IRC §42(g)(2)(C), the imputed income limit is the income limit which would apply to the household if the number of individuals occupying the unit were:

1. In the case of a unit which does not have a separate bedroom, 1 individual.
2. In the case of a unit which has 1 or more separate bedrooms, 1.5 individuals for each separate bedroom.

For IRC §42 projects financed with tax-exempt bonds under IRC §142(d), the imputed income limits under IRC §42(g)(2) are used rather than the applicable income limitations under IRC §142(d)(4)(B)(ii).

### **Assistance Provided Under the HOME Investment Partnership Act or NAHASDA**

For buildings placed in service on or before July 30, 2008, former IRC §42(i)(2)(E)(i) generally provided that assistance provided under the HOME Investment Partnerships Act (HOME) or the Native American Housing and Assistance and Self-Determination Act (NAHASDA) of 1996 with respect to any building will not be treated as a below market federal loan if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of the Average Median Gross Income (AMGI).

The gross rent, however, for all the low-income units in the building, including the units used to satisfy the rules under former IRC §42(i)(2)(E)(i), is based on the applicable income limitation under IRC §42(g). See Rev. Rul. 2004-82, Q&A #6. Therefore, if a household qualifies with income of less than or equal to 50% of the AMGI, the gross rent may be determined using 60% of AMGI if the taxpayer elected the 40-60 minimum set-aside under IRC §42(g)(1).

For buildings placed in service after July 30, 2008, assistance under HOME and NAHASDA are not characterized as below market federal loans and IRC §42(i)(2)(E) was removed from the Code under section 3002(b) of the Housing Assistance Tax Act of 2008.

If the taxpayer fails this test, the applicable percentage is reduced from the 70% value to the 30% value. See Chapter 14.

**Deep Rent Skewing**

Under IRC §142(d)(4)(B)(i), a project qualifies as a “deep rent skewed” project if 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI and the taxpayer elects to treat the project as a deep rent skewed project. The election is made on Form 8609, Line 10d.

1. The gross rent with respect to each low-income unit in the project does not exceed 30% of the applicable income limit which applies to the individuals occupying the unit, and
2. The gross rent with respect to each low-income unit in the project may not exceed half of the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

**Rural Development Assistance**

Gross rent for projects with Rural Development assistance are determined using Rural Development rules and may exceed the IRC §42 gross rent limit. Under IRC §42(g)(2)(B)(iv), gross rent does not include any rental payment to the taxpayer to the extent the taxpayer pays an equivalent amount to the USDA Rural Housing Service (formerly known as the Farmer’s Home Administration) under section 515 of the Housing Act of 1949. In other words, as long as the taxpayer pays Rural Development any rent amount paid in excess of the IRC §42 rent limit for a unit, the IRC §42 rent restriction requirements are satisfied for the unit.

**Section 8 or Comparable Rental Assistance**

Under IRC §42(g)(2)(B)(i), gross rent is determined based on the amount paid by the tenant and does not include any payment under section 8 of the United States Housing Act of 1937 (42 USCS § 1437f) or any comparable rental assistance program applicable to either the rental unit or the household occupying the unit.

See Chapter 11 of the Guide for Completing Form 8823 for a complete discussion.

Under IRC §42(g)(2)(E), if federal assistance is required to be reduced as the tenant’s income increases, so that the amount required to be paid by the tenant exceeds the gross rent limit, the unit continues to be considered rent-restricted if:

1. a federal rental assistance payment continues to be made with respect to the unit or its tenants, and
2. the sum of the rental assistance payment and the gross rent with respect to such unit does not exceed the sum of the amount of such payment which would be made and the gross rent that would be payable for the unit if the tenants’ income did not exceed the income limit and the units were rent restricted.

**Household Pays Towards Purchase of the Low-Income Unit**

A taxpayer and tenant can enter into an agreement for the purchase of a low-income unit after the end of the 15-year compliance period. Under IRC §42(g)(6), the tenant can make de minimis equity contributions while renting a low-income unit. The unit continues to be a low-income unit qualifying for the IRC §42 credit if:

1. the payments made by the tenant are paid on a voluntary basis (not as a condition of occupancy), the amount is de minimis, and the amount is held toward the purchase of a unit in the project;
2. all amounts paid are refunded to the tenant when the tenant stops occupying a unit in the project;
3. the purchase of the unit is not permitted until after the close of the 15-year compliance period with respect to the building in which the unit is located; and
4. any amount paid to the taxpayer as equity contributions is included in gross rent for purposes of determining whether the unit is rent-restricted.

The unit the tenant is buying does not need to be the low-income unit the tenant is occupying. See Rev. Rul. 95-49.

**Utility Allowance**

The maximum rent payable by a household is reduced by any applicable utility allowance. Under IRC §42(g)(2)(B)(ii) and Treas. Reg. §1.42-10, gross rent includes any utility allowance for the cost of any utilities, other than telephone, cable television, or Internet, paid directly by the tenant(s) and not by or through the owner of the building. Notice 2009-44 clarifies that utility costs paid by a tenant to the taxpayer based on actual consumption in a sub-metered rent-restricted unit are treated as paid directly by the tenant, and not by or through the owner of the building.

Treas. Reg. §1.42-10 and Chapter 18 of the Guide for Completing Form 8823 provide detailed information about utility allowances. Key points of this guidance include the following:

1. A separate utility allowance is computed for each utility. Different methods of determining utility allowances are available.
2. The utility allowances must be reviewed at least once during each calendar year and updated if required. As a practical matter, utility allowances are reviewed and updated when HUD releases the annual income limits.
3. Utility allowances are computed on a building-by-building basis.
4. For buildings receiving Rural Housing Service (RHS) assistance, or if any tenant in a building receives RHS assistance, then the method prescribed by RHS is used to determine the utility allowance for all the units in the building.
5. If the RHS rules are not applicable and the building is HUD-regulated, then the HUD utility allowance is used for all rent-restricted units in the buildings. If the building is not HUD-regulated, the applicable utility allowance for any unit occupied by a tenant receiving HUD rental assistance payments is the Public Housing Authority (PHA) utility allowance for section 8.

6. If the building is not subject to the RHS or HUD rules, then the taxpayer may choose to use the applicable PHA utility allowance, a utility company estimate, an estimate provided by the housing agency, the HUD Utility Schedule Model, or a utility allowance based on energy consumption model. The methods available for use for tax years beginning before July 29, 2009, are limited to the use of the PHA utility allowance and the utility company estimate.

The utility allowance requirement is satisfied when:

1. the appropriate utility allowance is used,
2. the utility allowance is properly calculated,
3. gross rent includes the utility allowance, and
4. the maximum gross rent is not exceeded.

#### **Documentation Requirements**

Treas. Reg. §1.42-10(d) specifically alerts taxpayers that any consumption estimates and supporting data must be retained as part of the taxpayer's records for purposes of Treas. Reg. §1.6001-1(a). Under this requirement, taxpayers are required to keep such permanent books of account or records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person. Under Treas. Reg. §1.6001-1, the IRS may require the owner to render such statements or keep such specific records as will enable the IRS to determine whether or not the owner is liable for tax. The books and records shall be kept at all times available for inspection by the IRS and shall be retained so long as the contents thereof may become material in the administration of the Internal Revenue Code.

#### **Provision of Services in Addition to Housing**

Units may be residential rental property notwithstanding the fact that services other than housing are provided. See Chapter 8. A taxpayer may charge a fee in addition to the rent if the service is optional. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent. See Treas. Reg. §1.42-11.

1. A service is optional when the service is not a condition of occupancy; i.e., low-income housing can be occupied without accepting the services. For example, a taxpayer may charge a separate fee for access to cable television.
2. If continual or frequent nursing, medical, or psychiatric services are provided by the taxpayer, it is presumed that the services are not optional and the building is ineligible for the credit, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See Treas. Reg. §1.42-9(b).
3. If a tenant is required to pay a fee for services as a condition of occupancy, then the fee must be included in gross rent even if federal or state law requires that the services be offered to tenants by building owners.
4. Refundable fees associated with renting a low-income unit (e.g., security deposits) are not included in the rent computation. Required costs or fees, which are not refundable, are included in the rent computation; e.g., fees for month-to-month tenancy or renter's insurance.

5. A taxpayer may charge all applicants an application fee 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-pocket costs of checking tenant qualifications. It is also acceptable for the applicant to pay the fee directly to the third party actually providing the applicant's rental history. For an example, see PLR 9330013, Issue 1.
6. Some fees are impermissible, such as a fee for preparing a unit for occupancy, and must not be charged. Taxpayers are responsible for physically maintaining low-income units in a manner suitable for occupancy. See IRC §42(i)(3)(B)(i) and Treas. Reg. §1.42-5(g). However, in accordance with state law, a taxpayer may require a tenant to pay for damages.

Treas. Reg. §1.42-11 provides exceptions to the general rule for (1) supportive services provided under IRC §42(g)(2)(B)(iii) discussed below, and (2) on a project basis, for the cost of mandatory meals in any federally-assisted project for the elderly and handicapped (in existence on or before January 9, 1989) that is authorized by 24 CFR 278 to provide a mandatory meals program.

**Supportive Services**

Under IRC §42(g)(2)(B)(iii), gross rent does not include any fee for a supportive service which is paid to the taxpayer (on the basis of the low-income status of the tenant of the unit) by any governmental program of assistance (or by an organization described in IRC §501(c)(3) and exempt from tax under IRC §501(a)) if such program (or organization) provides assistance for rent and the amount of assistance provided for rent is not separable from the amount of assistance provided for supportive services.

"Supportive service" means any service provided by the taxpayer under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. In the case of a single-room occupancy unit or a building described in IRC §42(i)(3)(B)(iii) related to transitional housing for the homeless, or IRC §42(i)(3)(B)(iv) related to single-room occupancy, such term includes any service provided to assist tenants in locating and retaining permanent housing. See Treas. Reg. §1.42-11(b)(3)(ii)(A).

**Common Areas**

If the cost of common areas is included in eligible basis (see Chapter 8), then, as explained in the legislative history for the original enactment of IRC §42, no fee can be used for the use of the facility.

“...the allocable cost of tenant facilities, such as swimming pools, other recreational facilities and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project.”

Alternatively, if the taxpayer excludes the allowable cost relating to the facility from eligible basis, IRC §42 does not control the taxpayer's use of the facility related to the excluded costs.



**Determining Whether Units are Rent-Restricted**

Under IRC §42(g)(2)(A), a unit qualifies as a low-income unit when the gross rent does not exceed 30% of the imputed income limitation applicable to such unit, which is an annual amount. Therefore, taxpayers must satisfy the rent-restrictions requirements on a tax year basis, as of the end of the tax year.

IRC §42(g)(2)(B) defines gross rent to exclude certain payments and includes consideration of any utility allowances and fees on a monthly basis. Therefore, taxpayer's must also satisfy the rent-restrictions each month of the tax year.

As a result, a unit can fail to satisfy the rent restriction requirements if the rent exceeds the limit on a tax year basis or on a monthly basis; i.e., any one or more months during the tax year. A unit also fails to satisfy the rent restriction requirement if an owner charges impermissible fees.

**Additional Resources**

Refer to Chapters 11 and 18 of the Guide for Completing Form 8823 for additional information.

**Audit Technique #1: Internal Controls and Taxpayer Interview**

First, the taxpayer's internal controls and efforts to ensure that the rents are correctly limited should be analyzed to determine whether there is a material risk that the rents exceed the rent limit during the tax year under audit.

As part of the interview with the taxpayer, ask:

1. How is the maximum gross rent determined and what procedures are in place to make sure maximum rent is correct?
2. What procedures are in place to make sure the rents are updated annually when HUD releases the updated AMGI amounts?
3. Who collects the rents? Who records the rents in the books? Who deposits the rents? What internal controls are in place to ensure all rents are reported as income on the tax return?
4. Are the buildings 100% low-income buildings, or do the building have market-rate units? How many bedrooms does each low-income and market rate unit have?
5. What are the vacancy rates and turnover rates for the low-income and market rate units?

Rental practices should also be reviewed with the taxpayer.

1. Do tenants pay utilities or are utilities included in the rent? If the tenants pay utilities, how is the utility allowance determined and who makes the determination?
2. Does the taxpayer require a security deposit or charge other fees such as a late payment fee, key replacement fee, or pet fee?
3. Does the taxpayer provide services for the tenants in addition to housing? Does the taxpayer charge a fee for the services?

4. Is the taxpayer renting to section 8 tenants? In which case, rent collected might be more than the maximum allowable gross rent.
5. If the project is using Rural Development assistance, is the rent collected in excess of the maximum allowable gross rent? Is the taxpayer making payments to Rural Housing Service as required? How often are payments made? How are the payments made?

**Audit  
Technique #2:  
Review Tenant  
Leases Rent  
Rolls**

Review tenant leases to determine the rent charged, as well as any other fees that might be charged as a condition of occupancy. For example, in addition to rent, a taxpayer may charge a fee for access to cable television, which would be a fee charged in addition to rent. However, charging a fee for entering into a month-to-month lease agreement would be includable in rent.

**Audit  
Technique #3:  
Compare Rents  
Paid to the  
Maximum  
Gross Rent**

Once the amount of rent actually paid by tenants is determined, compare to the maximum gross rent and determine whether the rent is correctly limited on both a monthly and annual basis. If the rent exceeded the maximum gross rent, then the unit is not a low-income unit for purposes of calculating the Applicable Fraction.

**Audit  
Technique #4:  
Reconcile  
Tenant Records  
to Rent Rolls**

Reconcile the rents and fees paid by the tenant as recorded in the tenant records to the amounts recorded in the rent rolls, which are mostly likely the same summary records used to report rent income on the taxpayer's tax return.

**Audit  
Technique #5:  
Complete  
Minimum  
Income Probes**

Complete the Minimum Income Probes as required in Internal Revenue Manual (IRM) 4.10.4.3.4, for businesses. See Chapter 20.

## **Suitability for Occupancy**

**Law**

Under IRC §42(i)(3)(B)(ii), a unit shall not be treated as a low-income unit unless the unit is suitable for occupancy under regulations prescribed by the Secretary taking into account local health, safety, and building codes.

**Annual  
Certifications**

Under Treas. Reg. §1.42-5(c)(1)(vi), a taxpayer must certify annually to the state agency that, for the preceding 12-month period:

1. the buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes (or other habitability standards), and

2. the state or local government unit responsible for making local health, safety, or building code inspections did not issue a violation report for any building or low-income unit in the project. If a violation report or notice was issued by the governmental unit, the owner must attach a statement summarizing the violation report or notice or a copy of the violation report or notice to the annual certification submitted to the state agency and explain whether the violation has been corrected.

**State Agency Inspections**

State agencies are required to physically inspect IRC §42 projects throughout the entire 15-year compliance period. The inspection includes all the low-income buildings and a sample of at least 20% of the low-income units in the project. Under Treas. Reg. §1.42-5(c)(2)(ii), the inspections are conducted:

1. by the end of the second calendar year following the year the last building in the project is placed in service, and
2. at least once every 3 years thereafter.

The state agency can choose the standard used for conducting inspections and determining compliance. The state agency can choose either:

1. local health, safety, and building codes (or other habitability standards), or
2. the uniform physical condition standards for public housing established by HUD. If the state agency uses HUD’s physical condition standards to conduct inspections, HUD’s standards do not supersede or preempt local health, safety, and building codes. A low-income housing project under IRC §42 must continue to satisfy the local health, safety and building codes.

The state agency must also review any local health, safety, or building code violations reports or notices retained by the taxpayer.

**Documentation Requirement**

Under Treas. Reg. §1.42-5((b)(3), a taxpayer must retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit for the state agency’s inspection. Retention of the original violation reports or notices is not required once the state agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

**Casualty Losses**

The determination that a unit is unsuitable for occupancy is based on its physical condition, without regard for the cause of the noncompliance, at the end of the taxable year. However, relief is available in the event of a casualty loss within the meaning of IRC §165. CCA 200134006 provides that “the definition of “casualty loss” under IRC §42(j)(4) would be the same as the definition utilized in Publication 547, Casualty, Disaster, and Thefts, and Publication 584, Casualty, Disaster, and Theft Loss Workbook; i.e., damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

CCA 200912012 provides that if a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, then there is no recapture and no loss of credits. However, if the building is not restored by the

end of the taxable year, no credit would be allowed for the entire taxable year even if the reasonable period (or reasonable restoration period) extends into the next taxable year. See Chapter 16 for more information.

IRC §42(j)(6)(E) provides relief from the credit recapture provisions to the extent the loss is restored by reconstruction or replacement within a reasonable period established by the Secretary. CCA 200134006 clarifies that a period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties. See IRC §1033.

**Casualty  
Losses in  
Federally  
Declared  
Disaster Areas**

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after July 2, 2007, and before August 21, 2014, then Rev. Proc. 2007-54 provides the following relief for projects that have been placed in service. (Similar relief provisions are provided in Rev. Proc. 95-28 for locations declared major disaster areas before July 2, 2007.)

1. If the low-income building is beyond the first year of the credit period, the taxpayer may continue to claim the credit even though the units are not suitable for occupancy if the units are restored within a reasonable restoration period. The state agency determines what a reasonable restoration period is, but the restoration period is not to exceed 24 months after the end of the calendar year in which the President issued the major disaster declaration. If the taxpayer fails to restore the building within the reasonable restoration period determined by the state agency, the taxpayer loses all credits claimed during the restoration period and is subject to the IRC §42(j) credit recapture provisions.
2. For buildings in the first year of the credit period, the state agency has the discretion to treat the allocation as returned credit under Treas. Reg. §1.42-14(d)(3) or may toll the beginning of the first year of the credit period until the project is restored. The tolling time period cannot be more than 24 months after the end of the calendar year in which the President declared the area a major disaster area. No qualified basis shall be established until the building is restored and no low-income housing credit shall be claimed during the restoration period of such first-year buildings.

NOTE: Rev. Proc. 2007-54 applies to IRC §42 credits, including credits through the volume cap under IRC §142(d). For example, compliance monitoring relief, first year of the credit period relief, and the restoration amount equally apply to bond-financed buildings.

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after August 21, 2014, then Rev. Proc. 2014-49 provides the following relief for projects that have been placed in service. The key difference between Rev. Proc. 2007-54 and Rev. Proc. 2014-49 is the definition of the restoration period.

1. If the low-income building is beyond the first year of the credit period, the taxpayer may continue to claim the credit even though the units are not suitable for occupancy if the units are restored within a reasonable restoration period. The state agency determines what a reasonable restoration period is, but the restoration period is not to extend beyond the end of the 25<sup>th</sup> month following the close of the

month of the major disaster declaration. To determine the allowable credit during the restoration period, the taxpayer must use the building's qualified basis at the end of the taxable year immediately preceding the first day of the incident period for the major disaster. If the taxpayer fails to restore the low-income building within the restoration period, the allowable credit, if any, is determined using the building's qualified basis at the end of each year of the credit period during the restoration period, and the taxpayer is subject to the IRC §42(j) credit recapture provisions.

2. For buildings in the first year of the credit period, the state agency has the discretion to treat the allocation as returned credit under Treas. Reg. §1.42-14(d)(3) or may toll the beginning of the first year of the credit period until the project is restored. The tolling time period must not extend beyond the end of the 25<sup>th</sup> month following the close of the month of the major disaster declaration. The taxpayer may not claim any low-income housing credit during the restoration period of these first-year building.

NOTE: Rev. Proc. 2014-49 applies to IRC §42 credits, including credits through the volume cap under IRC §142(d). For example, compliance monitoring relief, first year of the credit period relief, and the restoration amount equally apply to bond-financed buildings.

**Additional Resources**

Refer to Chapter 6 of the Guide for Completing Form 8823 for additional information.

**Audit Technique #1: Taxpayer's Annual Certification**

The taxpayer's annual certification to the state agency should be reviewed. If the taxpayer cannot provide the certification, request documentation from the state agency.

Ask the taxpayer to explain what internal controls are in place to ensure that the units are suitable for occupancy. What procedures are in place to maintain the project, identify physical deficiencies, and correct noncompliance issues on a continuing basis? Does the taxpayer follow a routine maintenance schedule? Does the taxpayer regularly inspect the units?

If an independent property manager operates the IRC §42 project, what oversight does the taxpayer provide to ensure that the manager maintains the project in compliance? Does the taxpayer conduct internal audits or personally visit the project and inspect the site?

**Audit Technique #2: Vacant Units**

Vacant units must be suitable for occupancy. While a reasonable period to clean a unit and repair any damages caused by a prior tenant is acceptable, vacant units that are not move-in ready are not suitable for occupancy.

1. Ask the taxpayer to explain the policies and procedures in place to prepare a vacated unit for a new tenant and how long it usually takes. For example, if the vacancy rate is high, a taxpayer may not be willing to expend funds to prepare a unit until a new tenant has been identified.

2. Review the tenant rent rolls to identify rental units that are vacated during the year and estimate the average time the units were vacant.
3. Identify rental units that are vacant for unusually long periods of time. Ask the taxpayer to document that the units were prepared for occupancy. For example, the taxpayer may show receipts for cleaning expenses or repairs.

**Audit  
Technique #3:  
Tour the  
Project Site**

Tour the project site (see Chapter 3) to observe the project's current physical condition and the taxpayer's on-going efforts to physically maintain the housing.

**Audit  
Technique #4:  
State Agency  
Reports  
Noncompliance**

If the state agency reported to the IRS on Form 8823 that the buildings were not suitable for occupancy during the year under audit, then:

1. Contact the state agency to obtain documentation supporting the determination that a specific low-income unit, building, or project was physically unsuitable for occupancy. The state agency should be able to provide reports (including descriptions), correspondence with the taxpayer or property manager, and in some cases, photographs.
2. Ask the taxpayer whether the noncompliance has been corrected. If the project is back in compliance, ask for documentation showing exactly when the project was restored.

**Audit  
Technique #5:  
Documentary  
Evidence of  
Compliance**

While it is not generally possible to physically observe a project during the taxable year under audit, documentary evidence of compliance should be reviewed.

1. Ask the taxpayer for a copy of the annual certification to the state agency made for the year under audit. See Treas. Reg. §1.42-5(c).
2. Ask the owner whether a state or local government conducted an inspection, and if so, if any violations were noted. Copies of the reports should be secured and reviewed to determine if any noted violations were corrected. Alternatively, state and local governments may be contacted directly to determine whether inspections occurred and whether violations were identified.
3. Determine whether the project was physically inspected for another purpose and secure any findings. For example, regular inspections will be conducted if the taxpayer is participating in HUD's housing programs or a commercial lender may conduct inspections to ensure that the assets securing the debt maintain their value.
4. Ask the taxpayer to provide a copy of the report issued by the state agency as a result of the agency's last physical inspection of the project. Even if the inspection was not conducted during the year under audit, the report will provide information about the taxpayer's due diligence in maintaining the project in good repair.

**Evaluating Evidence**

To facilitate consistent evaluations, the IRS uses HUD’s Uniform Physical Condition Standards (UPCS) and supporting Dictionary of Deficiency Definitions, which provides descriptions and levels of severity for five inspectable areas of the IRC §42 project: (1) site, (2) building exterior, (3) building systems, (4) dwelling units, and (5) commons areas. The Dictionary also includes a sixth category to address health and safety hazards associated with any of the five physical areas. The Dictionary’s three levels of severity are disregarded for purposes of IRC §42. See the Guide for Completing Form 8823, Chapter 6, for detailed discussion. The taxpayer must also comply with local health, safety, and building codes.

The determination that low-income units are suitable for occupancy is based on the units’ condition as of the last day of the taxpayer’s tax year. Generally,

1. If the noncompliance is confined to specific low-income units, an adjustment will be made to the applicable fraction on a unit-by-unit basis.
2. If the noncompliance impacts the entire low-income building, and therefore affects all the households residing in the building, then none of the units are suitable for occupancy. As explained in CCA 201042025, the “suitable for occupancy” requirement of IRC §42(i)(3)(B) does not have to be determined on a unit-by-unit basis if the facts exist that the condition of the exterior components of the building (e.g., wall, roof, etc.) are so poor as to lead to a factual determination that all the units in a building are not suitable for occupancy. For example, if an earthquake created large fissures in the foundation and exterior walls of a building then the building could be determined not suitable for occupancy for safety reasons without having to check each unit.

**Local Code v. UPCS**

Under IRC §42(i)(3)(B), low-income units may be considered suitable for occupancy under local code, even if HUD’s physical condition standard was not met. As explained in CCA 201042025, a violation of the HUD physical condition standard alone is sufficient for a violation of IRC §42(i)(3)(B). However, a taxpayer, in response to the IRS finding a violation, may prove that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result whereas the HUD standard does not reach a taxpayer favorable result. Under these circumstances, the local law would control as respects the violation itself.

**Noncompliance was Minor or Corrected Within Reasonable Period**

The taxpayer may argue that the noncompliance was of a minor nature or that the noncompliance was corrected within a reasonable time. The Committee Report on P.L. 103-66, the Omnibus Budget Reconciliation Act of 1993, provides this explanation:

“...the Committee expects that a facts and circumstances test will be applied to determine whether a unit is suitable for occupancy. A history of continuous noncompliance with local health, safety, and building code provisions that are not of a minor nature and that affect the safety and well-being of tenants is evidence that a unit is not suitable for occupancy. It is anticipated that minor code violations will not affect a unit’s status as a low-income unit...”

“...The rules requiring correction of violations should adopt a facts and circumstances analysis taking into consideration the types of repairs required, the cost and extent of such repairs, whether the repairs are scheduled for correction according to a reasonable maintenance schedule, and whether procedural requirements (such as a required formal bid process) are imposed on the owner to gain approval for the repairs...”

The legislative history for the original enactment of IRC §42 provides a general explanation:

“Owners and operators of low-income housing projects...must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any noncompliance is corrected within a reasonable period, there is no recapture.”

When addressing these arguments, consider the following:

1. The IRS has adopted HUD’s UPCS and Definitions of Deficiencies as the objective standard for evaluating whether IRC §42 projects are suitable for occupancy. Regardless of the source of information, if the observed physical condition of the low-income buildings, units, or site matches HUD’s descriptions of deficiencies, the deficiency results in noncompliance rendering the building or unit unsuitable for occupancy under IRC §42; i.e., the deficiency is not minor in nature.
2. Taxpayers are required to certify annually that low-income buildings and units are suitable for occupancy based on direct knowledge. The reasonable period for discovery and correction of noncompliance ends on the last day of the calendar year, which coincides with the end of the tax year for most taxpayers.
3. State agencies determine the correction period based on the type of noncompliance and the actions needed to correct the violations. While the correction period may be as long as six months under extenuating circumstances, the correction period is generally 90 days. Life threatening health and safety hazards require immediate correction.
4. IRC §42(c)(1)(A) provides a bright-line test for determining the applicable fraction as of the last day of the taxable year. The Code is clear and unambiguous. Reliance on interpretations and explanations in legislative history is not necessary.

**Portion of Annual Credit Should Be Allowed in the Event of a Casualty Event**

A taxpayer may argue that the units were qualified low-income units before a casualty event and a portion of the credit associated with the unit should be allowed.

1. If the President has issued a major disaster declaration under the Stafford Act and Rev. Proc. 2014-49 or Rev. Proc. 2007-54 applies, refer to Chapter 13.



2. If neither Rev. Proc. 2014-49 nor Rev. Proc. 2007-54 applies, then the determination of the applicable fraction is based on whether the units were suitable for occupancy at the end of the taxable year.

CCA 200913012 clarified that Rev. Proc. 2007-54 were issued under the authority of Treas. Reg. §1.42-13(a), which provides that, under IRC §42(n), the Secretary has authority to provide guidance through various publications in the Internal Revenue Bulletin. Rev. Proc. 2014-49 was also issued under the authority of Treas. Reg. §1.42-13(a).

## Available Unit Rule

### Law

The Available Unit Rule addresses the circumstance where the household's income rises above the income limit subsequent to moving into the low-income unit.

IRC §42(g)(2)(D), Treatment of units occupied by individuals whose incomes rise above limit.

- (i) In general.

Except as provided in clause (ii), notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under IRC §42(g)(1), such unit shall continue to be treated as a low-income unit if the income of such occupants initially met such income limitation and such unit continues to be rent-restricted.

- (ii) Next available unit must be rented to low-income tenant if income rises above 140% of income limit.

If the income of the occupants of the unit increases above 140% of the income limitation applicable under IRC §42(g)(1), clause (i) shall cease to apply to such 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 such income limitation. In the case of a project described in IRC §142(d)(4)(B), the preceding sentence shall be applied by substituting "170%" for "140%" and by substituting "any low-income unit in the building is occupied by a new resident whose income exceeds 40% of area median gross income" for "any residential unit in the building (of a size comparable to, or smaller than, such unit) is occupied by a new resident whose income exceeds such income limitation."

### Annual Income Recertifications

To determine whether an existing tenant's income has increased, taxpayers are required to complete an annual income certification for each low-income household. See Treas. Reg. §1.42-5(b)(1)(vi). The recertification process is identical to the initial certification in terms of documenting household composition, income, and income from assets. Taxpayers are expected to complete the annual income recertification process within 120 days before the anniversary of the effective date of the original tenant income certification.

Under Treas. Reg. §1.42-5(c)(4), a state agency may except certain buildings from the annual income recertification as part of its certification and review provisions.

These buildings are:

1. financed by the Rural Housing Service (RHS) under the section 515 program, or
2. 50% or more of the aggregate basis (taking into account the building and land) are financed with the proceeds of tax-exempt bonds.

Under this exception, taxpayers are not required to perform annual income recertifications specific to IRC §42, and instead may use the income recertifications for the RHS program or the tax-exempt bond program to determine whether a unit is over-income. Note, however, that RHS determines tenant eligibility based on its definition of “adjusted annual income,” rather than “annual income” as defined under the section 8 program. Therefore, the taxpayer should modify “adjusted annual income” to determine the household’s income for IRC §42 purposes.

For the exception to the annual income recertification under IRC §142(d)(3)(A), see section below titled “Audit Techniques: 100% Low-Income Buildings.”

See Chapter 5 of the Guide for Completing Form 8823 for additional discussion.

**Treas. Reg. §1.42-15**

Treas. Reg. §1.42-15 provides guidance for applying the Available Unit Rule, including operational definitions and examples.

**Additional Resources**

Chapter 14 of the Guide for Completing Form 8823 includes additional discussion for evaluating compliance with the Available Unit Rule.

**Key Concepts**

Key concepts of the Available Unit Rule include:

1. The Available Unit Rule ensures that the appropriate number of available units is rented to income-qualified households when there are over-income units in the building.
2. Over-income units may be returned to low-income status if the household’s income decreases or the income limit for the household increases prior to renting the next available unit. See Rev. Rul. 94-57.
3. In a project containing more than one low-income building, the Available Unit Rule applies separately to each building.
4. A low-income unit containing a household whose income rises above 140% (or 170% for deep rent skewed projects) of the current income limit is still considered a low-income unit as long as the rent remains restricted and the next available units of comparable or smaller size is rented to a qualified low-income household and the rent is restricted.

5. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available. Since a comparable unit may need to be identified before the end of the year when the qualified basis is determined, a taxpayer may consider a residential unit with the same number of bedrooms (or fewer) and comparable amenities to be a comparable unit.
6. All comparable units that are available or that subsequently become available in the same building must be rented as low-income units in order to continue treating the over-income unit as a low-income unit. Once the percentage of low-income units in a building (excluding the over-income units) equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance.
7. If any comparable or smaller unit that is available or that subsequently becomes available is rented to a nonqualified resident, all over-income units within the same building for which the available unit is comparable or larger lose their status as low-income units. See Treas. Reg. §1.42-15(f).

**Audit  
Techniques:  
Mixed Use  
Buildings**

If a building contains both low-income and market rate units, the following audit techniques should be used to evaluate whether a taxpayer is compliant with the Available Unit Rule throughout the tax year(s) under audit.

1. Review the taxpayer's internal controls for maintaining compliance; i.e., how does the taxpayer identify and track over-income units?
2. Evaluate whether the taxpayer is timely completing the annual income recertifications by reviewing a sample of tenant files for residents who have occupied their units for more than a year. If a unit was determined to be over-income, ask the taxpayer to demonstrate how the specific over-income unit was tracked and replaced by renting a unit of comparable size or smaller to an income-qualified tenant.
3. Review the rent roles to identify when units were rented at market rate; i.e., the unit was not rented as a low-income unit with restricted rent. Ask the taxpayer to demonstrate that at the time the unit was rented, there were no over-income units of comparable or larger size.

**Audit  
Techniques:  
100% Low-  
Income  
Buildings**

The Available Unit Rule has no immediate application for 100% low-income buildings because the next available unit is always presumed to be rented to an income-qualified household. As a result, for tax years ending after July 30, 2008, Congress amended IRC §142(d)(3)(A), so that if all the low-income buildings in the project are 100% low-income buildings, taxpayers are not required to complete annual tenant income recertifications. IRC §42(g)(4) applies IRC §142(d)(3)(A) to IRC §42 low-income projects.

Therefore, for purposes of the Available Unit Rule only, households documented as initially income-qualified households continue to be income-qualified as long as the taxpayer demonstrates due diligence when completing initial income certifications. Further, the taxpayer does not violate the Available Unit Rule when a unit is

unintentionally rented to a nonqualified household.

Compliance with the Available Unit Rule should be an audit issue if:

1. A taxpayer fails to rent a unit to an income-qualified household and cannot demonstrate due diligence when making the determination of income eligibility.
2. The taxpayer deliberately rents a unit as a market-rate unit; i.e., the rent is not restricted.

In such cases, the taxpayer has disregarded the Available Unit Rule and the building's qualified basis is deemed to be 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 taxpayer can establish compliance with the Available Unit Rule. The records need to be reliably reconstructed to clearly demonstrate that the units continued to be low-income units, or if a unit was determined to be an over-income unit, then the Available Unit Rule was correctly applied.

## **Vacant Unit Rule**

### **Legislative History**

The Vacant Unit Rule is not included in the Code, but is described in the legislative history for the initial enactment of IRC §42. It reads:

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by a qualified low-income individual for purposes of the set-aside requirement [IRC §42(g)(1)] (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the project are rented to nonqualifying individuals.

### **Vacant Unit Available for Rent**

The vacant unit rule does not apply to a vacant unit if the unit is no longer available for rent due to contractual arrangements that are binding under local law, such as a reservation entered into between a building owner and a prospective tenant. See Rev. Rul. 2004-82, Q&A #10.

### **Treas. Reg. §1.42-5**

Treas. Reg. §1.42-5(c) requires taxpayers to certify at least annually to the state agency that, for the preceding 12-month period, the project met the requirements for claiming the IRC §42 credit. The regulation lists the specific requirements for which the certification must be made. In part, Treas. Reg. §1.42-5(c)(ix) states:

“If a low-income unit in the project became vacant during the year, that reasonable attempts were or are being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income.”

The language used in the regulation differs slightly from the language in the legislative history. The regulation requires taxpayers to make reasonable attempts to rent low-income units before renting comparable units to nonqualifying tenant while the legislative history prohibits the taxpayer from renting comparable units to nonqualifying tenants until after the low-income units are rented. The language in the regulation is relied upon for evaluating compliance with the Vacant Unit Rule.

**Rev. Rul.  
2004-82:  
Reasonable  
Attempts**

Rev. Rul. 2004-82 provides guidance for evaluating whether a taxpayer is making reasonable attempts to rent vacant low-income units. Q&A #9 provides the following example and discussion.

Q-9.

Ten units previously occupied by income-qualified tenants in a 200-unit mixed-use housing project are vacant. None of the low-income units in the project had been over-income units. The project owner displayed a banner and for rent signs at the entrance to the project, placed classified advertisements in two local newspapers, and contacted prospective low-income tenants on a waiting list for the project and on a local public housing authority list of section 8 voucher holders about the low-income unit vacancies. These are customary methods of advertising apartment vacancies in the area of the project for identifying prospective tenants. Subsequent to the low-income unit vacancies, a market-rate unit of comparable size to the low-income units became vacant. Will the owner violate the vacant unit rule if the owner rents the market-rate unit before any of the low-income units?

A-9.

No. In accordance with Treas. Reg. §1.42-5(c)(1)(ix), the owner of a qualified low-income housing project has to use reasonable attempts to rent a vacant low-income unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project are rented to tenants not having a qualifying income. Thus, if the project owner makes reasonable attempts to rent the vacant low-income units to income-qualified tenants, the owner may rent the newly vacated market-rate unit before renting the low-income units and continue to characterize the vacant low-income units as low-income units for purposes of the minimum set-aside requirements in IRC §42(g)(1) and calculation of the applicable fraction under IRC §42(c)(1)(B).

What constitutes reasonable attempts to rent a vacant unit is based on 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. Under the facts in this situation, the owner used reasonable methods of advertising an apartment vacancy in the area of the project before the owner rented the market-rate unit. Thus, the owner made reasonable attempts to rent the vacant low-income units.

<b>Additional Resources</b>	Chapter 15 of the Guide for Completing Form 8823 includes additional discussion for evaluating compliance with the Vacant Unit Rule.
<b>Available Unit Rule has Precedence</b>	The Vacant Unit Rule is similar to the Available Unit Rule and, generally, uses the same operational definitions. The Available Unit Rule, however, has precedence over the Vacant Unit; i.e., regardless of reasonable attempts to rent vacant low-income units, a taxpayer cannot rent a unit to a nonqualifying household as long as there are outstanding over-income units.
<b>Audit Techniques: Mixed Use Buildings</b>	<p>The Vacant Unit Rule has immediate application for low-income buildings with both low-income and market rate rental units. The following audit techniques should be used to evaluate whether a taxpayer is compliant with the rule throughout the tax year(s) under audit.</p> <ol style="list-style-type: none"> <li>1. Determine that the taxpayer is compliant with the requirements for the Available Unit Rule and whether there were outstanding over-income units during the year before reviewing the Vacant Unit Rule.</li> <li>2. Review the taxpayer's marketing strategies and whether marketing efforts are reasonable. In part, this can be accomplished by reviewing the expense claimed for advertising and the supporting documentation.</li> <li>3. Review the rent roles to identify when units were rented at market rate; i.e., the unit was not rented as a low-income unit with restricted rent. Ask the taxpayer to demonstrate that at the time the unit was rented, the taxpayer had made reasonable attempts to first rent the low-income units.</li> </ol>
<b>Audit Techniques: 100% Low-Income Buildings</b>	<p>Like the Available Unit Rule, the Vacant Unit Rule has no immediate application for 100% low-income buildings because available units are only rented to qualifying households.</p> <p>As a result, for purposes of applying the Vacant Unit Rule, the IRS will treat all households documented as initially income-qualified households as income-qualified as long as the taxpayer demonstrates due diligence when completing the initial income certification. Further, the taxpayer does not violate the Vacant Unit Rule when a unit is unintentionally rented to a nonqualified household.</p> <p>The Vacant Unit Rule is violated when a taxpayer fails to make reasonable attempts to rent vacant units to qualified households, and either:</p> <ol style="list-style-type: none"> <li>1. the taxpayer attempted, but failed to rent a unit to an income-qualified household, and cannot demonstrate due diligence when making the determination of income eligibility, or</li> <li>2. The taxpayer deliberately rents a unit as a market-rate unit; i.e., the rent is not restricted.</li> </ol>

Unless a taxpayer can document which units were vacant low-income units when the taxpayer deliberately violated the Vacant Unit Rule, the building's qualified basis is deemed to be 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 taxpayer establishes compliance with the Vacant Unit Rule; i.e., the applicable fraction is deemed to be zero. Note: The taxpayer must first demonstrate that the Available Unit Rule was not applicable, or if applicable, was applied correctly. (See discussion of this rule above.)

## **General Public Use & Transient Use**

### **Law**

The General Public Use Requirement is not included in the Code, but is described in the legislative history for the initial enactment of IRC §42. It reads:

Residential rental units must be for use by the general public and all of the units in a project must be used on a non-transient basis. Residential rental units are not used by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing, sanitarium, life care facility, retirement home providing significant services other than housing dormitory, or trailer park may be a qualified low-income project. Factory-made housing which is permanently fixed to real property may be a qualified low-income building..."

### **Treas. Reg. §1.42-9**

Treas. Reg. §1.42-9 provides guidance for applying the General Public Use Requirement.

#### (a) General rule.

If a residential rental unit in a building is not for use by the general public, the unit is not eligible for an IRC §42 credit. A residential rental unit is for use by the general public if the unit is rented in a manner consistent with housing policy governing non-discrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD) (24 CFR subtitle A and chapters I through XX). See HUD Handbook 4350.3 (or its successor)..."

#### (b) Limitations.

Notwithstanding paragraph (a) of this section, if a residential rental unit is provided only for a member of a social organization or provided by an employer for its employees, the unit is not for use by the general public and is not eligible for credit under IRC §42. In addition, any residential rental unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally and physically handicapped is not for use by the general public and is not eligible for credit under IRC §42.

(c) Treatment of units not for use by the general public.

The costs attributable to a residential rental unit that is not for use by the general public are not excludable from eligible basis by reason of the unit's ineligibility for the credit under this section. However, in calculating the applicable fraction, the unit is treated as a residential rental unit that is not a low-income unit.

**Fair Housing Act**

Low-income projects are subject to the Fair Housing Act, which makes it unlawful to discriminate in any aspect relating to the sale or rental of dwellings, in the availability of transactions related to residential real estate, or in the provision of services and facilities in connection therewith because of race, color, religion, sex, disability, familial status, or national origin.

Under Treas. Reg. §1.42-9(c), failure to comply with the Fair Housing Act may result in the disallowance of the IRC §42 and credit recapture under IRC §42(j). However, the IRS does not have authority to make determinations regarding a taxpayer's compliance with the Fair Housing Act, or otherwise enforce its provisions. By Memorandum of Understanding with the Department of Justice (DOJ) and the Department of Housing and Urban Development, the IRS is notified when a violation has occurred. See Chapter 13 of the Guide for Completing Form 8823 for additional in-depth discussion.

**General Public Use Requirement**

In addition to complying with the Fair Housing Act, the taxpayer must also comply with the specific requirements under IRC §42. Specifically, residential rental units are not for use by the general public if:

1. A residential rental unit is provided only for a member of a social organization or provided by an employer for its employees, or
2. A residential rental unit is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally and physically handicapped.

**IRC §42(g)(9)**

As part of the Housing Assistance Act of 2008, IRC §42(g) was amended to add, and apply retroactively, a clarification of the General Public Use Requirement. IRC §42(g)(9) reads:

Clarification of general public use requirement. A project does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants—

- (A) with special needs,
- (B) who are members of a specified group under a Federal program or State program or policy that supports housing for such a specified group, or
- (C) who are involved in artistic or literary activities.

Refer to Chapters 12 and 13 of the Guide for Completing Form 8823 for additional discussions.



**Transient Use** As stated in the legislative history, all of the units in a project must be used on a non-transient basis. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. There are two exceptions to the general rule that the initial lease term must be six months or longer.

#### **Transition of Homeless Individuals to Independent Living**

Under IRC §42(i)(3)(B)(iii), transitional housing for homeless individuals is not considered to be used on a transient basis if the unit contains sleeping accommodations and kitchen and bathroom facilities and is located in a building, and

1. which is used exclusively to facilitate the transition of homeless individuals (within the meaning of section 103 of the Stewart B. McKinney Homeless Assistance Act [McKinney-Vento Homeless Assistance Act] (*42 U.S.C. 11302*), as in effect on the date of the enactment of this clause [enacted Nov. 5, 1990]) to independent living within 24 months, and
2. in which a governmental entity or qualified nonprofit organization (as defined in IRC §42(h)(5)) provides such individuals with temporary housing and supportive services designed to assist such individuals in locating and retaining permanent housing.

#### **Single Room Occupancy Unit**

Under IRC §42(i)(3)(B)(iv), a single-room occupancy unit is not treated as used on a transient basis merely because it is rented on a month-by-month basis.

See Chapter 20 of the Guide for Completing Form 8823 for additional discussion of the nontransient use requirement.

#### **Provision of Services**

The provision of services by the taxpayer for tenants to live independently is not a violation of the General Public Use Requirement, even when it can be anticipated that a large percentage (if not all) tenants will contract with the taxpayer for the provision of the services.

- The provision of services may, or may not, be intended to address a special need under IRC §42(g)(9)(A).
- The taxpayer can charge a fee in addition to rent for providing the services, however the use of the services must not be a condition of occupancy.
- The services cannot include nursing, medical, or psychiatric care. See Treas. Reg. §1.42-11, Provision of Services.

For example, a taxpayer may provide housing units on a non-transient basis for individuals of retirement age or older. All of the units in the project are available to members of the general public. Each unit has living, cooking, sleeping, bathing, and sanitation facilities. The taxpayer also makes other services available to the tenants so that they can live independently, such as laundry, housekeeping, meals in a common dining area, planned social activities, transportation, and a 24 hour monitored emergency call service. Services do not include continual or frequent

nursing, medical, or psychiatric services. The services are optional and the fees charged for providing the services are separately stated from the rent. While the services are optional, it is anticipated that services will be used by most, if not all, of the tenants. The provision of these services does not violate the General Public Use Requirement. See Rev. Rul. 98-47.

**Condition of Credit Allocation**

Under IRC §42(m)(1), a state housing agency is required to determine housing priorities and give preference to projects serving the lowest income tenants for the longest periods in areas where the housing will contribute to a community revitalization plan. As a result, a state agency may require a taxpayer to provide housing to households with income less than the Area Median Gross Income (AMGI) required for IRC §42 purpose as a condition of receiving an IRC §42 credit allocation. The specific conditions will be recorded in the extended use agreement and are enforceable by the state agency under state contract law. See Chapter 6.

**Additional Fact Patterns**

A taxpayer is compliant with the General Public Use Requirement when:

1. IRC §42 housing is likely to be used (exclusively or predominantly) by a specific group not otherwise allowable under IRC §42(g)(9), but there is no evidence that the taxpayer is intentionally targeting the group or engaging in exclusionary rental practices.
2. The taxpayer rents low-income units exclusively to income-qualified households in which one or more of the household's members are involved in artistic or literary activities under IRC §42(g)(9)(C); e.g., the graphic arts (drawing, painting, sculpture, ceramics, and architecture), literature and journalism, music, dramatic arts and dancing.
3. IRC §42 project is located on Indian land and it is anticipated that only income-qualified members of the designated Indian tribes will occupy the low-income units.

**Noncompliance Issues**

Noncompliance occurs if:

- Under Treas. Reg. §1.42-9(a), the owner failed to comply with the Fair Housing Act, as documented by notification from the Department of Justice or HUD under the MOU.
- Under Treas. Reg. §1.42-9(b), a residential unit is provided only for members of a social organization or provided by an employer for its employees.
- Under Treas. Reg. §1.42-9(b), any residential rental unit that is part of a hospital, nursing home, sanitarium, life care facility, retirement home providing significant services other than housing, dormitory, trailer park, or intermediate care facility for the mentally and physically disabled is not for use by the general public.
- The taxpayer is renting low-income units to members of a specified group allowable under IRC §42(g)(9)(B), but cannot document association with a federal program or state program or federal/state policy that supports housing for such a specified group as required under IRC §42(g)(9)(B).

Noncompliance may also occur when the following fact patterns are identified. This list is not intended to be all inclusive. Other scenarios requiring evaluation of the taxpayer's compliance with the General Public Use Requirement may be identified during an audit.

- The taxpayer sets aside a portion of the low-income units for the exclusive use of income-qualified households referred by a third party. For example, a taxpayer may enter into an agreement with a third party to set-aside 25 of its 100 low-income units for the exclusive use of income-qualified households referred by the third party and the third party guarantees rent payments for the 25 units while vacant.
- A taxpayer restricts low-income units to student households, even if the student households meet one of the exceptions under IRC §42(i)(3)(D) for households comprised entirely of full-time students. The student households are not a qualified group under IRC §42(g)(9) and the General Public Use Requirement has precedence over the exceptions under IRC §42(i)(3)(D).
- The tenants' special needs require physical adaptations or services such that the taxpayer is effectively providing nursing, medical, or psychiatric services, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See Treas. Reg. §1.42-11(b)(2). For example, tenants diagnosed with dementia are isolated in an area where the taxpayer has installed combination locks on doors so that the tenants, who cannot remember the combination or operate the lock, cannot wander off the premises.

**Audit  
Techniques**

Potential violations of the General Public Use Requirement may be identified using the following audit techniques.

1. Review the tenant files, including rental applications and income certifications, to determine whether particular qualifications or criteria, in addition to IRC §42 requirements, were used to select tenants. Determine if the tenants share a common characteristic in addition to being income-qualified under IRC §42(g)(1); e.g., all the tenants are students at a nearby university.
2. Review the rent records, which may indicate that low-income units remain vacant for extended periods of time or that low-income units are not rented in the name of the household for which the unit is the primary residence.
3. Review the taxpayer's advertising efforts for the year under audit to determine whether the owner advertised to a wide audience within the market area and made reasonable attempts to rent vacant low-income units. "Reasonable attempts" will vary depending on factors such as size and location of the project, tenant turnover rates, and market conditions. Common examples include banners and "For Rent" signs at the entrance to the project, classified ads in local newspapers and accessing the local public housing authority's list of section 8 voucher holders. Consider the appropriateness of the advertising for the location of the property. Also, advertising methods should be designed to be accessible to all prospective tenants. See Rev. Rul. 2004-82, Q&A #9.

4. Review the taxpayer's written materials such as printed advertisements, pamphlets, and brochures. These documents are likely to provide prospective tenants with detailed information about the housing and qualifications for living in the low-income unit.
5. Review the taxpayer's web site, which may provide information suggesting that the owner is targeting specific audiences (not otherwise allowable under IRC §42(g)(9)) to the exclusion of the general public.
6. Request a copy of the taxpayer's credit application from the state agency. The application should include a market study demonstrating that there is a need for low-income housing and identifying the potential market in the property's location.
7. Review the extended use agreement between the taxpayer and the state agency. This document is helpful for understanding the terms of the credit allocation and the state agency's expectations for meeting the needs of the community, such as serving tenants at levels lower than required under IRC §42. See IRC §42(h)(6) and Chapter 7.
8. Tour of the property. Note any evidence that access to the housing is limited to specific groups not otherwise allowable under IRC §42(g)(9). Also note any qualifications for living there, such as a social group's logo or school decals in car windows or physical features that would not normally be expected to be present in housing for the general public.

## **On-Going Business Activity**

### **Law**

IRC §42(c)(2)(B) refers to low-income buildings as any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply; i.e., costs includable in eligible basis must be depreciable property under IRC §168, Accelerated Cost Recovery System. IRC §168(a) references IRC §167(a), which reads:

- (a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--
  - (1) of property used in the trade or business, or
  - (2) of property held for the production of income.

Treas. Reg. §1.167(a)-10(b) explains that the period for depreciation of an asset begins when the asset is placed in service and ends when the asset is retired from service. Treas. Reg. §167(a)-11(e)(1)(i) defines "placed in service" as when first placed in a condition or state of readiness and available for a specifically assigned function" and references Treas. Reg. §1.46-3(d), which provides the same "placed in service" definition for property qualifying for the IRC §38 Investment Tax Credit.

To qualify for the IRC §42 credit, a low-income unit must be placed in service; i.e.,

1. Placed in a condition or state of readiness, and
2. Be available for a specifically assigned function. In this case, made available for rent to a qualified low-income household.

Failure to meet either requirement will result in the low-income unit no longer being placed in service and no credit for the unit would be allowable.

#### **Fact Patterns**

A taxpayer may cease efforts to make vacant low-income units available for rent. For example:

- the vacant units are extensively damaged or not prepared for a new tenant.
- the vacancy rate is high and there is no immediate need for the unit, or
- the taxpayer anticipates a disposition of the low-income project that will result in the termination of the extended use agreement and, through attrition, is attempting to reduce the number of low-income tenants protected under IRC §42(h)(6)(E)(ii) from evictions without cause and rent increases not otherwise allowed under IRC §42.

#### **Audit Techniques**

Individual low-income units, or entire low-income buildings, may no longer be placed in service. To determine whether the taxpayer is pursuing an on-going business activity:

1. Review the rent records to identify low-income units remain vacant for unexpectedly long periods of time.
2. Review the taxpayer's marketing and advertising efforts to determine whether the taxpayer is making reasonable attempts to rent vacant units. As noted earlier, "reasonable attempts" will vary. See Rev. Rul. 2004-82, Q&A #9.

### **Computing the Applicable Fraction**

To summarize, the audit of the Applicable Fraction begins with a unit-by-unit evaluation to determine whether the housing meets the three basic requirements:

1. the unit must be occupied by an income-qualified household,
2. the rent must be restricted, and
3. the unit must be suitable for occupancy.

In addition, the low-income units are subject to the following rules, for which the taxpayer's compliance should be evaluated.

- Available Unit Rule
- Vacant Unit Rule
- General Public Use Requirement and Transient Use Rule

Consideration may also be given to whether individual low-income units (or entire buildings) are placed in service and qualify as depreciable property under IRC §168.

Once the qualifying low-income units have been identified, the applicable fraction can be determined for each low-income building. The applicable fraction is always a fraction carried out four decimal places.

**Determined at the End of the Taxable Year**

Under IRC §42(c)(1)(A), the applicable fraction is determined on the last day of the taxable year.

**Example 1: Applicable Fraction Determined as of the Last Day of Taxable Year**

A taxpayer owns one low-income building consisting of 15 residential rental units of equal size. All of the units are intended to be low-income units. The taxpayer reports the applicable fraction is 100% (15/15) on Form 8609-A, line 2, included with its tax return.

For various reasons, 4 units are determined to be nonqualifying units at the end of the taxable year. The correct applicable fraction is  $(15-4) \div 15$ , or 73.33%

A taxpayer may suggest that consideration should be given to low-income housing provided during the taxable year, rather than basing the applicable fraction on a “snap shot” computation at the end of the taxable year. The interpretation of “on the last day of the taxable year” was explained in CCA 200913012, in which Chief Counsel concluded that if a taxpayer “failed to restore the building by [the end of the tax year], no credits would be allowed for the entire taxable year...even if the reasonable period (or reasonable restoration period) to the restore the building extends into [the subsequent tax year].”

**Example 2: “Snap Shot” Determination**

A taxpayer owns one low-income building consisting of 15 residential rental units. All of the units were qualified low-income unit from the beginning of the tax year on January 1<sup>st</sup> until December 15<sup>th</sup>, when the building was completely destroyed by a fire. The building was rebuilt and placed back in service in June of the subsequent year. The taxpayer prorated the applicable fraction, computed as  $(15/15) \times (11/12)$  or 91.67%, to account for the eleven full months that low-income housing was provided.

The applicable fraction is zero at the end of the year and no credit is allowable for the entire taxable year.

**Unit Fraction or Floor Space Fraction**

Under IRC §42(c)(1)(B), the applicable fraction is the smaller of the unit fraction or the floor space fraction.

**Example 3: Lesser of Unit Fraction or Floor Space Fraction**

A taxpayer owns one low-income building consisting of 15 residential rental units. Five units are 1-bedroom units with 950 square feet, five units are two-bedroom units with 1,100 square feet, and five of the units are 3-bedroom units with 1,500 square feet. All of the units are intended to be low-income units. The taxpayer reports the applicable fraction is 1.0000 (15/15 or 17,750/17,750 square feet) on Form 8609-A, line 2,

included with its tax return.

For various reasons, 4 of the 3-bedroom units are determined to be nonqualifying units at the end of the taxable year.

The correct applicable fraction is 67.14%, which is the lesser of:

1. The unit fraction:  $(15-4) \div 15$ , which is 73.33%, or
2. the floor space fraction:  $[17,750 - 4(1,500)] \div 17,750$ , which is 67.14%

**First Year of  
the 10-Year  
Credit Period:  
New  
Construction**

Under IRC §42(f)(2)(A), 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.

**Example 4: First Year Computation for Newly Constructed Building**

A taxpayer constructed a new IRC §42 building with 10 units. Units 1 through 5 are 750 square feet and Units 6 through 10 are 1,000 square feet. The total square footage of all the units is  $(5 \times 750 \text{ sq. ft.}) + (5 \times 1,000 \text{ sq. ft.}) = 8,750 \text{ sq. ft.}$  The building was placed in service on June 15, 2009, and 2009 is the first year of the credit period. The following chart indicates with an “X” which months during 2009 that the units were qualified low-income units.

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
Units	0	0	0	0	0	0	.5000	.8000	.9000	1.00	1.00	1.00
Sq.Ft.	0	0	0	0	0	0	.5143	.8286	.9143	1.00	1.00	1.00

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 using the Unit Fraction method is computed as

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

which equals 0.4333, or 43.33%.

Using the Floor Space Fraction method, the applicable fraction is computed as:

$$(.5143 + .8286 + .9143 + 1.00 + 1.00 + 1.00) \div 12$$

which equals 0.4381, or 43.81%

The applicable fraction is 0.4333, the smaller of the Unit Fraction or the Floor Space Fraction.

**First Year of the 10-Year Credit Period: Acquisition and Rehabilitation of an Occupied Building**

A taxpayer may acquire and rehabilitate a building qualifying for both the acquisition and rehabilitation credit under IRC §42, but the taxpayer is not required to determine two applicable fractions for the separate allocation of credit. 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 5: First Year Computation for Acquired and Rehabilitated Building**

A building has 10 units which were all occupied at the time the building was purchased. Units 1-5 have 750 square feet and Units 6-10 have 1,000 square feet. The total square footage of all the units is  $(5 \times 750 \text{ sq. ft.}) + (5 \times 1,000 \text{ sq. ft.}) = 8,750 \text{ sq. ft.}$  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 following chart indicates with an “x” which months during 2009 that the units were qualified low-income units. Typically, gaps occur (1) at the beginning of the year because the units are not occupied by qualifying tenants, and (2) while the units are being rehabilitated.



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
Units	.40	.80	.9000	.9000	.60	.3000	.80	1.00	1.00	1.00	1.00	1.00
Sq. Ft.	.40	.80	.9143	.9143	.60	.2857	.80	1.00	1.00	1.00	1.00	1.00

The applicable fraction for 2009 using the Unit Fraction is computed as

$$[.40 + .80 + .90 + .90 + .60 + .30 + .80 + (4 \times 1.00)] \div 12,$$

which equals 0.7250, or 72.50%.

Using the Floor Space Fraction, the applicable fraction for 2009 is computed as:

$$[.40 + .80 + .9143 + .9143 + .60 + .2857 + .80 + (4 \times 1.000)] \div 12,$$

Which equals .7262 or 72.62%

The applicable fraction is 0.7250 or 72.50%, the smaller of the Unit Fraction or the Floor Space Fraction.

Refer to Chapter 4 of the Guide for Completing Form 8823 for additional information.

**Year 11 of the 15-Year Compliance Period**

Under IRC §42(f)(2)(B), any reduction in allowable credit for the first year because of the special computation of the applicable fraction is allowable in the eleventh year of the compliance period and is accounted for on Form 8609-A, line 17.

<b>Additions to Qualified Basis</b>	Units first qualifying as low-income units after the end of the first year of the credit period are accounted for under IRC §42(f)(3) by modifying the applicable percentage. The modification doesn't affect the computation of the applicable fraction at the end of the taxable year, but it is helpful to identify units that were not qualified low-income units at the end of the first year of the credit period. See Chapter 13.
<b>Common Computation Errors</b>	<ol style="list-style-type: none"> <li>1. For the first year of the credit period, 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 taxpayer reports on Form 8609-A that the applicable fraction is .7500, computed as 9 month ÷ 12 months.</li> <li>2. For the first year of the credit period, 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.</li> <li>3. The taxpayer does not compute both the unit fraction and floor space fraction to determine the lesser fraction.</li> </ol>

### Minimum Set-Aside

To qualify for the IRC §42 credit, a taxpayer must provide a minimum number of low-income units, which is referred to as the “minimum set-aside.” If a taxpayer fails to meet the minimum set-aside requirement after the first year of the credit period, then no credit is allowable for the tax year. If the taxpayer fails to meet the minimum set-aside for the first year of the credit period, then the buildings do not qualify as low-income buildings under IRC §42 and no credit is allowable for any year of 10-year credit period.

<b>Law</b>	<p>IRC §42(g)(1) defines a qualified low-income housing “project” as any project for residential rental property if the project meets one of the three following tests, as elected by the taxpayer.</p> <ul style="list-style-type: none"> <li>• 20-50 test. The project meets the requirements if 20% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50% or less of area median gross income.</li> <li>• 40-60 test. The project meets the requirements of this subparagraph if 40% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60% or less of area median gross income.</li> <li>• 25-60 test. For projects located in a city having 5 boroughs and a population in excess of 5,000,000, the 40-60 minimum set-aside test is applied by substituting 25% for 40%. See IRC §142(d)(6), which is made applicable to IRC §42 projects under IRC §42(g)(4).</li> </ul>
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<b>Making the Election</b>	The election is made on Form 8609, line 10c. As noted in language following IRC §42(g)(1), the minimum set-aside election, once made, is irrevocable.
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**Project Defined** Under IRC §42(g)(3)(D), each low-income building is considered a separate project unless the taxpayer identifies each building which is, or will be, part of the project. Under IRC §42(g)(7) and Treas. Reg. §1.103-8(b)(4)(ii), two or more qualified low-income buildings can be included in a project only if the buildings:

- are located on the same tract of land, unless all the units in all the “scattered site” buildings to be included in the project are low-income units.
- are owned by the same person (entity) for federal tax purposes.
- are financed under a common plan for financing, and
- have similarly constructed housing units.

A taxpayer may elect to group low-income buildings in any combination to best satisfy IRC §42 requirements and maximize the allowable credit for the first year of the credit period. The decision is often based on when the buildings are placed in service and “leased-up.”

**Project Identified** Under IRC §42(g)(3)(D), a low-income project with more than one building must be identified. A project is treated as consisting of only one building unless each building which is (or will be) part of the project is identified in such form and manner as the Secretary may provide.

Multi-building projects are identified as part of the taxpayer’s first year certification on Form 8609, line 8b. In addition to checking the box “yes,” the taxpayer must include an attachment to the Form 8609, with the following information:

- Name and address of the project and every building included in the project.
- Building Identification Number (BIN) for every building in the project,
- Aggregate credit dollar amount for the project, and
- Credit allocated to each building in the project.

If the taxpayer checks the “yes” box on Form 8609, but fails to include the attachment with the required information, then each building is considered a separate project.

**Date for Meeting Requirement** Under IRC §42(g)(3)(A), a building is treated as a qualified low-income building only if the project of which such building is a part satisfies the minimum set-aside requirement not later than the close of the first year of the credit period for such building.

IRC §42(g)(3)(B) provides an alternative when a building relies on one or more buildings placed in service after the building for qualification as a qualified low-income building. The taxpayer can use this method to effectively create a “project” if two conditions are met:

1. The later buildings must be placed in service within 12 months of the date the first building is placed-in-service.
2. Within the 12-month period after the first building is placed in service, all the subsequent buildings collectively must meet the minimum set-aside requirement.

If the taxpayer uses this methodology, then the building relying on subsequent buildings for qualification as a low-income building is treated as placed in service on the most recent date any additional building was placed in service. See IRC §42(g)(3)(B). The alternative treatment under IRC §42(g)(3)(B) is seldom applied.

For tax planning reasons and ease of operating the project during the 15-year compliance period, taxpayers usually (but not always) organize a multi-building project such that all the low-income buildings begin the credit period at the same time. IRC §42 does not require that all the buildings in a project begin the credit period at the same time. The only requirement is that a low-income building is part of a project that meets the minimum set-aside no later than at the end of the first year of the building's credit period.

**Continuous Compliance**

The minimum set-aside must be met each year of the 15-year compliance period. Under IRC §42(c)(2)(A), a “qualified low-income building” is any building which is part of a “qualified low-income housing project” at all times during the building's 15-year compliance period. That is:

1. beginning on the first day in the compliance period for which the building is a part of the project, and
2. ending on the last day of the compliance period with respect to the building.

Under IRC §42(g)(5), a taxpayer may elect to treat a building as not part of a qualified low-income housing project for any period beginning after the compliance period for such building.

**Waiver of De Minimis Errors**

Under IRC §42(g)(8), the IRS may waive de minimis errors in meeting the minimum set-aside requirement.

- Taxpayers can request private letter rulings to obtain the waiver.
- If a de minimis error is discovered as part of an IRS audit, the examiner should contact the IRC §42 program analyst. Examiners do not have authority to waive de minimis errors.

**Testing for the Minimum Set-Aside Requirement**

Once the applicable fraction for each low-income building in the project has been determined, the taxpayer's compliance with the minimum set-aside requirement can be tested.

### Example 1: Minimum Set-Aside Test

A taxpayer owns IRC §42 low-income housing consisting of 10 single family homes. The homes are equal in size and comparably constructed. Each home was allocated IRC §42 credit equaling \$10,000 and the taxpayer elected the 40-60 minimum set-aside. The taxpayer claimed credit equaling \$100,000 on its tax return for the 2014 tax year, the sixth year of the credit period.

The 2014 return was audited and the examiner determined that, at the end of the 2014 taxable year:

- Homes #1 and #3 were occupied by households whose income exceeded 60% of AMGI at the time of move-in during 2014.
- Home #4 was occupied by a household composed entirely of full-time students that was not a qualified low-income student household under IRC §42(i)(3)(D).
- Home #5 was vacant at the end of the year. The taxpayer could not find the last tenant's file to establish that the unit was last occupied by a low-income tenant.
- Home #7 was vacant at the end of the year. The state housing agency filed Form 8823 to report that the unit was not suitable for occupancy; i.e., it not been cleaned and prepared for a new tenant.
- Homes #8 and #9 were not low-income unit because the rent paid by the tenants exceeded the gross rent limit after considering utility allowances and fees paid by the tenants.
- Homes #2, #6, and #10 were qualified low-income units at the end of the taxable year.

Homes #1, #3, #4, #5, #7, #8 and #9 are not qualified low-income buildings. The examiner must now consider how the taxpayer defined the "qualified low-income project" by reviewing the taxpayer's elections on Form 8609.

1. If the taxpayer treated each home as a separate project, then homes #2, #6 and #10 are qualified low-income projects and the taxpayer's allowable credit for 2014 is \$30,000, computed as 3 x \$10,000.
2. If the taxpayer treated all the homes as a single project, then at least four of the ten homes must be qualified low-income units to meet the 40% minimum set-aside requirement. In this case, however, only three of the buildings are qualified low-income units. The taxpayer has failed the test and no credit is allowable because the taxpayer did not provide the minimum amount of low-income housing.

The above example demonstrates the two most likely project configurations. A taxpayer may choose to create multiple projects with any combination of buildings meeting the definition of a qualified low-income project.

**Failure to Satisfy Minimum Set-Aside Requirement**

If the project fails the minimum set-aside requirement, then the qualified basis of each building in the project is deemed to be zero. See Chapter 13 for discussion of qualified basis.

## **Deep Rent Skewing**

**Deep Rent Skewing**

Under IRC §142(d)(4)(B)(i), a taxpayer can elect to provide housing to households with incomes of 40% or less of AMGI. The election is made on Form 8609, Low-Income Housing Certification, line 10d. The project qualifies if:

1. 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI;
2. The gross rent with respect to each low-income unit in the project does not exceed 30% of the applicable income limit applicable to the individuals occupying the unit; and
3. The gross rent with respect to each low-income unit in the project does not exceed half of the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

**Relationship to Minimum Set-Aside**

Low-income units satisfying the deep rent skewing election also satisfy the minimum set-aside requirement.

**Failure to Satisfy Deep Rent Skewing Election**

If the project fails to satisfy the deep rent skewing election, then none of the units purported to satisfy the deep rent skewing election are low-income units for purposes of determining the building's applicable fraction or whether the minimum set-aside requirement is met.

## **Summary**

1. The applicable fraction is the percentage of rental units in a building that qualify as low-income units, measured as a percentage of floor space or as a percentage of units.
2. The applicable fraction is determined on the last day of the taxable year and is a fraction carried out four decimal places.
3. The applicable fraction for the "rehabilitation" credit is the same for the "acquisition" credit.
4. There are special rules for determining the applicable fraction for the first year of the credit period.

5. To qualify as a low-income unit, the unit must satisfy three basic requirements: (1) the unit must be occupied by an income-qualified household, (2) the rent must be restricted, and (3) the unit must be suitable for occupancy.
6. The taxpayer is also subject to four rules governing the operation of the IRC §42 project: (1) the Available Unit Rule, (2) the Vacant Unit Rule, (3) the General Public Use Requirement, and (4) the Transient Use Rule.
7. The low-income units must be placed in service.
8. The taxpayer must provide a minimum amount of low-income housing to qualify for any credit. The taxpayer may elect to provide a minimum of:
  - 40% of the housing for households with income at or below 60% of the Area Median Gross Income (AMGI).
  - 20% of the housing for households with income at or below 50% of AMGI.
  - 25% of the housing for households with income at or below 60% of the Area Median Gross Income, but only if the project is located in a city having 5 boroughs and a population in excess of 5,000,000.

The election, referred to as the “minimum set-aside,” is made on Form 8609 and is irrevocable.

9. If the taxpayer fails the minimum set-aside for the first year of the credit period, then the project never qualifies for the credit.
10. In addition to the minimum set-aside, the taxpayer may elect deep rent skewing, so that at least 15% of the housing is occupied by households with income at or below 40% of AMGI.

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## **Chapter 13**

### **Qualified Basis**

**Introduction** Qualified basis is the portion of a low-income building's eligible basis associated with the low-income units.

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

While qualified basis is a function of both eligible basis and the applicable fraction, there are specific IRC §42 rules and limitations applied to qualified basis as a whole.

#### **Topics**

- Law
- Increases to Qualified Basis
- Decreases in Qualified Basis
- Maximum Qualified Basis
- Supportive Services for the Homeless
- Imputed Zero Qualified Basis
- Imputed Qualified Basis in the Event of Casualty Loss in Disaster Area
- Qualified Basis Subject to Recapture
- Summary

#### **Law**

##### **Qualified Basis Defined**

Under IRC §42(c)(1), the qualified basis of any qualified low-income building for any taxable year is an amount equal to:

1. the applicable fraction (determined as of the close of such taxable year) of
2. the eligible basis of such building determined under IRC §42(d)(5).

A qualified low-income building's qualified basis is determined for each taxable year in the building's 15-year compliance period. To qualify as a low-income building, the building must be part of a qualified low-income project beginning on the first day in the compliance period on which such building is part of such a project, and ending on the last day of the compliance period for that building. See IRC §42(c)(2).

#### **Increases to Qualified Basis**

Qualified basis is initially determined at the end of the first year of the credit period and, since the eligible basis is fixed at the same time, qualified basis is (generally) a function of the applicable fraction. The qualified basis may increase after the initial determination, but only if the number of qualified low-income units increases after the end of the first year of the credit period; i.e., the applicable fraction increases.

The credit associated with an increase in qualified basis after the end of the first year of a building's credit period is computed differently than the credit determined at the close of the first year of the building credit period. Under IRC §42(f)(3)(A), the applicable percentage under IRC §42(b) is equal to two-thirds of the applicable percentage that would otherwise apply to the building. As a result, the credit associated with an increase in qualified basis is commonly referred to as the "2/3 credit."

### Example 1: Increase in Qualified Basis

A taxpayer owns a qualified low-income building with 100 units for which the eligible basis is \$10,000,000. The applicable percentage is .0835 and the applicable fraction at the end of the first year of the credit period was .8500; i.e., 85 of the 100 units are qualified low-income units.

The qualified basis for the first year of the credit period is:

$$\$10,000,000 \times .8500 = \$8,500,000$$

The credit for the first year of the credit period is computed as the qualified basis x the applicable percentage:

$$\$8,500,000 \times .0835 = \$709,750$$

The applicable fraction for the second year of the credit period was .950. The qualified basis is  $\$10,000,000 \times .9500 = \$9,500,000$  and the increase in qualified basis is

$$\$9,500,000 - \$8,500,000 = \$1,000,000.$$

The credit for the initial qualified basis is the same as computed for the first year of the credit period, \$709,750. The 2/3 credit associated with the \$1,000,000 increase in qualified basis is computed as:

$$\$1,000,000 \times (.0835)(2/3) = \$55,611$$

In total, the taxpayer may claim credit equal to \$765,361, computed as  $\$709,750 + \$55,611$ .

#### Rules Relating to Increases in Qualified Basis

Increases in qualified basis are subject to the following rules:

1. Under IRC §42(f)(3)(B), when computing the applicable fraction for the increase in qualified basis for the first year of the increase, the special rule for the first year of the credit period in IRC §42(f)(2) is applied; i.e., the sum of the applicable fractions determined at the end of each full month of such year divided by 12. See Chapter 12.

The computation of the applicable fraction for the increase in qualified basis was not shown in the example above. Suppose the taxpayer uses a calendar tax year and that 10 additional units were rented to qualifying households in January of the second year of the credit period, the first month of the taxable year and remained low-income units the entire year. The applicable fraction would be .10, computed as  $10 \div 100$ , each month for 12 months, the sum of which is divided by 12 month.

$$(10 \text{ units} \div 100 \text{ units}) \times (12 \text{ months}) \div (12 \text{ months}) = .100$$

2. The increase in qualified basis can only result from an increase in the applicable fraction; i.e., low-income units are first occupied by qualifying households after the end of the first year of the credit period.
3. The sum of the credit associated with the initial qualified basis and the 2/3 credit cannot exceed the maximum allowable credit allocated to the building by the state housing agency.
4. The 2/3 credit is claimed for each remaining year in the 15-year compliance period after the end of the first year of the credit period that the unit qualifies.

## Decreases in Qualified Basis

### Nonrecourse Financed

Under the IRC §42(k)(1) credit at-risk rules, a IRC §42 building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing. Nonqualified nonrecourse financing may be identified as part of the analysis of a taxpayer's financial resources. See Chapter 10 for complete discussion.

## Maximum Qualified Basis

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility and viability as a qualified low-income housing project throughout the credit period.

This limit on the credit amount can be accomplished by limiting the qualified basis used to compute the credit. Under IRC §42(h)(7)(D), the state agency making the credit allocation specifies the maximum qualified basis associated with the low-income building. The maximum qualified basis specified can be less than, but never more than, the actual qualified basis. The building's maximum qualified basis is documented on Form 8609, line 3a.

When the actual qualified basis exceeds the maximum qualified basis, the difference is commonly referred to as "excess basis." See Chapter 15 for additional discussion.

## Supportive Services for the Homeless

### Limitation on Costs Included in Qualified Basis

Under IRC §42(c)(1)(E), a low-income building's qualified basis includes the portion of the building used to provide supportive services for homeless individuals. If the building qualifies as transitional housing under IRC §42(i)(3)(B)(iii), then the qualified basis for any taxable year is increased by the lesser of:

1. so much of the building's eligible basis as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
2. 20% of the qualified basis of such building (determined without regard to the facility used to provide supportive services).

## **Imputed Zero Qualified Basis**

A building's qualified basis can be deemed to be zero, as described in the following examples. Other fact patterns may result in the same treatment.

1. The entire building is noncompliant with IRC §42 requirements. For example, the building is not considered suitable for occupancy because of building-level noncompliance with the Uniform Physical Condition Standards. See CCA 201042025.
2. The project, of which the building is a part, did not satisfy the minimum set-aside requirement under IRC §42(g)(1). See Chapter 12.
3. The extended use agreement is not in place at the end of the year and the taxpayer failed to correct the noncompliance with the IRC §42(h)(6) requirements within one year of the date it was determined the agreement was not in place. See IRC §42(h)(6)(J) and Chapter 5.
4. The taxpayer disposes of the building and the taxpayer is subject to recapture. For dispositions before July 31, 2008, recapture could be avoided if it was reasonably expected that the building would continue to be operated in compliance with IRC §42 requirements and the taxpayer posted a disposition bond with, or pledged securities to, the IRS. See Rev. Rul. 90-60 and Rev. Proc. 99-11. For dispositions after July 30, 2008, no recapture is required if it is reasonably expected that the building will continue to be operated in compliance with IRC §42. Beginning July 31, 2008, taxpayers who had posted disposition bonds could elect to discontinue maintaining the bond (or pledged securities) under Rev. Proc. 2008-60.

## **Imputed Qualified Basis in the Event of Casualty Loss in Disaster Area**

In the event of a casualty loss in a presidentially declared major disaster area, Rev. Proc. 2007-54 provides that the building's qualified basis at the end of the taxable years of the casualty loss and restoration period is the qualified basis at the end of the taxable year that preceded the President's major disaster declaration. See Rev. Proc. 2007-54, Section 7.02.

## **Qualified Basis Subject to Recapture**

The allowable credit for the qualified basis at the end of the first year of the credit period is determined based on the premise that the taxpayer is obligated to provide low-income housing for five years after the end of the 10-year credit period. Effectively, a portion of the allowable credit each year is claimed in advance of providing the low-income housing. If there is a decrease in qualified basis at any time subsequent to the first year of the credit period, then the portion of credit allowed in advance of performance is subject to recapture. The recapture provisions under IRC §42(j) are discussed in Chapter 16.

The 2/3 credit associated with increases in qualified basis is based on providing low-income housing for that taxable year only. Therefore, the credit is not subject to the recapture provisions under IRC §42(j). See IRC §42(j)(4)(C)

## Summary

1. Qualified basis is computed as the product of the eligible basis and applicable fraction.
2. Qualified basis is determined each year of the 15-year compliance period, even if no credit is allowable.
3. Qualified basis may increase after the end of the first year of the credit period, but only if the number of qualified low-income units increases after the end of the first year of the credit period; i.e., the applicable fraction increases. Credit associated with the increase in qualified basis is known as the 2/3 credit and is allowable for each taxable year of the 15-year compliance period.
4. Increases in eligible basis after the end of the first year of the credit period do not increase qualified basis.
5. The maximum qualified basis is determined by the state agency at the time the credit allocation is made so that the amount of credit allocated does not exceed the amount necessary to ensure the building's financial feasibility and viability. Maximum qualified basis may be equal to or less than, but should not be more than, the actual qualified basis.
6. Qualified basis in excess of the maximum qualified basis is commonly referred to as "excess basis" and is associated with costs includable in eligible basis.
7. The cost of facilities used to provide supportive services can be included in eligible basis if the building qualifies as transitional housing under IRC §42(i)(3)(B)(iii). The qualified basis is increased by the lesser of the eligible basis of the building used to provide the supportive services or 20% of the qualified basis of the building determined without regard to the eligible basis of the building used to provide the services.
8. A building's qualified basis is deemed to be zero if:
  - The entire building is noncompliant with IRC §42 requirements.
  - The minimum set-aside requirement under IRC §42(g)(1) is not satisfied.
  - An extended use agreement is not in place at the end of the taxable year and the taxpayer has failed to correct the noncompliance within the one-year correction period.
  - The taxpayer disposes of the building and is subject to recapture; i.e., it is not reasonable to expect that the building will continue to be operated as a qualified low-income building for the remainder of the compliance period.
9. Only the qualified basis determined at the end of the first year of the credit period is subject to the IRC §42(j) recapture provisions.
10. In the event of a casualty loss qualifying for relief under Rev. Proc. 2007-54, the imputed qualified basis for the year(s) of the casualty loss and the restoration period is the qualified basis at the end of the taxable year proceeding the year of the casualty event.

11. IRC §42 is often written using the term “qualified basis” rather than specifying the eligible basis or the applicable fraction. Caution is warranted when applying rules written in the “qualified basis” context.

## **Chapter 14**

### **Applicable Percentage**

**Introduction**      The applicable percentage is the discount factor used to account for the present value of the credit over the 10-year credit period. The taxpayer reports the applicable percentage on Form 8609-A, Annual Statement for Low-Income Housing Credit, line 5.

The applicable percentage is dependent on three basic factors:

1. When the low-income building was placed in service, unless the taxpayer elects otherwise.
2. Whether the housing is new or acquired existing housing.
3. Whether the housing is federally subsidized.

For buildings placed in service in 1987, the applicable percentage was an annual rate of 9% for the 70% present value credit and 4% for the 30% present value credit. Although the present value of the credit is based on fluctuating interest rates and varies from month to month, the IRC §42 credit is commonly described as the “9%” and “4%” credits.

**Topics**

- Law
- Federally Subsidized – Buildings Placed in Service Before July 31, 2008
- Federally Subsidized – Buildings Placed in Service After July 30, 2008
- Audit Issues and Techniques
- Adjustments to the Applicable Percentage
- Summary
- Reference

**References**      To audit the applicable percentage, the following references are needed:

1. Guide for Completing Form 8823, Chapter 9.
2. Former IRC §42(i)(2), which is included as a reference at the end of the chapter.

### **Law**

#### **Applicable Percentage Defined**

The applicable percentage is the factor which, when multiplied by the building’s qualified basis, equals the credit allowable to the building.

For buildings placed in service during 1987, the first year the credit was allowable, the applicable percentage was fixed. Under former IRC §42(b)(1), the applicable percentage was:

1. 9% for new buildings which were not federally subsidized for the taxable year, or
2. 4% for new buildings which are federally subsidized for the taxable year, and existing buildings.

For buildings placed in service after 1987 and before July 31, 2008, under former IRC §42(b)(2)(B), the applicable percentage was prescribed by the IRS such that it would yield, over the 10-year credit period, an amount of credit having a present value equal to:

1. 70% of the qualified basis of a new building that is not federally subsidized for the taxable year, and
2. 30% of the qualified basis of (1) a new building that is federally subsidized for the taxable year or (2) an existing building.

As part of the Housing Assistance Tax Act of 2008, IRC §42(b) was amended and renumbered. For buildings placed in service after July 30, 2008, IRC §42(b)(1)(B) now provides that the applicable percentage is determined by the IRS such that the credit over the 10-year credit period will yield a present value equal to:

1. 70% of the qualified basis of a new building that is not federally subsidized for the taxable year, and
2. 30% of the qualified basis of all other buildings.

Congress amended IRC §42(b)(2) to provide a temporary minimum applicable percentage of 9% for new buildings that are:

1. not federally subsidized,
2. placed in service after July 30, 2008, and
3. received an allocation of credit before December 31, 2013.

**Rehabilitation Expenses Treated as New Building**

Under IRC §42(e), rehabilitation expenses are treated as a separate new building qualifying for the 70% present value credit or the 30% present value credit if federally subsidized. See Chapter 9 for complete discussion.

**Increases in Qualified Basis**

Under IRC §42(f)(3)(A), the credit associated with increases in qualified basis is computed using an applicable percentage equal to two-thirds of the applicable percentage that would otherwise apply to the building. See Chapter 13.

**Applicable Percentage Determined**

Under IRC §42(b)(1), the taxpayer uses the applicable percentage for the earlier of:

1. the month in which the low-income building is placed in service, or
2. at the taxpayer's election, (1) the month in which the taxpayer and the state agency enter into an agreement as to the amount of credit to be allocated to the building, or (2) if the aggregate basis of a building and land upon which the building is located is financed 50% or more with tax-exempt bonds, the month in which the tax-exempt bonds are issued.



The election must be made no later than the fifth day after the close of such month and once made, the election is irrevocable. Procedures for making the election are outlined in Treas. Reg. §1.42-8. The election is binding if:

1. it is in writing,
2. is binding under state law on the state agency, taxpayer, and all successors in interest,
3. specifies the types of buildings to which the credit applies,
4. specifies the amount of credit allocated to the buildings, and
5. is dated and signed by the taxpayer and state agency during the month in which the requirements above are met.

See Treas. Reg. §1.42-8 for complete discussion.

**State Agency Authority to Specify Applicable Percentage**

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a project so that it does not exceed an amount necessary to ensure the project's financial feasibility as a qualified low-income housing project throughout the credit period.

This limit on the credit amount can be accomplished by limiting the applicable percentage used to compute the credit. Under IRC §42(h)(7)(D), the state agency making the credit allocation has the authority to specify the applicable percentage for the low-income building. The applicable percentage specified can be less than, but never more than, the applicable percentage otherwise prescribed.

**Identifying the Applicable Percentage**

The IRS prescribes the applicable percentage as required under IRC §42(b)(1)(B). The present value is determined as of the last day of the first year of the 10-year credit period and by using a discount rate equal to 72% of the average of the annual federal mid-term rate and the annual federal long-term rate applicable under IRC §1274(d)(1) to the month and compounded annually, and assuming that the credit allowable under IRC §42 for any year is received on the last day of such year. See IRC §42(b)(1)(C).

The IRS publishes the applicable percentages on a monthly basis in the IRS Bulletin.

**Applicable Percentage Documented**

The maximum applicable percentage is documented on Form 8609, line 2.

**Federally Subsidized – Buildings Placed in Service Before July 31, 2008**

**Federally Subsidized New Building Defined**

For new buildings placed in service before July 31, 2008, federally subsidized buildings are defined in former IRC §42(i)(2)(A). A new building is treated as federally subsidized for any taxable year if, at any time during any taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under IRC §103 (tax-exempt bond), or any below market federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation.

Under former IRC §42(i)(2)(D), the term “below market federal loan” means any loan funded in whole or in part with federal funds if the interest rate payable on the loan is less than the applicable federal rate in effect under IRC §1274(d)(1) as of the date on which the loan was made. Such term shall not include any loan which would be a below market federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 as in effect on December 19, 1989.

Under Treas. Reg. §1.42-3, effective for loans made after August 8, 1989, below market loans funded in whole or in part with funds from the Affordable Housing Program established under section 721 of the Financial Institution Reform, Recovery and Enforcement Act of 1989 are not, solely by reason of the Affordable Housing Program funds, below market federal loans under former IRC §42(i)(2)(D).

**Election to Reduce Eligible Basis**

A new building is not federally subsidized if the taxpayer elected, under former IRC §42(i)(2)(B), to reduce eligible basis for purposes of IRC §42(d) by the principal amount of the loan or, in the case of a tax-exempt obligation, the proceeds of the obligation. The election is made on Form 8609, line 9a.

**Federally Subsidized Construction Financing**

A new building is not federally subsidized if the tax-exempt obligations or below market federal loans used to provide financing during the construction of the building are, respectively, redeemed or repaid before the building is placed in service.

**Loans from Community Development Block Grant Funds**

Generally, below-market loans made from Community Development Block Grant (CDBG) funds are below market federal loans. Exceptions include funds derived under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (see IRC §42(i)(2)(D)). Additional exceptions are provided for under IRC §1400N(c)(6) for low-income buildings located in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone if the low-income buildings were placed in service during the period beginning on January 1, 2006 and ending on December 31, 2010.

**HOME or NAHASDA Assistance and the 40-50 Rule**

Under former IRC §42(i)(2)(E), assistance provided under the HOME Investment Partnerships Act (as in effect on August 10, 1993) or the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4101 et seq.), (as in effect on October 1, 1997) with respect to any building shall not be characterized as a below market federal loan under IRC §42(i)(2)(D) if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of area median gross income (40-50 rule).

If the building is located in a city described in IRC §142(d)(6), having five boroughs and a population in excess of 5,000,000, then 25% is substituted for 40%.

Buildings subject to the 40-50 rule are identified on Form 8609, line 6f.

If the building is subject to the 40-50 rule, then IRC §42(d)(5)(B) does not apply to the building. That is, the building does not qualify for the increase in eligible basis for buildings located in qualified census tracts or difficult to develop areas. On Form 8609, line 3b should not be more than 100%.

## **Federally Subsidized – Buildings Placed in Service After July 30, 2008**

### **Federally Subsidized New Building Defined**

For new buildings placed in service after July 30, 2008, federally subsidized buildings are defined in IRC §42(i)(2)(A). A new building is treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103 (tax-exempt bonds), the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation.

### **Election to Reduce Eligible Basis**

A new building is not be categorized as federally subsidized if the taxpayer elects, under IRC §42(i)(2)(B) to exclude from eligible basis for purposes of IRC §42(d) the proceeds of such obligation. The election is made on Form 8609, line 9a.

### **Federally Subsidized Construction Financing**

A new building will not be categorized as federally subsidized if the tax-exempt obligations used to provide financing during the construction of the building identifies the building when the obligation is issued and the obligation is redeemed before the building is placed in service.

## **Audit Issues and Techniques**

### **Step 1: Reconcile Applicable Percentage on Form 8609**

Confirm that the applicable percentage is the correct percentage for:

1. the month the building was placed in service as documented by the certificate of occupancy and on Form 8609, line 5, or
2. if the taxpayer made an effective election, (1) the month in which the taxpayer and the state agency entered into an agreement as to the amount of credit to be allocated to the building, or (2) if the building is financed with tax-exempt bonds, the month in which the tax-exempt bonds were issued.

If the applicable percentage documented on the Form 8609 is less than the percentage under (1) or (2) above, then the percentage was limited by the state agency.

Also confirm that the applicable percentage on Form 8609-A, line 5, is the same as on the Form 8609.

Confirm that the applicable percentage correctly reflects the 70% present value credit for new buildings or the 30% present value credit for all other buildings.

### **Step 3: Consider Type of Finance**

If any federal subsidies (i.e., below market federal loans or tax-exempt bonds) are identified during the analysis of the taxpayer's financial resources, confirm that the applicable percentage value is correct for the 70% present value credit or 30% present value credit. See Chapter 10 for complete discussion.

## **Adjustments to the Applicable Percentage**

The following rules are applied when adjusting the applicable percentage.

1. The adjustment will always be based on the applicable percentage for the month the building was placed in service or, if applicable, the month of the election under IRC §42(b)(1)(A)(ii). The taxpayer cannot make an election under IRC §42(b)(1)(A)(ii) during an audit.

2. The applicable percentage can never be adjusted to be greater than designated by the housing agency allocating the credit.

## Summary

1. 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.
2. The discount factor is known as the applicable percentage and is based on certain interest rates. Applicable percentages are published in the IRS Bulletin each month.
3. The applicable percentage is dependent on three basic factors:
  - When the low-income building was placed in service. The applicable percentage for the month the building is placed in service is used unless the taxpayer elects otherwise. If the building is financed with tax-exempt bonds, the taxpayer may elect the month in which the tax-exempt bonds were issued.
  - Whether the housing is new construction or acquired existing housing.
  - Whether the housing is federally subsidized. The definition of “federally subsidized” differs based on whether the building was placed in service before July 31, 2008, or after July 30, 2008.
4. The state agency may lower the applicable percentage so that the credit allocated to a building does not exceed the amount necessary to ensure the building’s financial feasibility as a qualified low-income housing project throughout the credit period. The state agency cannot increase the applicable percentage above the otherwise prescribed amount.
5. The applicable percentage for increases in qualified basis after the end of the first year of the credit period is two-thirds of the applicable percentage that would otherwise apply.

## Reference

### Former IRC §42(i)(2)

IRC §42(i)(2), as applicable to buildings placed in service before July 31, 2008.

(2) Determination of whether building is federally subsidized.

(A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b)(1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

(B) Election to reduce eligible basis by balance of loan or proceeds of obligations. A loan or tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d)--

- (i) in the case of a loan, the principal amount of such loan, and
- (ii) in the case of a tax-exempt obligation, the proceeds of such obligation.

(C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if--

- (i) such obligation or loan (when issued or made) identified the building for which the proceeds of such obligation or loan would be used, and
- (ii) such obligation is redeemed, and such loan is repaid, before such building is placed in service.

(D) Below market Federal loan. For purposes of this paragraph, the term “below market Federal loan” means any loan funded in whole or in part with Federal funds if the interest rate payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date on which the loan was made). Such term shall not include any loan which would be a below market Federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (as in effect on the date of the enactment of this sentence [enacted Dec. 19, 1989]).

(E) Buildings receiving home assistance or Native American housing assistance.

(i) In general. Assistance provided under the HOME Investment Partnerships Act (as in effect on the date of the enactment of this subparagraph [enacted Aug. 10, 1983]) or the Native American Housing Assistance and Self-Determination Act of 1996 (*25 U.S.C. 4101 et seq.*) (as in effect on October 1, 1997) with respect to any building shall not be taken into account under subparagraph (D) if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of area median gross income. Subsection (d)(5)(C) shall not apply to any building to which the preceding sentence applies.

(ii) Special rule for certain high-cost housing areas. In the case of a building located in a city described in section 142(d)(6), clause (i) shall be applied by substituting “25%” for “40%”.

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## Chapter 15

### Computing Adjustments to the Allowable Annual Credit

#### Introduction

After auditing the eligible basis, applicable fraction and applicable percentage, the impact of any adjustments on the IRC §42 credit can be determined. In many cases, it will be possible to simply compute the correct allowable credit and compare it to the credit claimed by the taxpayer to determine the adjustment to the credit.

Eligible Basis:	\$8,753,000
Applicable Fraction:	x <u>.7500</u>
Qualified Basis:	\$6,564,750
Applicable Percentage:	x <u>0.0900</u>
IRC §42 Credit per Audit:	\$590,828
Credit per Tax Return:	<u>\$810,000</u>
Adjustment:	(\$219,172)

For other cases, more complex computations are needed to account for:

- Excess Qualified Basis
- Disposition or Acquisition of a Low-Income Building
- Increases in Qualified Basis

As a result, it is highly recommended that adjustments to the credit be calculated using the format presented on Form 8609-A Part II, Computation of Credit.

#### Topics

This chapter presents a line-by-line discussion of the computation presented in Form 8609-A, Part II, which are relevant to the computation of the correct allowable credit determined during an audit. Each section presents a summary of possible issues related to that line and references to in-depth discussions if clarification is needed.

- Adjustments to Eligible Basis
- Adjustments to the Applicable Fraction
- Qualified Basis
- Disposition or Acquisition of a Low-Income Building During the Taxable Year
- Applicable Percentage
- Allowable Credit Before Adjustments
- Adjustments to the Allowable Credit for Increases to Qualified Basis
- Federal Grants Received After the End of the First Year of the Credit Period
- Accounting for Maximum Qualified Basis
- Summary

## Adjustments to Eligible Basis

The building's eligible basis on entered on Form 8609-A, line 1. The examination of eligible basis fundamentally requires consideration of five issues:

1. Character of the assets,
2. Cost of the assets,
3. When the cost was paid or incurred,
4. Whether costs were reasonably allocated among the assets, and
5. Whether the assets is continuously placed in service during the entire 15-year compliance period.

These topics are discussed in Chapter 8. Based on the examination results, the actual dollar value of assets includable in eligible basis is adjusted as needed. Once the actual dollar value of costs includable in eligible basis is determined, the limitations and adjustments explained in Chapter 9, 10, and 11 should be applied. Adjustments or limitations are applicable for:

1. disproportionate standards,
2. federal grants,
3. IRC §47, Rehabilitation Credit,
4. IRC §48, Energy Credit,
5. supportive services for the homeless, and
6. tax-exempt bonds financing

The last adjustments made to eligible basis are the (1) the limitations on the cost of a community service facility and (2) increase for buildings located in high cost areas.

## Adjustments to the Applicable Fraction

The applicable fraction is the percentage of rental units or floor space in a building that qualify as low-income units. The applicable fraction is entered on Form 8609-A, line 2. The examination of the applicable fraction fundamentally requires consideration of three issues; i.e.,

1. whether the units were occupied by an income-qualified household,
2. whether the rent for the units is correctly restricted, and
3. whether the units are suitable for occupancy.

Based on the examination results, the applicable fraction can be adjusted as needed.

1. The applicable fraction is always determined on the last day of the taxable year.
2. The applicable fraction is always the lesser of the unit fraction or the floor space fraction.
3. A special rule is applied when determining the applicable fraction for the first year of the credit period.
4. If the taxpayer acquires and rehabilitates a building qualifying for both the acquisition and rehabilitation credit, the applicable fraction for the substantial rehabilitation credit will be the same as the applicable fraction for the acquisition credit.



5. Any reduction in allowable credit for the first year because of the special computation of the applicable fraction is allowable in the eleventh year of the compliance period.

A complete discussion, with examples, is included in Chapter 12

### **Qualified Basis**

The building's qualified basis is computed on Form 8609-A line 3. Once adjustments to eligible basis and the applicable fraction have been made, adjustments and limitations applicable to the qualified basis are considered.

### **Nonrecourse Debt**

A building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing. See Chapter 10 for complete discussion.

### **Qualified Basis Deemed to be Zero**

Qualified Basis may be deemed to be zero. See Chapter 13 for complete discussion.

### **10-Year Credit Period Has Ended**

Generally, no credit is allowable for the 11<sup>th</sup> through 15<sup>th</sup> year of the 15-year compliance period. There are two exceptions.

1. Under IRC §42(f)(2)(B), any credit not allowable because of the special rule for computing the applicable fraction for the first year of the credit period is allowable in the 11<sup>th</sup> year of the 15-year compliance period. This remaining credit is accounted for on Form 8609-A, line 17.
2. Under IRC §42(f)(3), the taxpayer may claim credit based on the "increase" in qualified basis associated with low-income unit first qualifying for the credit after the end of the first year of the credit period and qualifying for the "2/3 credit," but only to the extent that qualified basis exceeds the qualified basis at the end of the first year of the credit period.

Any decrease in qualified basis after the end of the 10-year credit is subject to the IRC §42(j) credit recapture provisions, even though the taxpayer did not claim credit (other than the exceptions identified above). See Chapter 16.

### **Disposition or Acquisition of a Low-Income Building During the Taxable Year**

Under IRC §42(f)(4), if a low-income building is disposed of during any year for which credit is allowable, the credit shall be allocated between the parties on the basis of the number of days during such year the building was held by each. This adjustment to qualified basis is entered on Form 8609-A, line 4.

As explained in Rev. Rul. 91-38, for purposes of IRC §42(f)(4), the owner who has held the property for the longest period during the month in which a transfer occurs is deemed to have held the property for the entire month and may claim a credit accordingly. In cases in which the transferor and transferee have held the property for the same amount of time during the month of the transfer, the transferor is deemed to have held the property for the entire month and the transferee's ownership of the property is deemed to begin the first day of the following month.

### Example 1: Disposition/Acquisition During the Credit Period

A calendar year partnership owning an IRC §42 building disposes of the building on May 25<sup>th</sup> of the 5<sup>th</sup> year of the credit period, a 365-day calendar year. The qualified basis is \$10,000,000. The buyer is also a calendar year partnership.

The seller is deemed to have owned the building for the entire month of May, for a total of 151 days of the 365-day tax year, and the buyer owned the building for the remaining 214 days. The seller will multiply \$10,000,000 by  $(151 \div 365)$  to compute the allowable qualified basis of  $\$10,000,000 \times 0.4147 = \$4,136,986$ . The seller will be able to claim the credit only if the seller is not subject to the IRC §42(j) recapture provisions. See Chapter 6.

Similarly, the buyer would compute the allowable qualified basis as \$10,000,000 multiplied by  $(214 \div 365)$ ; i.e.,  $\$10,000,000 \times 0.8563 = \$5,863,014$ .

The adjustment described here is only necessary when the partnership owning the low-income building disposes of the building or the partnership is acquiring a building in which it had no previous ownership interest. This adjustment is not made when there is a change in the interests of the partners in the partnership. Instead, the partnership will reflect these changes in the amount of credit passed through to the partners.

### Applicable Percentage

The applicable percentage is reported on Form 8609-A, line 5, which is labeled “Credit Percentage.” The examination of the applicable percentage requires consideration of the following:

1. When the low-income building was placed in service.
2. Whether the housing is new or acquired housing.
3. Whether the housing is financed with federal funding.

These topics are discussed in Chapters 14. Based on the examination results, the percentage may be adjusted.

1. The adjustment will always be based on the applicable percentage for the month the building was placed in service, or, if applicable, the month of the election under IRC §42(b)(1)[A](ii). The taxpayer cannot make an election under IRC §42(b)(1)[A](ii) during an audit. Note: Under IRC §42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, with respect to credit allocations made before January 1, 2014, shall not be less than 9%.
2. The applicable percentage can never be adjusted to be greater than designated by the housing agency allocating the credit.

3. The applicable percentage is a decimal carried out four places; i.e., 8.54% is 0.0854.

### **Allowable Credit Before Adjustments**

The allowable credit before adjustment is computed on Form 8609-A, line 6, by multiplying the applicable percentage (Line 5) by either:

1. The qualified basis on line 3 if the taxpayer owned the building the entire tax year, or
2. The qualified basis on line 4 if the taxpayer disposed or acquired the building during the tax year.

### **Adjustments to the Allowable Credit for Increases in Qualified Basis**

If there is an increase to qualified basis under IRC §42(f)(3), then an adjustment is needed to account for the reduced applicable percentage. The adjustment is made on Form 8609-A, lines 7 through 12.

#### **Calculating Increase in Qualified Basis**

The increase in qualified basis entered on line 7 is calculated by subtracting the qualified basis determined at the end of the first year of the credit period from the qualified basis reported on line 3. The qualified basis at the end of the first year of the credit period is identified by the taxpayer on Form 8609 Part II as part of the certification for the first year of the credit period.

If the result is zero or less, then there is no increase in qualified basis.

#### **Disposition and Acquisition of a Low-Income Building During the Tax Year**

Since the increase to qualified basis is calculated based on the qualified basis before the adjustment to allocate the credit between the seller and buyer of a low-income building on line 4, a similar allocation of the increase in qualified basis must be made between seller and buyer. For line 8, use the same percentages used to determine the allowable qualified basis for line 4.

#### **Two-Thirds Applicable Percentage**

Under IRC §42(f)(3)(A), the credit associated with increases in qualified basis is computed using an applicable percentage equal to two-thirds of the applicable percentage that would otherwise apply.

Since the credit computed on line 6 includes the increase in qualified basis multiplied by the applicable percentage, it is necessary to reduce line 6 by the one third that is not allowable. The entry on line 9 is one third of the applicable percentage identified on line 5. The computation is carried out four decimal points. For example, if the applicable percentage is 0.0813, then  $0.3333 \times 0.0813 = 0.0271$ .

#### **Unallowable Credit**

Line 10 is the computation of the credit associated with the increase that is not allowable. Multiply line 9 by:

1. Line 7 if the taxpayer owned the building the entire year, or
2. Line 8 if the taxpayer disposed of or acquired the building during the year.

**First Year of Increase in Qualified Basis**

Under IRC §42(f)(3)(B), when computing the applicable fraction for the increase in qualified basis for the first year of the increase, the special rule for the first year of the credit period in IRC §42(f)(2) is applied; i.e., the sum of the increased applicable fractions determined at the end of each full month of such year divided by 12.

First, determine whether the increase in qualified basis for the year under audit is more than the increase in qualified basis reported for the prior year. Subtract the qualified basis reported on Form 8609-A line 3, for the prior year from the corrected qualified basis computed for the current year to determine the “current year increase.”

- If the result is zero or less, there has been no increase in qualified basis and IRC §42(f)(3) is not applicable. The entry on line 11 is zero.
- If the qualified basis reported for the prior year is more than zero, but less than the qualified basis at the end of the first year of the credit period (Form 8609, Part II), then enter the amount on Form 8609-A line 7 on line 11.

Second, if the result is a positive amount, then there is a “current year increase” and IRC §42(f)(3) is applicable.

1. Determine the applicable fraction for the first year of the increase. For each month of the taxable year, determine the increase in the applicable fraction above the applicable fraction for the prior year (as reported on Form 8609 line 2). For example, the prior year’s applicable fraction was 0.5000 and continued to be the applicable fraction for the first nine months of the next year. The applicable fraction then increased to 0.7500 for October, November and December. The increase is  $0.7500 - 0.5000 = 0.2500$  for each month. Add these amounts together and divide by 12.  $(0.2500 + 0.2500 + 0.2500) \div 12 = 0.0625$
2. Compute the current year increase in qualified basis entitled to the reduced credit by multiplying the applicable fraction determined in (1) by the corrected eligible basis.
3. Subtract (2) above from the “current year increase,” to determine the portion of the qualified basis included in “current year increase” that is not entitled to the reduced credit because of the IRC §42(f)(3) rule.
4. Multiply (3) by two-thirds (0.6666) of the applicable percentage reported on Form 8609-A line 5. The result is the portion of the credit that is not allowable because of the IRC §42(f)(3) rule. Enter this amount on Form 8609-A line 11

**Total Adjustment for Increases in Qualified Basis**

Line 12 is the total adjustment necessary for increases to qualified basis after the end of the first year of the credit period:

- Line 10 reflects the adjustment for the reduced applicable percentage applied to the entire increase in qualified basis, and
- Line 11 reflects the additional adjustment to the current year increase in qualified basis to account for the months that the units were not low-income units.

Subtract line 12 from line 6, and enter the result on line 13. This is the allowable credit after adjustments for increases in qualified basis.

### **Federal Grants Received after the End of the First Year of the Credit Period**

Line 14 is used by taxpayers to account for federal grants that reduce eligible basis under IRC §42(d)(5)(A), but are included in the eligible basis reported on line 1. Most likely, the grant was received after the end of the first year of the credit period.

For audit purposes, any grants self-reported on line 14 by the taxpayer when filing a tax return should be included as an adjustment to eligible basis on line 1.

### **Accounting for Maximum Qualified Basis**

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility as a qualified low-income housing project throughout the credit period. This limit on the credit amount can be accomplished by limiting the qualified basis. The "maximum" qualified basis can be less than, but should not be more than, the actual qualified basis. Maximum qualified basis is documented on Form 8609, line 3a.

If the actual qualified basis equals the maximum qualified basis, then the state agency has allocated credit so that there is a dollar-to-dollar match between the costs included in eligible basis and the costs financed by the credit. Any adjustment to either the eligible basis or applicable fraction will automatically result in a corresponding adjustment to the qualified basis used to compute an adjustment to the credit.

If the actual qualified basis is more than the maximum qualified basis, then the state agency has allocated credit to support only a portion of the assets included in eligible basis.

Two important points:

1. The state agency determines the maximum qualified basis based on the final cost certification presented by the taxpayer under IRC §42(m)(2)(C)(i)(III) and the applicable fraction as documented in the extended use agreement.
2. The state agency is not required to identify the costs to be included in the maximum qualified basis.

This limit on the allowable annual credit is accounted for on Form 8609-A line 15. The taxpayer must compare the allowable credit as computed on the form to the amount actually allocated on Form 8609 line 1b. The amount claimed cannot exceed the amount allocated.

**Example 1: Qualified Basis in Excess of Maximum Qualified Basis**

A taxpayer constructs a new 100% low-income building, which, according to the final cost certification presented to the state agency, has an actual eligible basis of \$10,000,000. The actual qualified basis is \$10,000,000 x 100% = \$10,000,000. However, the state agency, when allocating the credit, limited the qualified basis to \$9,000,000 and documented the maximum qualified basis on Form 8609 line 3a.

The taxpayer has “excess” qualified basis equaling \$1,000,000, computed as \$10,000,000 - \$9,000,000.

Any adjustment to either the eligible basis and/or applicable fraction will result in a decrease in qualified basis. For audit purposes, the decrease in qualified basis must first be applied against the excess qualified basis.

**Example 2: Qualified Basis Reduced Below Maximum Qualified Basis**

A 100% low-income building has an actual eligible basis of \$10,000,000. The actual qualified basis is also \$10,000,000. However, the state agency limited the qualified basis to \$9,000,000 and used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to both the eligible basis and applicable fraction, an examiner determines that the actual qualified basis is \$8,500,000.

	Per Return	Per Audit
1. Actual Qualified Basis	\$10,000,000	\$8,500,000
2. Applicable Percentage	<u>x 0.0900</u>	<u>x 0.0900</u>
3. Annual Credit Amount (without limitation)	\$900,000	\$765,000
4. Annual Credit Allocated	\$810,000	\$810,000
5. Allowable Credit	\$810,000	\$765,000

The allowable credit is the lesser of line 3, based on actual costs, and line 4, the annual credit allocated. For audit purposes, the adjustment to the allowable credit is calculated based on line 5 above; i.e., \$810,000 - \$765,000 = \$45,000.

No adjustment is made to the allowable credit if the actual qualified basis after adjustment is equal to or more than the maximum qualified basis.

**Example 3: Qualified Basis Not Reduced Below Maximum Qualified Basis**

A 100% low-income building has an actual eligible basis of \$10,000,000. The actual qualified basis is also \$10,000,000. However, the state agency limited the qualified basis to \$9,000,000. The state agency used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to eligible basis, an examiner determines that the actual qualified basis is \$9,500,000. The building's qualified basis is still more than the maximum qualified basis determined by the state agency.

	Per Return	Per Audit
1. Actual Qualified Basis	\$10,000,000	\$9,500,000
2. Applicable Percentage	<u>x 0.0900</u>	<u>x 0.0900</u>
3. Annual Credit Amount (without limitation)	\$900,000	\$855,000
4. Annual Credit Allocated	\$810,000	\$810,000
5. Allowable Credit	\$810,000	\$810,000

The allowable credit is the lesser of line 3, based on actual costs, and line 4, the annual credit allocated. For audit purposes, there is no adjustment to the credit.

**Noncompliance with Extended Use Agreement**

Even though noncompliance may not result in a reduction of allowable credit, state agencies are expected to enforce the terms of the extended use agreement to the extent a taxpayer does not provide the low-income housing as agreed (see Chapter 5). Alternatively, as discussed in Chapter 14, a state agency may limit the credit amount by lowering the applicable percentage used to compute the credit.

**Example 4: Adjustment to Applicable Fraction Reduces Qualified Basis**

A 100% low-income building has an actual eligible basis of \$10,000,000. The actual qualified basis is also \$10,000,000. However, the state agency limited the qualified basis to \$9,000,000. The state agency used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to the applicable fraction, an examiner determines that the actual qualified basis \$9,500,000. The building's qualified basis is still more than the maximum qualified basis determined by the state agency.

	Per Return	Per Audit
1. Eligible Basis	\$10,000,000	\$10,000,000
2. Applicable Fraction	100%	95%
3. Actual Qualified Basis	\$10,000,000	\$9,500,000
4. Applicable Percentage	<u>x 0.0900</u>	<u>x 0.0900</u>
5. Annual Credit Amount (without limitation)	\$900,000	\$855,000
6. Annual Credit Allocated	\$810,000	\$810,000
7. Allowable Credit	\$810,000	\$810,000

As in Example 3, the allowable credit is the lesser of line 5, based on actual costs, and line 6, the annual credit allocated. For audit purposes, there is not adjustment to the credit. In this example, there is no reduction of the allowable credit as long as the applicable fraction is at least 90.00% and no adjustment is made to the actual costs including in

eligible basis.

## Summary

This chapter focused on computing the corrected allowable annual credit based on adjustments to the eligible basis, applicable fraction, qualified basis, applicable percentage, or any combination of the four factors. Primary points include:

1. Because the computation of the correct credit amount can be complex, the format presented in Form 8609-A Part II should be followed when computing adjustments to the credit.
2. IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility as a qualified low-income housing project throughout the credit period. This limit can be achieved by limiting the qualified basis (maximum qualified basis).
3. A special computation is needed to account for increases in qualified basis after the end of the first year of the credit period, and a second computation is needed if the increase occurs in the year under audit.
4. Under IRC §42(f)(2)(B), credit not allowable because of the special rule for computing the applicable fraction for the first year of the credit period is allowable in the 11<sup>th</sup> year of the 15-year compliance period. The credit for the 11<sup>th</sup> year is entered on Form 8609-A, line 17.
5. Under IRC §42(f)(4), if a low-income building is disposed of during any year for which the credit is allowable, the credit is allocated between the parties. This adjustment to qualified basis is entered on Form 8609-A, line 4.
6. Form 8609-A, line 14, is used by taxpayers to account for federal grants that reduce eligible basis under IRC §42(d)(5)(A). Most likely, the grant was received after the end of the first year of the credit period.



## Chapter 16 Credit Recapture

### Introduction

Although a taxpayer claims the IRC §42 credit over a ten-year credit period, the taxpayer is required to provide low-income housing in compliance with IRC §42 for fifteen years (the compliance period). In effect, the taxpayer is claiming credit in advance of providing housing during the last five year after the credit period has ended. As a result, one-third of the credit claimed each year during the credit period is associated with providing housing during years 11 through 15 of the compliance period.

The 1/3 portion of the credit claimed each year is commonly referred to as the “accelerated portion” of the credit. The accelerated portion of the credit subject to recapture decreases during the last five years of the compliance period as the taxpayer provides the housing for which the taxpayer claimed the accelerated credit during the credit period.

The recapture of accelerated credit claimed for years prior to the year of an audit is a separate adjustment and is characterized as an addition to the taxpayer tax liability. The disallowance of credit for the year under audit is a reduction of credit available to reduce the taxpayer’s federal income tax liability.

A taxpayer may self-report a credit recapture amount using Form 8611, Recapture of Low-Income Housing Credit.

### Topics

- Law
- Special Rules
- Noncompliance with IRC §42(h)(5), Nonprofit Set-Aside
- Noncompliance with IRC §42(h)(6), Extended Use Agreement
- Certain Partnerships Treated as the Taxpayer
- Disposition Other than by Foreclosure or Transaction in Lieu of Foreclosure
- Disposition by Foreclosure or Transaction in Lieu of Foreclosure
- Taxpayer Acquires Building During the 15-Year Compliance Period
- Taxpayer Claimed Credit in Excess of Amount Allocated
- Taxpayer Continues to Claim Credit After the End of the Credit Period
- Summary

### Law

#### When

Under IRC §42(j)(1), if the qualified basis at the close of any taxable year in the compliance period of any low-income building is less than the building’s qualified basis at the close of the preceding taxable year, then the taxpayer’s federal income tax for that taxable year is increased by the credit recapture amount.

#### Credit Recapture Amount

IRC §42(j)(2) defines the credit recapture amount as equal to the sum of:

1. the aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if the “accelerated portion of the credit” allowable under IRC §42 were not allowed for all prior taxable years with respect to the excess qualified basis described in IRC §42(j)(1), plus

2. interest at the overpayment rate established under IRC §6621 on the amount determined under (1) above for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

No deduction is allowable for the interest described in (2) above for federal income tax purposes. Computation of the interest portion of the recapture amount is demonstrated in Chapter 17.

In the event there is a reduction in qualified basis such that the remaining qualified basis is equal to or more than the maximum qualified basis identified by the state agency, then there is no reduction of credit or corresponding recapture on the decrease. See Chapter 15.

Note also that the recapture rules do not apply when a credit is disallowed based on an adjustment to the applicable percentage.

### **Accelerated Portion of Credit**

The “accelerated portion of the credit” described in IRC §42(j)(2) is defined in IRC §42(j)(3). The accelerated portion of the credit for each of the prior taxable years with respect to any amount of qualified basis is the difference between the allowable credit under IRC §42 and the credit that would have been allowable if the aggregate credit allowable for the entire compliance period were allowable ratably over 15 years.

#### **Example 1: Accelerated Portion of the Credit**

A low-income building received an allocation of credit equaling \$30,000. The aggregate allowable credit for the entire 10-year credit period is \$300,000. Had the \$300,000 been allowable ratably over 15 years, the annual credit would have been  $\$300,000 \div 15 = \$20,000$ . The accelerated portion of the credit is  $\$30,000 - \$20,000 = \$10,000$ .

For any year of the 10-year credit period, the accelerated portion of the credit equals one-third of the allowable annual credit. For computation purposes, the fraction is carried out three decimal places (0.333) and is commonly referred to as the recapture rate.

For the first 10 years, the entire accelerated portion of the credit, 5/15, is subject to recapture. As the taxpayer provides the low-income housing associated with the accelerated portion of the credit claimed in prior years during the last five years of the compliance period, the accelerated portion of the credit subject to recapture decreases.

If there is a decrease in qualified basis during the 11<sup>th</sup> year of the compliance period, when the accelerated credit has not been “earned,” the recapture rate is still 0.333 or 5/15. Thereafter, the recapture rate decreases 1/15 for every year the taxpayer provides low-income housing after the end of the 10-year credit period. For the last four years of the compliance period, the recapture rate is:

- 4/15 or 0.267 for year 12
- 3/15 or 0.200 for year 13
- 2/15 or 0.133 for year 14
- 1/15 or 0.067 for year 15

**Example 2: Decrease in Qualified Basis During the 13<sup>th</sup> Year of the 15-Year Compliance Period**

A low-income building received an allocation of credit based on a qualified basis of \$1,000,000 and an applicable percentage of 0.0900. The allowable annual credit amount is \$90,000.

The tax return for the 13<sup>th</sup> year of the compliance period is audited and adjustments are made to both the eligible basis and applicable fraction such that the corrected qualified basis was \$750,000. The adjustment to qualified basis is \$250,000

First, determine how much credit is associated with the \$250,000 adjustment by multiplying by the applicable percentage; i.e.,  $\$250,000 \times 0.0900 = \$22,500$ . The recapture rate in year 13 is 3/15 (or 0.200). The accelerated portion of the credit to be recaptured is then calculated as  $\$22,500 \times 0.200 = \$4,500$  for each year of the 10-year credit period, or \$45,000 total.

## Special Rules

IRC §42(j)(4) provides six special rules for applying the credit recapture provisions.

### Tax Benefit Rule

Under IRC §42(j)(4)(A), the taxpayer's tax liability is only increased for the recapture amount computed with respect to credits used to reduce the taxpayer's tax liability in prior years. If the credit was not used to reduce a tax liability, then the carryforwards and carrybacks of the credit under IRC §39 are appropriately adjusted.

This rule is not applicable when calculating the recapture amount for the partnership (or limited liability corporation) owning the IRC §42 project. The maximum recapture amount is computed and attributed to each partner according to the partners' partnership interests.

The tax benefit rule is applied when calculating the recapture amount for taxpayers whose actual tax liability is reduced, usually partners in partnerships owning IRC §42 projects. See Chapter 19 for discussion.

### Qualified Basis for Credit Allowed

Under IRC §42(j)(4)(B), only qualified basis for which the taxpayer actually claimed credit is subject to recapture. This rule effectively limits the recapture provisions so that, mathematically, the accelerated credit is not "recaptured" more than once.

**Example 1: Multiple Recapture Events**

A 100% low-income building received an allocation of IRC §42 credit equal to \$90,000. The applicable percentage is 0.0900 and the qualified basis is \$1,000,000.

The taxpayer began the 10-year credit period in 2001 and claimed \$90,000 in credit each year for 2001, 2002, and 2003. There was a reduction in qualified basis to \$800,000 for 2004. The allowable credit on the \$800,000 qualified basis amount is \$72,000. The accelerated portion of the credit recaptured from 2001, 2002, and 2003 was computed as  $(\$90,000 - \$72,000) \times .333 = \$5,994$ . The recapture amount (including the interest portion) was \$19,829, which the taxpayer reported when filing its 2004 tax return.

For 2005 and subsequent years the qualified basis was restored to the original \$1,000,000 and the taxpayer claimed \$90,000 in credit for each year 2005 through 2008.

The taxpayer's 2009 tax return is now audited and the qualified basis was determined to be \$650,000. The taxpayer's allowable credit for 2009 is  $\$650,000 \times 0.0900 = \$58,500$ . The adjustment to the credit is  $\$90,000 - \$58,500 = \$31,500$ .

To the extent that the accelerated portion of the credit has been recaptured in a taxable year, it cannot be recaptured again. Therefore, for 2001, 2002, 2003 and 2004, the reduction in qualified basis in 2009 takes the 2004 recapture event in account by using the qualified basis claimed by the taxpayer for 2004; i.e.,  $\$800,000 - \$650,000 = \$150,000$  and the associated credit is \$13,500 computed as  $\$150,000 \times 0.0900$ . The accelerated portion of the credit recaptured from 2001, 2002, 2003, and 2004 is  $\$13,500 \times .333 = \$4,496$ .

For 2005, 2006, 2007, and 2008, the reduction in qualified basis is based on the entire reduction in qualified basis between the 2008 and 2009 taxable years; i.e.,  $\$1,000,000 - \$650,000 = \$350,000$ . The associated credit is  $\$350,000 \times .0900 = \$31,500$ , and the accelerated portion of the disallowed credit to be recaptured is  $\$31,500 \times .333 = \$10,490$  for 2005, 2006, 2007, and 2008.

The total recapture "amount" includes interest as determined under IRC §42(j)(2)(B).

As a quick check, the credit previously recaptured from 2001, 2002, 2003, and 2004 added to the amount recaptured for these years in 2009 should equal the credit recaptured from 2005, 2006, 2007 and 2008. In this case,  $\$5,994 + \$4,496 = \$10,490$ .

**Increases to Qualified Basis**

Credit associated with increases to qualified basis after the close of the first year of the credit period are claimed over the remaining years of the 15-year compliance period and do not include an "accelerated portion of credit." Therefore, as explained in §42(j)(4)(C), the recapture provisions do not apply to the credit associated with increases to qualified basis under IRC §42(f)(3).

## Example 2: Credit Claimed for Increases to Qualified Basis

A 100% low-income building consists of 100 units of identical size. The applicable percentage is 0.0900 and its eligible basis is \$10,000,000. The allocated credit is \$900,000 ( $\$10,000,000 \times 0.0900$ ). At the end of the first year of the credit period, 75 of the units are qualified low-income units and 25 are vacant units that had never been occupied.

Disregarding the special rule for the first year of the credit period and the first year of any increase in qualified basis, the maximum credit the taxpayer may claim during the 10-year credit period is \$825,000, computed as:

- For the \$7,500,000 initial qualified basis:

$$\$7,500,000 \times 0.0900 = \$675,000$$

- For the \$2,500,000 increase in qualified basis after the end of the first year of the credit period:

$$\$2,500,000 \times 0.0900 \times 2/3 = \$150,000$$

For each year, 2 through 7 of the credit period, the taxpayer claimed  $\$675,000 + \$150,000 = \$825,000$ . Upon audit of the 7<sup>th</sup> year, however, the qualified basis was reduced from \$10,000,000 to \$7,000,000; i.e., decreased \$3,000,000. To determine the amount of accelerated credit subject to recapture, the decrease in qualified basis must first be reduced by the increase in qualified basis after the end of the first year of the credit period. In this case,  $\$3,000,000 - \$2,500,000 = \$500,000$ .

The accelerated portion of the credit to be recapture from each of the prior six years is  $\$500,000 \times .0900 \times .333 = \$14,985$ .

Two observations about the example above are appropriate.

First, no attempt is made to match the decrease in qualified basis to specific low-income units. For example, the \$300,000 decrease in qualified basis could be associated with 30 of the 75 units that were qualified low-income units at the end of the first year of the credit period. Alternatively, the \$300,000 may be caused by an adjustment to the building's eligible basis, in which case \$3,000 of the adjustment is associated with each unit.

Second, if the \$300,000 decrease in qualified basis for the 7<sup>th</sup> year had been less than or equal to the increase in qualified basis after the end of the first year of the credit period, there would have been a reduction in credit allowable for the year, but no recapture of the accelerated portion of credit from prior years.

**Tax Credits  
Not Applied  
Against the  
Recapture  
Amount**

Under IRC §42(j)(4)(D), the credit recapture amount (accelerated credit + interest) cannot be offset by any other tax credit; i.e., the credit recapture amount is not treated as a federal income tax against which any federal tax credit can be applied.

Generally, this rule is applied when calculating the recapture amount for taxpayers who actually reduced their tax liability by claiming the credit, usually partners in a partnerships owning a IRC §42 project. See Chapter 19. The rule also has application at the partnership level to prevent taxpayers from offsetting a recapture amount by reducing the credit allowable for the taxable year.

**Example 3: Offsetting the Recapture Amount at the Partnership Level**

A taxpayer owns a 100% low-income building with a \$120,000 allocation of credit. The taxpayer claimed the full credit each year, for year 1 through 8 of the credit period. At the end of the 9<sup>th</sup> year, there was a reduction in the qualified basis such that the allowable credit for the year was \$95,000 and the resulting recapture amount was \$54,000.

The taxpayer cannot reduce the allowable credit by the recapture amount (\$95,000 - \$54,000) and claim IRC §42 credit in the amount of \$41,000 for the 9<sup>th</sup> year.

The taxpayer must separately report the \$95,000 credit allowable for the 9<sup>th</sup> year and \$54,000 recapture amount.

**Casualty  
Losses**

Under IRC §42(j)(4)(E), the recapture provisions do not apply if the reduction in qualified basis results from a casualty loss if the lost qualified basis is restored by reconstruction or replacement within a reasonable time established by the Secretary.

As explained in Chapter 12, a casualty loss for purposes of IRC §42 is the same as defined under IRC §165; i.e., the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Property damage is not considered a casualty loss if the damage occurred during normal use, the owner willfully caused the damage or was willfully negligent, or was progressive deterioration such as damage caused by termites.

In CCA 200134006, Chief Counsel clarified that a period of up to two years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties.

If the taxpayer fails to restore or replace the lost qualified basis within a reasonable period, then the recapture provisions are applied for the tax year in which the casualty event occurred. In CCA 200913012, Chief Counsel explained that if the statute of limitations is closed, whether for the casualty event or credits claimed during the restoration period under Rev. Proc. 95-28 or Rev. Proc 2007-54, then the taxpayer's first open taxable year in the compliance period should be treated as the year of the taxpayer's reduction in qualified basis. In other words if a taxpayer represents on its returns that it was entitled to IRC §42 credits in a closed taxable year, then the taxpayer is estopped under the duty of consistency to deny that it had qualified basis at the end of that taxable year.

A common misunderstanding when accounting for casualty losses is that the recapture relief provisions under IRC §42(j)(4)(E) also allows the taxpayer to claim credit during the period that the qualified basis is reduced and the reconstruction period when the casualty event is not addressed under Rev. Proc. 2007-54. Chief Counsel, in CCA 200913012, explained that IRC §42(j)(4)(E) only provides recapture relief for casualty events; it does not provide for the allowance of credit during the period of time that the building is being restored.

**De Minimis  
Change in  
Floor Space**

IRC §42(j)(4)(F) grants the Secretary (IRS) authority to determine that the credit recapture provisions will not be applied if:

1. the credit recapture amount results from a de minimis change in the floor space fraction under IRC §42(c)(1), and
2. the building is a qualified low-income building after such change.

If a de minimis change in floor space is discovered as part of an IRS audit, the examiner should contact the IRC §42 program analyst.

**Noncompliance with IRC §42(h)(5), Nonprofit Set-Aside**

**IRC §42(j)  
Credit  
Recapture  
Provision Not  
Applicable**

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h)(5)(B) requirements. Failure to comply with IRC §42(h)(5)(B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c)(1). Therefore, the IRC §42(j) credit recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA 201352009. See Chapter 6 for complete discussion of IRC §42(h)(5).

**Noncompliance with IRC §42(h)(6), Extended Use Agreement**

**IRC §42(j)  
Credit  
Recapture  
Provision Not  
Applicable**

Under IRC §42(h)(6)(A), no credit is allowable under IRC §42 with respect to a building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year. However, IRC §42(h)(6)(J) provides a correction period should there be a determination that an extended use agreement is not in effect. If the failure is corrected within one year from the date of the determination, then the determination will not apply to any period before such year.

If the taxpayer fails to correct the failure within the one-year correction period, the credit in its entirety can be disallowed. However, the noncompliance does not result in a decrease in qualified basis and the IRC §42 credit recapture provisions are not applicable.

**Certain Partnerships Treated as the Taxpayer**

IRC §42(j)(5) provides that certain partnerships will be treated as the taxpayer for which the credit is allowable and the credit recapture provisions are applied. In other words, to relieve administrative burdens, the partnership owning the low-income project is treated as a taxable entity and the credit recapture amount is assessed against the partnership rather than the individual partners.

<b>Partnerships to which IRC §42(j)(5) Applies</b>	<p>Under IRC §42(j)(5)(B), any partnership which has 35 or more partners will be treated as the taxpayer for which the credit is allowable unless the partnership elects not to have the rule apply. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10b, and is irrevocable.</p> <p>This rule applies only to the partnership owning the low-income project and only if there are 35 or more partners holding a partnership interest. A husband and wife (and their estates) are treated as one partner. The rule does not apply to partnerships holding partnership interests in partnerships owning low-income project.</p>
<b>Credit Amount Allowed to the Partnership</b>	<p>Under IRC §42(j)(5)(A)(ii), the amount of credit deemed allowed to the partnership is the credit amount the partnership reported and allocated to its partners.</p>
<b>Computing the Credit Recapture Amount</b>	<p>Under IRC §42(j)(5)(A)(iii), the tax benefit rule under IRC §42(j)(4)(A) is not applied. The partnership is treated as if the entire credit claimed was used to reduce its tax liabilities in prior years.</p>
<b>Assessment Against Partnership</b>	<p>Assessment is made directly against the partnership. Contact the IRC §42 program analyst for assistance.</p>
<b>Allocation of Credit Recapture Amount Among Partners</b>	<p>IRC §42(j)(5)(A)(iv) provides that the credit recapture amount assessed against the partnership is income to the partners and will be allocated among the partners of the partnerships in the same manner as the partnership's taxable income for the taxable year.</p>

### **Disposition Other than by Foreclosure or Transaction in Lieu of Foreclosure**

Generally, the disposition of a low-income building (or interest therein) is a credit recapture event. However, under IRC §42(j)(6), the credit recapture provisions are not applied under specific circumstances if the disposition was not by foreclosure or a transaction in lieu of foreclosure.

For partnerships with fewer than 35 partners, and those electing out of the large partnership provisions of IRC §42(j)(5), a partner (taxpayer) may elect to avoid or defer recapture until the taxpayer has, in the aggregate, disposed of more than 33 1/3 percent of the taxpayer's greatest total interest in the qualified low-income building through the partnership at any time. Once dispositions aggregate more than 33 1/3 percent, further deferral is possible for dispositions only if IRC §42(j)(6) is applicable.

<b>Dispositions After July 30, 2008</b>	<p>IRC §42(j)(6)(A), as amended by the Housing and Economic Recovery Act, provides that the credit recapture provisions are not applicable solely by reason of the disposition of a qualified low-income building (or interest therein) if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period. Instead, the taxpayer disposing of the low-income building (or interest therein) remains subject to the credit recapture provisions should there be any reduction in the building's qualified basis resulting in the recapture of credit under IRC §42(j)(1)</p>
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for the year of the disposition or any subsequent taxable year.

In addition, the taxpayer disposing of the low-income building (or interest therein) is required to notify the Secretary (IRS) if there is any reduction in qualified basis resulting in the application of the IRC §42(j) credit recapture provisions. See Rev. Proc. 2012-27. The statutory period for the assessment of the credit recapture amount does not expire before the expiration of three years from the date the taxpayer notifies the IRS and such credit recapture amount may be assessed notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

**Dispositions  
Before  
July 31, 2008**

If a taxpayer disposed of a low-income building (or interest therein) before the 2008 amendment, credit recapture could be avoided if two conditions were met:

1. Under former IRC §42(j)(6)(B), the taxpayer reasonably expected that the building would continue to be operated as a qualified low-income building for the remaining years of the 15-year compliance period, and
2. Under former IRF §42(j)(6)(A), the taxpayer furnished the IRS with a disposition bond in an amount satisfactory to the Secretary and for the period required by the Secretary.

Bonds were posted with the IRS using Form 8693, Low-Income Housing Credit Disposition Bond, according to instructions provided in Rev. Rul. 90-60. As an alternative, taxpayers were allowed to provide Treasury securities as collateral instead of a bond (see Rev. Proc. 99-11). The bond or collateral remained in effect until 58 months after the end of the 15-year compliance period.

An owner who disposed of a low-income building (or interest therein) on or before July 30, 2008, and timely posted a bond (or collateral) may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the collateral funds. Instructions for making the election are included in Rev. Proc. 2008-60.

The IRS can “call a bond” to recapture credit if it subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

**Audit Issues  
and  
Techniques**

If the partnership reported the credit recapture event:

1. Was the credit recapture amount reported on Form 8611 correct?
2. Did the taxpayer correctly allocate the recapture amount among the partners on Schedules K-1?

If the taxpayer did not report the disposition or credit recapture event:

1. Confirm that the disposition was a transaction other than a foreclosure or transaction in lieu of foreclosure by reviewing the sales documents. These documents will also be reviewed to determine whether the taxpayer accurately reported the gain/loss upon disposition.

2. Did the partnership have reason to expect that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the IRC §42(j) credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.
3. Is the building actually being operated in compliance with IRC §42 requirements at the time of the audit. If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions. The building's current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation.

## Disposition by Foreclosure or Transaction in Lieu of Foreclosure

In the event of a foreclosure (or transaction in lieu of foreclosure), the extended use period is terminated and the building is no longer a qualified low-income building. See IRC §42(h)(6)(E). The termination of the extended use period results in the disallowance of the credit for the year of disposition (unless the new owner enters into a new extended use agreement by the close of the year of disposition or IRC §42(h)(6)(j) otherwise applies), but does not automatically result in recapture under IRC §42(j). See CCA 201146016.

The disposition is treated like any other disposition of the property. Therefore, the question is whether the taxpayer has a reasonable expectation 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. This may more difficult to establish in the event of a foreclosure where the building is seized by a creditor and the extended use period is terminated. See Chapter 5. The taxpayer may not be able to structure the transaction to include continued compliance with IRC §42 requirements, include-ing requiring the new owner to enter into an extended use agreement, as a condition of transferring the title.

### **Audit Issues: Taxpayer Reports Foreclosure as Recapture Event**

If the partnership reports the foreclosure as a recapture event, then the issues are the same as for any other disposition:

1. Was the credit recapture amount reported on Form 8611 correct?
2. Did the taxpayer correctly allocate the recapture amount among the partners on Schedules K-1?

### **Audit Issues: Taxpayer Does Not Report Foreclosure as Recapture Event**

If the taxpayer did not report the foreclosure as a recapture event, the taxpayer may argue that even though the low-income building was disposed of as a result of a foreclosure, the taxpayer knew with reasonable certainty that the new owner would continue to operate the building in accordance with IRC §42 requirements.

Consider the following fact patterns:

- A bank forecloses on an outstanding mortgage on an IRC §42 project during the 10-year credit period and would like to claim the credit for the time period that it owns and operates the housing as a qualifying IRC §42 project. The bank intends to hold the property for only a temporary period and will sell the project when a

buyer can be identified.

What influence does the taxpayer have to ensure the bank will sell the project to a party willing to maintain the project in compliance with IRC §42?

- HUD forecloses on an outstanding mortgage financing an IRC §42 project and intend to operate the property according to rules governing section 8 or another HUD housing program, which may have rules similar to, but not exactly the same as IRC §42 requirements. In the event the rules conflict, the stricter of the rules will be followed.

Since the IRC §42 rules will not always be the stricter rule (and “stricter” is not defined), it is questionable whether the taxpayer can reasonably expect that the project will continue to be operated in compliance with IRC §42 requirements absent some other assurances.

- A state housing agency forecloses on an outstanding mortgage it holds on an IRC §42 project. The agency intended to operate the project as an IRC §42 project until a buyer willing to operate the project in compliance with IRC §42 can be identified.

#### **Audit Issues**

1. Since the original extended use period was terminated, confirm that the new owner has entered into a new extended use agreement with the state agency and that the agreement is not subordinated to other restrictive covenants governing the use of the property. If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions.
2. Did the partnership have a reasonable expectation that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the IRC §42(j) credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.
3. Is the building actually being operated in compliance with IRC §42 requirements at the time of the audit? If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions. The building’s current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation.

#### **Taxpayer Acquires Building During the 15-Year Compliance Period**

Regardless of whether the acquisition was through a purchase or foreclosure (or transaction in lieu of foreclosure), a taxpayer acquiring a low-income building, or interest therein, during the 15-year compliance period is entitled to claim any allowable credit if the building is operated in compliance with IRC §42. The credit allowable to the taxpayer for any period after acquisition during the compliance period is the amount of credit which would have been allowable for the period to the prior owner who disposed of the building. See IRC §42(d)(7)(A)(ii).

## Taxpayer Claimed Credit in Excess of Amount Allocated

In some cases, a taxpayer may have claimed more than the allowable credit for tax years before the year of the audit.

### Example 1: Taxpayer Relies on Carryover Allocation Amount

A taxpayer receives a carryover allocation of credit equaling \$150,000. The low-income building is timely placed in service in 2006 and the taxpayer claims the \$150,000 credit for 2006, 2007 and 2008 before receiving the Form 8609 in January of 2010. However, the state agency did not allocate \$150,000 as identified in the carryover agreement. Instead, the state agency determined that the taxpayer needed only an allocation of \$130,000 to ensure that the project would be financially feasible. The taxpayer claimed the lesser \$130,000 when filing its 2009 and subsequent year returns, but did not amend the prior year returns to correct the overstated credit amount.

Under IRC §42(j)(3)(A), the accelerated portion of the credit is the excess of the credit “allowed” over the allowable credit that would have been allowable for the entire period were the credit allowable ratably of 15 years. To continue the example above:

The taxpayer’s 2011 tax return is audited and, based on adjustments to both the eligible basis and applicable fraction, the examiner determines that the correct allowable annual credit is \$120,000. The accelerated portion of the credit to be recaptured from each prior year is computed as:

$$(\$130,000 - \$120,000) \times .333 = \$3,330$$

For 2006, 2007, 2008, the determination of the amount to be recaptured must account for the taxpayer’s overstatement of credit.

The allowable credit, after adjustment for the recapture of the accelerated portion of the credit is  $\$130,000 - \$3,330 = \$126,670$ . The excess of the allowed over the allowable to be recaptured from 2006, 2007, and 2008 is  $\$150,000 - \$126,670 = \$23,330$ .

For 2009 and 2010, where the credit “allowable” and “allowed” are equal, the accelerated credit to be recaptured is \$3,330.

## Taxpayer Continues to Claim Credit After the End of the Credit Period

In some cases, a taxpayer may continue to claim the entire annual credit amount after the end of the credit period, (not the 11<sup>th</sup> year credit under IRC §42(f)(2) or the 2/3 credit under IRC §42(f)(3)).

### Example 1: Taxpayer Incorrectly Determines the Credit Period

A taxpayer receives an allocation of credit equaling \$130,000, timely placed the building in service, and started claiming the credit in 2000. The taxpayer claim credits equaling \$130,000 each taxable year 2000 through 2011.

Under IRC §42(j)(3)(A), the accelerated portion of the credit is the excess of the credit “allowed” over the allowable credit that would have been allowable for the entire period were the credit allowable ratably of 15 years. To continue the example above:

The taxpayer’s tax return for 2011, the 12<sup>th</sup> year of the compliance period, is audited and based on adjustments to both the eligible basis and applicable fraction, the examiner determines that the correct allowable annual credit is \$120,000. Although no credit is allowable, the accelerated portion of the credit to be recaptured from each prior year is computed as:

$$(\$130,000 - \$120,000) \times 4/15 = \$2,667$$

For taxable year 2000 through 2009, the accelerated portion of credit to be recaptured is \$2,667.

The examiner also determines that the 10-year credit period was 2000 through 2009 and that no credit is allowable in 2010 or 2011. The statute of limitation is closed for the 2010 year, so the IRC §42(j) credit recapture provisions are applied. The excess of the allowed over the allowable to be recaptured from 2010, is \$130,000 - \$0 = \$130,000. For 2011, the year under audit, the examiner disallows the entire \$130,000 credit claimed. Had the 2010 statute of limitation not been closed, the 2010 tax return should have been audited and the entire credit disallowed.

### Summary

1. Because a taxpayer claims the credit over a ten-year credit period, but is required to provide low-income housing for fifteen years, the taxpayer is claiming credit in advance of providing the low-income housing. The 1/3 portion of the credit claimed each year and associated with providing low-income housing in the future is commonly referred to as the “accelerated portion” of the credit.
2. The “accelerated” portion of the credit claimed in prior years is subject to “recapture” if there is a decrease in qualified basis.
3. The accelerated portion of the credit subject to recapture decreases during the last five years of the compliance period as the taxpayer provides the housing for which the taxpayer previously claimed the accelerated credit during the credit period.

4. The recapture amount is equal to the aggregate of accelerated credit recaptured from each prior year plus interest on the recaptured accelerated credit for the period beginning on the due date for filing the return for the prior taxable year involved to the due date for the tax return on which the recapture is reported.
5. The recapture amount is a separate adjustment and is characterized as an addition to the taxpayer's tax liability.
6. Special rules are applied when computing the recapture amount:
  - Only credit actually used to reduce a tax liability is recaptured; the tax benefit rule is applied. If the credit was not used to reduce a tax liability, then the carryforwards and carrybacks of the credit are appropriately adjusted.
  - Only qualified basis for which the taxpayer actually claimed credit is subject to recapture. This rule effectively limits the recapture provisions so that, mathematically, the accelerated credit is not "recaptured" more than once.
  - Credit associated with increases to qualified basis after the close of the first year of the credit period is claimed over the remaining years of the 15-year compliance period and is not subject to recapture.
  - The recapture amount cannot be offset by any other tax credit; i.e., the recapture amount is not treated as a federal income tax against which any federal tax credit can be applied.
  - The recapture provisions do not apply when the reduction in qualified basis results from a casualty loss if the lost qualified basis is restored by reconstruction or replacement within a reasonable time period.
  - The IRS has authority to determine that the credit recapture provisions will not be applied under specific circumstances.
7. Any partnership with 35 or more partners is treated as the taxpayer for which the credit is allowable and the recapture provisions are applied unless the partnership elects not to have the rule apply.
8. Generally, the disposition of a low-income building (or interest therein) is a credit recapture event. However, under IRC §42(j)(6), the credit recapture provisions are not applied under specific circumstances.
9. Regardless of whether the acquisition was through a purchase or foreclosure (or transaction in lieu of foreclosure), a taxpayer acquiring a low-income building, or interest therein, during the 15-year compliance period is entitled to claim any allowable credit if the building is operated in compliance with IRC §42 and an enforceable extended use agreement is in place.

10. The computation of the recapture amount is modified if:
  - The taxpayer claimed more than the allowable credit for taxable years subject to recapture, or
  - The taxpayer claimed credit for taxable years after the end of the credit period.
11. A taxpayer may self-report a credit recapture amount using Form 8611, Recapture of Low-Income Housing Credit.

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## Chapter 17 Examples

**Introduction** This chapter presents seven case studies demonstrating how adjustments to the allowable credit are computed and the IRC §42(j) recapture rules are applied.

**Topics**

- First Year of the Credit Period and Additions to Qualified Basis
- Partial Disallowance of Credit During the 10-Year Credit Period
- Partial Disallowance of Credit in the 11<sup>th</sup> Year
- Recapture After the End of the 10-Year Credit Period
- Disallowance of Credit in Multi-Year Audits
- Accounting for Prior Recapture Events
- Failure to Meet the Minimum Set-Aside Requirement: One Building Project
- Failure to Meet the Minimum Set-Aside Requirement: Multi-Building Projects
- Summary

**Explanations** The case studies have been simplified. Unless otherwise stated:

- All the units are of equal size.
- The applicable percentage is 9%.

### First Year of the Credit Period and Additions to Qualified Basis

This example demonstrates the interaction between:

- the rules for computing the credit for the first year of the credit period under IRC §42(f)(2), and
- the rules for additions to qualified basis after the end of the first year of the credit period under IRC §42(f)(3).

**Facts** A taxpayer received a credit allocation of \$50,000 for a new 100% IRC §42 low-income building with 50 units. The building was timely placed in service on June 26, 2010. The taxpayer determined that the building's eligible basis was \$555,556. Because the building was placed in service for six full months during the year (July through December), the taxpayer decided that the applicable fraction was 50%. The taxpayer computed the allowable credit for 2010 as:

$$\$555,556 \times 50\% \times 9\% = \$25,000$$

**Audit Results** The 2010 tax return was audited and the examiner determined that:

- the taxpayer had included \$95,000 of unallowable costs in eligible basis. The correct eligible basis is  $\$555,556 - \$95,500 = \$460,056$ .
- the taxpayer had not applied the special rule under IRC §42(f)(2) when computing the applicable fraction for the first year of the credit period. After reviewing the tenant files and applying the special rule, the correct applicable fraction was determined to be 41%.

- 47 of the 50 units (94%) were qualified low-income units at the end of the taxable year and therefore, the taxpayer met the 40-60 minimum set-aside requirement, as elected.

**Adjustment to Allowable Credit for 2010**

The corrected allowable credit is computed as:

$$\$460,056 \times 41\% \times 9\% = \$16,976$$

**Credit Recapture**

The IRC §42(j) credit recapture rules are not applicable since 2010 is the first year of the credit period.

**Required Filing Checks**

The examiner inspected the taxpayer's subsequent year return and determined that the taxpayer had claimed the entire allowable credit based on the overstated eligible basis and without accounting for the three units that were not qualified low-income units at the end of the first year of the credit period (2010). The examiner expanded the audit to include the 2011 return. There are two adjustments:

1. The eligible basis is reduced to \$460,056.
2. The credit is adjusted to account for the 3 units that were first qualified low-income units after the end of the first year of the credit period, resulting in an addition to qualified basis.

First, the examiner computed the qualified basis at the end of the first year of the credit period without applying the special rule under IRC §42(f)(2). The applicable fraction was determined as  $47 \div 50 = 94\%$

$$\text{Qualified Basis} = \$460,056 \times 94\% = \$432,253$$

The examiner determined that all the units were qualified low-income units at the end of the 2011 taxable year, and the qualified basis was computed as:

$$\$460,056 \times 100\% = \$460,056$$

There was an increase in qualified basis calculated as:

$$\$460,056 - \$432,253 = \$27,603$$

The increase in qualified basis is then multiplied by one third of the applicable percentage, computed as  $0.0900 \times 0.3333 = 0.0300$ . This is the portion of the credit associated with the increase in qualified basis that is *not* allowable.

$$\$27,603 \times 0.0300 = \$828$$

Because the special rule under IRC §42(f)(2) also applies to additions to qualified basis, the examiner then determined, based on when the units were first occupied by qualified households, that the applicable fraction for the addition to qualified basis was 4.25%.

The examiner then multiplied the eligible basis by the applicable fraction using the special rule for the first year of the increase, to determine the addition to qualified basis for 2011.

$$\$460,056 \times .0425 = \$19,522$$

An adjustment must be made to account for the increase in qualified basis not allowed because of the first year rule.

Total Addition to Qualified Basis:	\$27,603
First Year Addition to Qualified Basis:	<u>\$19,552</u>
Addition to Quailed Basis Not Allowed:	\$ 8,051

The credit associated with the \$8,051 Addition to Qualified Basis that is not allowable because of the special rule for the first year of the increase is:

$$\$8,051 \times (2/3)(9\%) = \$483$$

Therefore, to account for the addition to qualified basis, the allowable credit must be reduced by  $\$828 + \$483 = \$1,311$ .

The allowable credit is computed as:

$$(\$460,056)(100\%)(9\%) - \$1,311 = \$42,716$$

**Subsequent  
Years of the  
Compliance  
Period**

The adjustments to the eligible basis and additions to qualified basis will impact the computation of the credit for all subsequent years. If the taxpayer operates the project in compliance with IRC §42 requirements for the remainder of the 15-year compliance period, then:

- For years 3 through 10 of the credit period the allowable credit will be \$40,577, computed as  $\$41,405 - \$828$ .
- For year 11, the taxpayer may claim the remainder of credit not claimed because of the special rule for the first year of the credit period. The allowable credit is computed as:

$$(\$460,056)(94\%)(9\%) - \$16,976 = \$21,945$$

- For years 11-15, the taxpayer may claim the “2/3 credit” associated with the increase in qualified basis, computed as:

$$\$27,603 \times (2/3)(9\%) = \$1,656$$

## Partial Disallowance of Credit During the 10-Year Credit Period

In this example, a portion of the credit claimed in the 7<sup>th</sup> year of the compliance period is disallowed.

### Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 2006.
- All the units were occupied by qualifying low-income tenants at the end of the first year of the credit period. Based on the special computation of the applicable fraction for the first year of the credit period under IRC §42(f)(2)(A), the taxpayer claimed \$72,000 for 2006.
- The taxpayer claimed the entire \$100,000 credit for 2007 through 2012.

### Audit Results

The 2012 tax return was audited and resulted in an adjustment of \$15,000 to the allowable credit based on the disallowance of ineligible costs incorrectly included in eligible basis.

- The credit to be recaptured from each prior year is  $\$15,000 \times .333 = \$5,000$  for 2007 through 2011.

To apply the IRC §42(j) recapture provisions to the 2006 year, it is necessary to allocate the \$15,000 adjustment between the 1<sup>st</sup> and 11<sup>th</sup> year. Since the taxpayer claimed \$72,000 of the \$100,000 credit (72%) in 2006, 72% of the \$15,000 adjustment is associated with the \$72,000 claimed the first year.

$$\$15,000 \times .72 = \$10,800$$

For 2006, the recaptured credit portion of the recapture amount is  $\$10,800 \times 0.333 = \$3,596.40$ .

- The interest portion of the recapture amount is computed as follows:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2006	April 15, 2007 - April 15, 2013	\$3,596.40	\$1,129.27	\$4,725.67
2007	April 15, 2008 - April 15, 2013	\$5,000.00	\$1,084.00	\$6,084.00
2008	April 15, 2009 - April 15, 2013	\$5,000.00	\$763.50	\$5,763.50
2009	April 15, 2010 - April 15, 2013	\$5,000.00	\$537.50	\$5,537.50
2010	April 15, 2011 - April 15, 2013	\$5,000.00	\$333.50	\$5,333.50
2011	April 15, 2012 - April 15, 2013	\$5,000.00	\$152.00	\$5,152.00
Total		\$28,596.40	\$3,999.77	\$32,596.17

Further, because the disallowance of credit is based on a permanent reduction in eligible basis, the credit allowable in 2013 through 2016 is also reduced from the original \$100,000 allocated by the housing agency to \$85,000.

For 2017, the 11<sup>th</sup> year of the 15-year compliance period, the allowable credit is based on IRC §42(f)(2)(B); i.e., credit not allowed in the first year of the credit because of the IRC §42(f)(2)(A) special rule is allowable in the 11<sup>th</sup> year.

- Before the adjustment, the credit allowable in the 11<sup>th</sup> year was \$28,000, computed as \$100,000 - \$72,000.
- The portion of the \$15,000 adjustment allocated to the 11<sup>th</sup> year is \$4,200, computed as \$15,000 - \$10,800.
- The allowable credit for 2017 is \$28,000 - \$4,200 = \$23,800

### **Partial Disallowance of Credit in the 11<sup>th</sup> Year**

In this example, a portion of the credit claimed in the 11<sup>th</sup> year of the compliance period is disallowed. An allocation of the adjustment must be made between the first and 11th year of the compliance period to account for the special rule under IRC §42(f)(2) for computing the applicable fraction for the first year of the credit period.

#### **Facts**

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 1999.
- All the units were occupied by qualifying low-income tenants at the end of the first year of the credit period. Based on the special computation of the applicable fraction for the first year of the credit period under IRC §42(f)(2)(A), the taxpayer claimed \$72,000 in credit.
- The taxpayer claimed the entire \$100,000 credit for years 2000 through 2008.
- For 2009, the taxpayer claimed the remainder credit under IRC §42(f)(2)(B); i.e., \$28,000.

#### **Audit Results**

The 2009 tax return was audited and resulted in an adjustment of \$10,000 to the allowable credit. The credit to be recaptured from each prior year is \$10,000 x .333 = \$3,330.

To properly apply the IRC §42(j) recapture provisions to the 1999 year, it is necessary to allocate the \$10,000 adjustment between the 1<sup>st</sup> and 11<sup>th</sup> year. Since the taxpayer claimed \$28,000 of the \$100,000 credit (28%) in 2009, 28% of the \$10,000 adjustment is made on the 2009 tax return; i.e., \$2,800 is disallowed.

For purposes of computing the recaptured credit from 1999, \$7,200 of the \$10,000 adjustment is associated with the \$72,000 credit claimed the first year (1999). Therefore:

- For 1999, the recaptured credit portion of the recapture amount is:

$$\$7,200 \times 0.333 = \$2,398$$

- For 2000 through 2008, the recaptured credit portion of the recapture amount is:

$$\$10,000 \times 0.333 = \$3,330$$

- The interest portion of the recapture amount is \$12,767.65, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
1999	April 15, 2000 - April 15, 2010	\$2,398.00	\$2,072.35	\$4,470.35
2000	April 15, 2001 - April 15, 2010	\$3,330.00	\$2,346.98	\$5,676.98
2001	April 15, 2002 - April 15, 2010	\$3,330.00	\$1,967.36	\$5,297.36
2002	April 15, 2003 - April 15, 2010	\$3,330.00	\$1,673.33	\$5,003.33
2003	April 15, 2004 - April 15, 2010	\$3,330.00	\$1,452.55	\$4,782.55
2004	April 15, 2005 - April 15, 2010	\$3,330.00	\$1,229.44	\$4,559.44
2005	April 15, 2006 - April 15, 2010	\$3,330.00	\$940.73	\$4,270.73
2006	April 15, 2007 - April 15, 2010	\$3,330.00	\$620.71	\$3,950.71
2007	April 15, 2008 - April 15, 2010	\$3,330.00	\$328.34	\$3,658.34
2008	April 15, 2009 - April 15, 2010	\$3,330.00	\$135.86	\$3,465.86
Total		\$32,368.00	\$12,767.65	\$45,135.65

- The total recapture amount is \$45,135.65

### Recapture After the End of the 10-Year Credit Period

No credit is allowable after the end of the credit period, but a low-income building is deemed to have qualified basis equal to:

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

Any decrease in a low-income building's qualified basis from the prior year's qualified basis is a recapture event, even though no credit is allowable in years 11-15 of the compliance period.

The recapture rate, based on the year of the 15-year compliance period, is:

- Years 1-11,  $5 \div 15 = .333$
- Year 12,  $4 \div 15 = .267$
- Year 13,  $3 \div 15 = .200$
- Year 14,  $2 \div 15 = .133$
- Year 15,  $1 \div 15 = .067$

### Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units of equal size.
- The building was placed in service timely and the first year of the credit period was 1997.
- For 1997, the taxpayer claimed \$72,000. For each year, 1998 through 2006, the taxpayer claimed the entire \$100,000. For 2007, the taxpayer claimed \$28,000.

The state agency filed a Form 8823 to report that the building was no longer participating in the IRC §42 program, as of June 23, 2009.

**Audit Results**

The 2009 tax return was audited. Even though the taxpayer did not claim credit for 2009, the IRC §42(j) recapture requirements are applicable. In this case, the qualified basis at the end of 2009 is deemed to be zero and the entire credit claimed in prior years is subject to recapture using the recapture rate applicable to the year of the recapture event.

The recapture rate for 2009, the 13<sup>th</sup> year, is  $3 \div 15 = .200$ .

For 1997,  $\$72,000 \times 20\% = \$14,400$

For 1998 through 2006,  $\$100,000 \times 20\% = \$20,000$

For 2007,  $\$28,000 \times 20\% = \$5,600$

The recapture amount is \$316,737, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
1997	April 15, 1998 - April 15, 2010	\$14,400.00	\$17,040.96	\$31,440.96
1998	April 15, 1999 - April 15, 2010	\$20,000.00	\$20,412.00	\$40,412.00
1999	April 15, 2000 - April 15, 2010	\$20,000.00	\$17,284.00	\$37,284.00
2000	April 15, 2001 - April 15, 2010	\$20,000.00	\$14,096.00	\$34,096.00
2001	April 15, 2002 - April 15, 2010	\$20,000.00	\$11,816.00	\$31,816.00
2002	April 15, 2003 - April 15, 2010	\$20,000.00	\$10,050.00	\$30,050.00
2003	April 15, 2004 - April 15, 2010	\$20,000.00	\$8,724.00	\$28,724.00
2004	April 15, 2005 - April 15, 2010	\$20,000.00	\$7,384.00	\$27,384.00
2005	April 15, 2006 - April 15, 2010	\$20,000.00	\$5,650.00	\$25,650.00
2006	April 15, 2007 - April 15, 2010	\$20,000.00	\$3,728.00	\$23,728.00
2007	April 15, 2008 - April 15, 2010	\$5,600.00	\$552.16	\$6,152.16
Total		\$200,000.00	\$116,737.12	\$316,737.12

**Disallowance of Credit in Multi-Year Audits**

This example demonstrates how the IRC §42(j) recapture rules are applied when noncompliance involves more than one tax year. The accelerated portion of the credit associated with the decrease in allowable credit is recapture just once, in the earliest year open for audit.

**Facts**

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 2005, the year after the building was placed in service.
- All the units were occupied by qualifying low-income housings for the entire year of the first year of the credit period, so that the applicable fraction was 100% after applying the IRC §42(f)(2) special rule for computing the application fraction for the first year of the credit period.

- The taxpayer claimed the entire \$100,000 credit for years 2005, 2006, 2007, 2008, 2009, and 2010.

**Audit Results**

The 2008 tax return was selected for audit. The examiner determined that the taxpayer correctly reported the eligible basis as \$1,111,111. Based on reports of noncompliance submitted by the state agency, the examiner also determined that 25 of the 100 units were not qualified low-income units at the end of the 2008 taxable year.

The corrected allowable credit for 2008 is:

$$\$1,111,111 \times 75\% \times 9\% = \$75,000$$

The audit adjustment to the allowable credit is  $\$100,000 - \$75,000 = \$25,000$ .

The examiner also contacted the state agency and confirmed that none of the noncompliance issues associated with the 25 units in 2008 were corrected until June of 2011. Since the noncompliance existed at the end of the 2009 and 2010 tax years, the examiner expanded the audit to include the two subsequent years and made the same adjustment; i.e., the disallowance of \$25,000 in credit.

The examiner must also make an adjustment under IRC §42(j) to recapture a portion of the credit claimed in prior years. Using the recapture rate for the 4<sup>th</sup> year of the credit period (.333), the accelerated portion of the \$25,000 disallowed credit is computed as:

$$\$25,000 \times .333 = \$8,325$$

The recapture amount is computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2005	April 15, 2006 - April 15, 2009	\$8,325.00	\$1,933.07	\$10,258.07
2006	April 15, 2007 - April 15, 2009	\$8,325.00	\$1,164.67	\$9,489.67
2007	April 15, 2008 - April 15, 2009	\$8,325.00	\$462.87	\$8,787.87
Total		\$24,975.00	\$3,560.60	\$28,535.60

For 2008, there are two separate adjustments. \$25,000 in credit will be disallowed for the current year, and \$28,536 will be recaptured.

For 2009 and 2010, only the \$25,000 adjustment to the allowable credit is needed.

**Accounting for Prior Recapture Events**

Prior recapture events taken into account will affect the amount of any subsequent credit recaptured, since the accelerated portion of the credit can only be recaptured once.

**Facts**

- A taxpayer received a credit allocation of \$900,000 for the construction of a new low-income building with an eligible basis of \$10,000,000 and consisting of 100 units.



- The building was placed in service timely in 2001 and the taxpayer elected to begin the credit period in 2002.
- All the units were leased to qualified low-income households during 2001, so the applicable fraction for 2002 using the special rule under IRC §42(f)(2) for the first year of the credit period was 100%.
- The taxpayer claimed the entire \$900,000 credit for years 2002, 2003, 2004.
- For 2005, the taxpayer claimed \$855,000 because 5 units were out of compliance at the end of the 2005 tax year. The taxpayer also correctly reported a recapture amount equal to \$15,000 for each of the prior years 2002, 2003, and 2004, plus interest. The noncompliance was corrected in 2006 and the taxpayer resumed claiming the entire \$900,000 credit for 2006, 2007, 2008, 2009, and 2010.

**Audit Results**

The 2009 tax return was selected for audit. The examiner determined that the taxpayer correctly reported the \$10,000,000 eligible basis. The examiner also determined that 25 of the units were not qualified low-income units.

The corrected allowable credit is  $\$10,000,000 \times 75\% \times 9\% = \$675,000$

The adjustment to the current year credit is  $\$900,000 - \$675,000 = \$225,000$ .

The accelerated credit to be recaptured from each prior year is  $\$225,000 \times .333 = \$74,925$ . However, the examiner must account for \$15,000 already recaptured from the 2002, 2003, and 2004.

- For 2002, 2003, and 2004, the accelerated credit to be recaptured is  $\$74,925 - \$15,000 = \$59,925$ .
- For 2005, since the taxpayer did not claim \$45,000 due to the noncompliance, the accelerated credit recaptured is again limited to \$59,925.
- For 2006, 2007, and 2008, the recaptured accelerated credit is the entire \$74,925.

The entire recapture amount is \$584,190, computed as:

Tax Year	Interest Computation Period	Credit Recapture	Recapture Interest	Recapture Amount
2002	April 15, 2003 - April 15, 2010	\$59,925.00	\$30,112.31	\$90,037.31
2003	April 15, 2004 - April 15, 2010	\$59,925.00	\$26,139.29	\$86,064.29
2004	April 15, 2005 - April 15, 2010	\$59,925.00	\$22,124.31	\$82,049.31
2005	April 15, 2006 - April 15, 2010	\$59,925.00	\$16,928.81	\$76,853.81
2006	April 15, 2007 - April 15, 2010	\$74,925.00	\$13,966.02	\$88,891.02
2007	April 15, 2008 - April 15, 2010	\$74,925.00	\$7,387.61	\$82,312.61
2008	April 15, 2009 - April 15, 2010	\$74,925.00	\$3,056.94	\$77,981.94
Total		\$464,475.00	\$119,715.29	\$584,190.29

## Failure to Meet the Minimum Set-Aside Requirement: One Building Project

If a taxpayer fails to provide the minimum number of low-income units, the qualified basis is deemed to be zero and no credit is allowable.

### Facts

A taxpayer constructed one new 100% IRC §42 low-income building with 100 units. The building was timely placed in service in 2000. The taxpayer determined that the building's eligible basis was \$15,000,000. Based on the taxpayer's certified cost analysis, the state agency determined the allowable credit to be  $\$15,000,000 \times 100\% \times 9\% = \$1,350,000$ . The taxpayer:

- Elected the 40-60 minimum set-aside under IRC §42(g)(1).
- Elected to begin the credit period in 2001.

The taxpayer claimed the entire credit each year 2001 through 2009.

### Audit Results

The 2009 tax year was audited and the examiner determined that 62 of the units could not be documented as qualified low-income units. The applicable fraction was 38%, computed as  $(100 - 62) \div 100$ . Since the project is comprised of one building, the taxpayer also failed the minimum set-aside

No credit is allowable for 2009 because the taxpayer did not meet the 40% minimum set-aside. In addition, the taxpayer is subject to the recapture provisions since the qualified basis at the end of 2009 is zero and less than the qualified basis at the end of prior taxable year as reported when filing the 2008 tax return. The recapture rate is .333 and the recaptured credit from each prior year is  $\$1,350,000 \times .333 = \$449,500$ . The recapture amount is \$4,722,897, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2001	April 15, 2002 - April 15, 2010	\$449,500.00	\$265,564.60	\$715,064.60
2002	April 15, 2003 - April 15, 2010	\$449,500.00	\$225,873.75	\$675,373.75
2003	April 15, 2004 - April 15, 2010	\$449,500.00	\$196,071.90	\$645,571.90
2004	April 15, 2005 - April 15, 2010	\$449,500.00	\$165,955.40	\$615,455.40
2005	April 15, 2006 - April 15, 2010	\$449,500.00	\$126,983.75	\$576,483.75
2006	April 15, 2007 - April 15, 2010	\$449,500.00	\$83,786.80	\$533,286.80
2007	April 15, 2008 - April 15, 2010	\$449,500.00	\$44,320.70	\$493,820.70
2008	April 15, 2009 - April 15, 2010	\$449,500.00	\$18,339.60	\$467,839.60
Total		\$3,596,000.00	\$1,126,896.50	\$4,722,896.50

## Failure to Meet the Minimum Set-Aside Requirement: Multi-Building Projects

A taxpayer may decide to treat each low-income building as a separate project, include all the buildings in a single multi-building project, or group low-income buildings in multiple projects. The taxpayer's decision will be influenced by such factors as when the buildings are placed in service, when the units within the buildings first qualify as low-income units, and whether the buildings are 100% low-income or mixed use.

**Facts**

- A taxpayer constructed 10 identical four-plexes; i.e., 4 identical units in each building. The buildings are intended to be 100% low-income housing and each building's eligible basis is \$500,000.
- The allowable annual credit for each building is  $\$500,000 \times 100\% \times 9\% = \$45,000$ . The total allowable credit for the 10 buildings is \$450,000.
- When completing the First-Year Certification, the taxpayer elected to treat buildings 1 through 6 as a project and buildings 7 through 10 as a separate project. The taxpayer elected the 40-60 minimum set-aside for both projects and included an attachment to each Form 8609 to identify which buildings were to be included in each project.
- For 2002, the first year of the credit period, the applicable fraction for each building was 75%, computed using the special rule under IRC §42(f)(2), and the taxpayer claimed \$337,500 in credit. Thereafter, the taxpayer claimed the entire \$450,000 credit each year based on a 100% applicable fraction.

**Audit Results**

The tax return for 2009, the 8<sup>th</sup> year of credit period, was audited. When determining whether the units in the six-building project were qualified low-income units, the following facts were established.

- 2 units each in buildings 1, 2, 3, and 4 are qualified units,
- 1 unit in building 5 is a qualified unit,
- All 4 units in building 6 are qualified units.

The examiner next considered whether the project met the minimum set-aside. Altogether there are 24 units in the six-building project and the minimum set-aside is computed as  $24 \times 40\% = 9.6$  units. Rounding up to the next whole number, the taxpayer must provide at least 10 low-income units within the six-building project to meet the minimum set-aside. In this project, there are 13 qualifying low-income units and the minimum set-aside is met.

$$(4 \times 2) + 1 + 4 = 13, \text{ and the minimum set-aside is met.}$$

- The allowable credit for buildings 1, 2, 3, and 4 is computed as:

$$\$500,000 \times 50\% \times 9\% = \$22,5000$$

- The minimum set-aside requirement is a "project" requirement; i.e., the buildings within the project may have an applicable fraction less than the minimum set-aside percentage and qualify for the credit as long as the minimum set-aside for the entire project is met. The allowable credit for building 5 is computed as:

$$\$500,000 \times 25\% \times 9\% = \$11,250$$

- The allowable credit for building 6, where the applicable fraction is 100%, is  $\$500,000 \times 100\% \times 9\% = \$45,000$ .

The examiner then considers the second project consisting of buildings 7 through 10.

- None of the units in building 7 are qualified units,
- 1 unit in building 8 is a qualified unit,
- 2 units in building 9 are qualified units, and
- 3 units in building 10 are qualified units.

Since there are 16 units in the 4 buildings, the examiner determines that the taxpayer must provide at least 7 low-income units to meet minimum set-aside requirement for the project; i.e.  $16 \times 40\% = 6.4$ , rounded up to 7. Since there are only 6 qualified low-income units in the four-building project, no credit is allowable for buildings 7, 8, 9, or 10.

The taxpayer's allowable credit for the 8<sup>th</sup> year of the credit period is computed as follows based on buildings 1-6.

$$(4)(\$22,500) + \$11,250 + \$45,000 = \$146,250$$

The adjustment to the credit is  $\$450,000 - \$146,250 = \$303,750$ .

The last consideration is the computation of the recapture amount. The accelerated credit to be recaptured from each prior year is  $0.333 \times \$303,750 = \$101,149$ . For the first year of the credit period, where the taxpayer claimed 75% of the credit, the recaptured accelerated credit would be  $\$101,149 \times 75\% = \$75,862$ .

The recapture amount is \$863,871.00, computed as:

Tax Year	Interest Computation Period	Credit Recapture	Recapture Interest	Recapture Amount
2002	April 15, 2003 - April 15, 2010	\$75,862.00	\$38,120.66	\$113,982.66
2003	April 15, 2004 - April 15, 2010	\$101,149.00	\$44,121.19	\$145,270.19
2004	April 15, 2005 - April 15, 2010	\$101,149.00	\$37,344.21	\$138,493.21
2005	April 15, 2006 - April 15, 2010	\$101,149.00	\$28,574.59	\$129,723.59
2006	April 15, 2007 - April 15, 2010	\$101,149.00	\$18,854.17	\$120,003.17
2007	April 15, 2008 - April 15, 2010	\$101,149.00	\$9,973.29	\$111,122.29
2008	April 15, 2009 - April 15, 2010	\$101,149.00	\$4,126.88	\$105,275.88
Total		\$682,756.00	\$181,115.00	\$863,871.00

## Summary

When computing adjustments to the allowable credit and the recapture amount, the computation must account for:

1. The special rule under IRC §42(f)(2) for computing the applicable fraction for the first year of the credit period. Only the credit claimed is subject to the IRC §42(j) recapture provisions.
2. Additions to qualified basis after the end of the first year of the credit period, which is not subject to the IRC §42(j) recapture provisions.

3. Whether the entire annual credit is disallowed or only a portion.
4. Allocations between the first and eleventh year of the compliance period.
5. Whether a reduction in qualified basis occurs after the end of the 10-year credit period; i.e., no credit is allowable in years 11-15, but the taxpayer remains subject to the IRC §42(j) recapture provisions.
6. Prior recapture events, for which the taxpayer correctly accounted, because the accelerated credit cannot be recaptured more than once.
7. Whether the taxpayer fails to meet the minimum set-aside, in which case no credit is allowable for any low-income building in the project. Alternatively, a low-income building's applicable fraction may be less than the minimum set-aside if the building is part of a multi-building project that, in aggregate, meets the minimum set-aside.

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## Chapter 18

### Report Writing for Partnership Audits

<b>Introduction</b>	Audit reports should contain all the information necessary to ensure a clear understanding of the adjustments and document how the tax liability was computed. Examination reports (unlike workpapers) are legally binding documents and, when executed, serve as the basis for assessment and collection action. Examiners should take all necessary steps to ensure report accuracy. See IRM 4.10.8.
<b>Background Explanation</b>	Since almost all taxpayers owning IRC §42 projects are partnerships, this chapter presents the basic report writing requirements for partnership audits.
<b>Topics</b>	<ul style="list-style-type: none"><li>• Audit Reports</li><li>• Form 886-A, Explanation of Items</li><li>• Form 886-S, Partners' Shares of Income, Deductions and Credits</li><li>• Summary</li></ul>
<b>Audit Report</b>	
<b>Forms: Non-TEFRA</b>	<p>Form 4605, Examination Changes - Partnerships, Fiduciaries, S Corporations and Interest Charge Domestic International Sales Corporations, is used for presenting the audit results and includes a signature line for the Tax Matters Partner to sign when the case will be closed agreed.</p> <p>Form 4605-A, Examination Changes - Partnerships, Fiduciaries, S Corporations and Interest Charge Domestic International Sales Corporations (Unagreed and Excepted Agreed) is used when the case will be closed unagreed.</p>
<b>Forms: TEFRA</b>	The audit results can be presented on Form 4605-A, because TEFRA includes separate agreement forms.
<b>Adjustment to Current Year Credit</b>	<p>Any adjustment to the allowable IRC §42 credit for the year under audit will be reflected on Line 5, as an "Other Adjustment." The adjustment's title must identify when the buildings were placed in service to correctly compute the Alternative Minimum Tax at the partner level. The choices in RGS (Report Generating System) are:</p> <ul style="list-style-type: none"><li>• Low-Income Housing Credit in service after 1989 and before 2008, or</li><li>• Low-Income Housing Credit in service after 2007.</li></ul>
<b>Recapture Amount</b>	<p>The IRC §42(j) credit recapture amount is a separate adjustment under Line 5 as an "Addition to Tax."</p> <ul style="list-style-type: none"><li>• The full recapture amount should be disclosed; i.e., the recaptured credit and interest combined as a single "recapture amount."</li></ul>

- The maximum recapture amount should be disclosed, without attempting to apply the IRC §42(j)(4)(A) tax benefit rule, which will be applied when the adjustment is made for the taxpaying partner.
- The recapture amount should be assessed for the year of the recapture event. Under certain circumstances where the taxpayer has failed to restore the IRC §42 project within a reasonable period, the recapture amount will be assessed for the earliest year under audit. See IRC §42(j)(4)(E).

**Remarks:  
Explanations**

The “Remarks” section of the report should be used to provide explanations. This section can be used to explain how the IRC §42(j)(4)(A) tax benefit rule will be applied at the partner level. For example:

“The recapture amount shown in this report reflects the maximum possible recapture amount. When determined at the partner level, IRC §42(j)(4)(A) will be applied so that the tax for the taxable year is increased only with respect to the credits allowed by reason of this section which were used to reduce the partner’s tax liability. In the case of credits not so used to reduce tax liability, the carryforwards and carrybacks under IRC §39 shall be appropriately adjusted. The interest portion of the recapture amount under IRC §42(j)(2)(B) will be computed using the overpayment rate under IRC §6621(a); i.e., the federal short-term rate determined under subsection (b) plus 3 percentage points (2 percentage points in the case of a corporation). No deduction is allowable for the interest portion of the recapture amount computed under IRC §42(j)(2)(B).

**Remarks:  
Complete  
Disclosure of  
Audit Results**

The “Remarks” section of the report should also be used to disclose additional audit results to which the taxpayer is agreeing.

For example, the permanent disallowance of specific costs incorrectly included in eligible basis by the taxpayer should be specifically stated so there is no doubt that the eligible basis upon which the credit will be computed in future years has been reduced.

“The taxpayer also agrees to the permanent reduction of eligible basis of the low-income buildings. The corrected eligible basis for each affected building is shown on the attached schedule.”

A schedule should be used if the remarks section has insufficient space. For the example above, the schedule should identify each affected low-income building by BIN, and show the eligible basis reported on the tax return, the adjustment, and the corrected eligible basis.

**Form 886-A, Explanation of Items**

The Form 886-A can be provided to the taxpayer with explanations for the adjustments made to the credit. Alternatively, an examiner may provide copies of issue leadsheets prepared as workpapers during the audit.



**Minimum Requirement**

At a minimum, the explanation should include a:

- Summary of adjustments to the three components of the credit computation; i.e., the eligible basis, applicable fraction, and applicable percentage. The format and depth of the explanation may vary.
- Computation of the recapture amount, year-by-year, including a separate statement of the credit recaptured and the interest components.

**Unagreed Cases**

If the case is closed unagreed, the Explanation of Items should be presented in the formal “fact, law, and argument” format.

**Form 886-S, Partners’ Shares of Income, Deductions and Credits**

Form 886–S is used to identify partner level adjustments for each year in which a change is recommended. The form should reflect:

- The corrected allowable credit for each partner.
- The recapture amount, shown as two adjustments. First, the total recaptured credit component under IRC §42(j)2)(A), and second, the interest component under IRC §42(j)2)(B).

**Summary**

This chapter focused on unique aspects of preparing audit reports when making adjustments to the IRC §42 credit.

1. Adjustments to the credit for the year under audit are reflected as an “Other Adjustment” on Form 4605, line 5.
2. The current year adjustment’s title must identify when the buildings were placed in service to correctly compute the Alternative Minimum Tax at the partner level.
3. The recapture amount is a separate adjustment on Line 5 as an “Addition to Tax”. The full recapture amount should be disclosed; i.e., the recaptured credit and interest combined as a single “recapture amount.”
4. The “Remarks” section of the report should be used to provide explanations and disclose additional audit results to which the taxpayer is agreeing.
5. Form 886-A should be used to provide the taxpayer with explanations for the adjustments made to the credit. Alternatively, an examiner may provide copies of issue leadsheets prepared as workpapers during the audit. The format and depth of the explanation may vary.
6. Form 886–S is used to identify partner level adjustments for each year in which a change is recommended. The form should reflect the corrected allowable credit for each partner. The recapture amount should be broken out into its component parts; i.e., the recaptured credit and the interest portions of the recapture amount should be separately stated.

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## Chapter 19 Auditing Partners

**Introduction** The computation of the allowable IRC §42 credit is not solely dependent on the amount reported as a flow-through item from the partnership owning the IRC §42 project. The allowable credit is also subject to limitations at the partner level.

**Topics**

- Claiming the IRC §42 Credit
- Required Filing Checks
- IRC §6222, Consistent Treatment of Partnership Items
- IRC §38(d), Ordering Rules
- IRC §39, Carryback and Carryforward of Unused Credits
- IRC §469, Passive Activity Limitations
- IRC §55, Alternative Minimum Tax
- Flow-Through Adjustments from Partnership Audits: Current Year Adjustments
- Flow-Through Adjustments from Partnership Audits: The Recapture Amount
- Disposition of Interest in Partnership Owning IRC §42 Project
- Summary

### Claiming the IRC §42 Credit

**Form 8586, Low-Income Housing Credit** Form 8586, Low-Income Housing Credit, is filed with the taxpayer's tax return to claim the credit. The allowable credit flowing through is reported on line 4 of Part I or line 11 of Part II, depending on when the low-income buildings were placed in service.

**Form 3800, General Business Credit** The IRC §42 credit is included in the General Business Credit under IRC §38(b)(5). The allowable IRC §38 business credit is calculated on Form 3800, General Business Credit. The reporting of the IRC §42 credit depends on when the low-income buildings were placed in service.

- For buildings placed in service before January 1, 2008, the credit is reported in Part I.
- For buildings placed in service after December 31, 2007, the credit is reported in Part II.

### Required Filing Checks

**Audit Requirements** If the taxpayer owns an interest in an IRC §42 project, directly or indirectly through tiered partnerships, then the taxpayer and the partnerships are related and the taxpayer is subject to the Required Filing Checks as outlined in IRM 4.10.5.4.

**Confirm Filing** Confirm that the related partnership filed its tax return. No partnership items flowing through from the partnership are allowable if the partnership has not filed its tax return.

**Consistent Treatment** Confirm that the taxpayer has claimed the IRC §42 credit and other flow-through items as reported on the Schedule K-1 provided by the partnership.

**Related Partnership is Under Audit** Determine whether the partnership is currently under audit. Any pending adjustments at the partnership level may impact adjustments considered at the partner level.

**Transactions Between Related Parties** Taxpayers claiming the credit are usually limited partners that are not involved in the day-to-day operation of the IRC §42 project or partnership itself. However, depending on the relationship, there may be other transactions between the related parties to consider. For example:

- The taxpayer under audit is the IRC §42 partnership's general partner who has control of the partnership. Did the taxpayer also develop the IRC §42 project and receive a developer fee? If so, has the taxpayer properly reported the fee as income? Similarly, is the taxpayer managing the IRC §42 project and receiving a management fee? If so, is the taxpayer properly reporting the management fee?
- The taxpayer under audit is an intermediary tiered partnership. Did the taxpayer correctly report the amount of credit on the Schedules K-1 provided to its partners based on the Schedules K-1 it received?
- In addition to the capital contribution, did the taxpayer loan the partnership money, or has the partnership loaned funds to the taxpayer?

**Large, Unusual, or Questionable Items** Inspect the related taxpayer's tax return and evaluate large, unusual, and questionable items, such as the IRC §42 credit, for audit potential. This evaluation is independent of the taxpayer under audit.

**Audit Techniques** The following audit techniques should be used.

- Interview the taxpayer and ask about the taxpayer's involvement with the IRC §42 partnership. Specifically, other than its capital contribution, was the taxpayer involved in any other transactions with the partnership?
- Review the taxpayer's partnership agreement.
- When examining the taxpayer's books and records, consider the effect of items on related returns.

## **IRC §6222, Consistent Treatment of Partnership Items**

**Law** Under IRC §6222(a), a partner is required to treat partnership items the same way as the partnership treated the item. Under IRC §6222(c), if a partnership item is treated inconsistently on the partner's return, the IRS may assess any resulting deficiency without regard to the restriction on an assessment attributable to a partnership item under IRC §6225.

IRC §6231(a)(3) defines a partnership item as any item required to be taken into account for the partnership's taxable year to the extent such item is more appropriately determined at the partnership level than at the partner level.

IRC §6231(a)(6) defines a computational adjustment as the change in the tax liability of a partner which properly reflects the treatment of a partnership item under the TEFRA. That is, a computational adjustment is the computation of a tax liability attributable to a partnership item.

### **“True-Ups”**

It is not unusual for taxpayers to hold ownership interests in multiple IRC §42 projects directly or through multi-tiered partnerships. Sometimes, if the Schedules K-1 are not received by the time the taxpayer files its tax return, the taxpayer will claim “estimated” losses and IRC §42 credit. The taxpayer does not always file Form 8082, Notice of Inconsistent Treatment, with its tax return to provide notice that partnership items on the tax return are inconsistent with the treatment of those items on the partnership return.

When the Schedules K-1 are received, the taxpayer will then reconcile the losses and credits claimed on its tax return with the amounts reported on the Schedules K-1. However, instead of filing an amended return to correct any discrepancy, the taxpayer will account for the discrepancy by adjusting the losses and credits claimed on its subsequent year tax returns. The adjustment is referred to as a “true-up” adjustment.

There are two primary issues:

1. “True-ups” are allowable only to the extent the adjustment is made to report the correct allowable credit for that tax year; i.e., a computational adjustment under IRC §6231(a)(6). Refer to Field Service Advisory (FSA) 200125014 for additional discussion.
2. “True-ups” of credits from year-to-year are not a permissible accounting method. Under IRC §446(a), taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. As explained in CCA 200812023, “IRC §42 tax credits must be allocated in the same proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year.”

### **IRC §38(d), Ordering Rules**

#### **Law**

The IRC §42 credit is included under IRC §38 as a general business credit and is subject to the ordering rules under IRC §38(d). The ordering rules are important because taxpayers who invest in IRC §42 projects are likely to invest in other credit programs such as the New Markets Tax Credit (IRC §45D) and Rehabilitation Credit (IRC §47). IRC §38(d) reads:

Ordering rules. For purposes of any provision of this title where it is necessary to ascertain the extent to which the credits determined under any section referred to in IRC §38(b) are used in a taxable year or as a carryback or carryforward—

- (1) In general. The order in which such credits are used shall be determined on the basis of the order in which they are listed in IRC §38(b) as of the close of the taxable year in which the credit is used.

- (2) Components of investment credit. The order in which the credits listed in IRC §46 are used shall be determined on the basis of the order in which such credits are listed in IRC §46 as of the close of the taxable year in which the credit is used.

The credit ordering rules are also important when applying the IRC §42(j)(4)(A) tax benefit rule; i.e., the recapture amount is calculated based on the credit used to reduce tax liability. This topic is addressed later in this chapter.

## **IRC §39, Carryback and Carryforward of Unused Credits**

IRC §39 accounts for allowable credit not used to reduce the taxpayer's tax liability for the current taxable year. IRC §38(a) provides that the allowable business credit is equal to the sum of:

1. the business credit carryforwards carried to such taxable year,
2. the amount of the current year business credit, plus
3. the business credit carrybacks carried to such taxable year.

### **General Rule**

IRC §39(a) provides that if the sum of the business credit carryforwards and current year credit exceed the amount of the limitations imposed under IRC §38(c), then the excess credit is:

1. a business credit first carried back to the taxable year preceding the unused credit year. For tax years beginning before January 1, 1998, the credit could be carried back 3 years.
2. Any business credit not carried back is carried forward to each of the 20 taxable years following the year the credit was not used. For tax years beginning before January 1, 1998, the credit could be carried forward 15 years.

Under IRC §39(b) and (c), the IRC §38 ordering rules and limitation are applied when the credit is carried back or forward.

### **Transitional Rule**

Under IRC §39(d), the unused general business credit cannot be carried back to any taxable year before the first taxable year for which the specific credit listed in IRC §38(b) is allowable. For IRC §42, the credit was first allowable for the 1987 tax year.

## **IRC §469, Passive Activity Limitations**

The passive activity limitations under IRC §469(a)(2) apply to any individual, estate, trust, closely held C corporation, and any personal service corporation.

When an individual purchases an interest in a partnership, a limited liability company (LLC) treated as a partnership, or an S corporation, losses and credits may be limited by the passive activity limitation rules under IRC §469. Both passive losses and passive credits generated by rental activities are limited to the tax deduction equivalent of \$25,000. Passive losses are reflected on Form 8582, and passive credits are reflected on Form 8582-CR.

**IRC §42 Losses** Losses generated by IRC §42 projects are subject to the passive activity limitations. The taxpayer must actively participate to qualify for the \$25,000 offset. Furthermore, the \$25,000 amount is phased out at the rate of 50 cents for every dollar over modified Adjusted Gross Income (AGI) of \$100,000. If modified AGI exceeds \$150,000, no losses may be deducted unless the taxpayer has passive income.

Since most individual investors are limited partners, and limited partners do not meet the active participation standard, losses generally should be entered on Form 8582, line 3b (not line 1b). Consequently, no \$25,000 offset is available and losses are deductible only to the extent of passive income reported on the return.

**IRC §42 Credits** IRC §469(i)(3)(D) and (6)(B) provide exceptions for IRC §42 credits; i.e., there is no active participation requirement for the \$25,000 offset and there is no phase-out of the credit based on modified Adjusted Gross Income. Therefore, a taxpayer may use the credit to offset taxable income subject to the \$25,000 limit. For example, the maximum IRC §42 credit allowable to a taxpayer in the 35% bracket is \$8,750.

The only reasons an individual could claim IRC §42 credit in excess of the tax deduction equivalent of \$25,000 are:

1. There is tax attributable to net passive income on Form 8582-CR, line 6.
2. The taxpayer is a real estate professional under IRC §469(c)(7) and materially participates in the rental real estate activity generating the low-income housing credits. For example, the taxpayer owns a construction company and works on the low-income housing project.

**Only One \$25,000 Offset** IRC §469(i) provides only one \$25,000 offset for losses and credits combined. The sum total of passive losses on Form 8582, line 10 and the credit equivalent on Form 8582-CR cannot exceed \$25,000 unless the taxpayer has passive income.

**Ordering Rules** Under IRC §469(i)(3)(E), the \$25,000 offset is absorbed first by passive losses, then by any passive activity credit, then by the rehabilitation credit, and finally by the low income housing credit. Passive losses and other passive credits are absorbed before the rehabilitation tax credit, which is absorbed before the IRC §42 credit.

If the \$25,000 offset is completely used up by passive losses, no low-income housing credit may be used. For example, if the taxpayer deducts \$25,000 in rental real estate losses under the provisions of IRC §469(i), no IRC §42 credit or any other passive credit may be used, unless the taxpayer has passive income. Similarly, if the taxpayer deducts \$20,000 in rental real estate losses, only the tax deduction equivalent of \$5,000 (approximately \$1,750 credit for someone in the 35% bracket) remains for passive credits.

**Disposition of Passive Activity** On disposition of a passive activity to an unrelated party in a fully taxable transaction, excess current and suspended losses are fully deductible (after having been subjected to basis and at-risk limitations). However, IRC §42 credits are not automatically allowable in full. Instead, the taxpayer has two choices:

1. Under IRC §469(j)(9), the taxpayer may elect to increase the basis of the IRC §42 project (or an interest therein) by completing Form 8582CR, Part VI, or
2. Under IRC §469(b), the taxpayer may continue to carry forward the credit. In which case, the credit is allowed to the extent of the tax equivalent of passive income (see IRC §469(d)(2)) and the credit is allowed to the extent of the \$25,000 offset (see IRC §§ 469(i)(1) and 469(i)(6)(B)).

**Accounting for Passive Activity Limitations**

If the taxpayer is an individual, a personal service corporation, or a closely held C corporation, then the taxpayer must account for the passive activity limitations.

For individuals filing Form 1040, and the buildings were placed in service before January 1, 2008, the passive activity limitations are applied on Form 3800, Part I, lines 3 and 5. For buildings placed in service after December 31, 2007, the passive activity loss limitation is accounted for on Form 8582 and the passive activity credits on Form 8582-CR.

Personal service corporations and closely held C corporations file Form 8810, Corporate Passive Activity Loss and Credit Limitations. The passive activity credits are accounted for in Part II.

**IRC §55, Alternative Minimum Tax**

**Law**

IRC §55, Alternative Minimum Tax (AMT), is a tax equal to the excess (if any) of the tentative minimum tax for the taxable year, over the regular tax for the taxable year. The AMT computation is based on “alternative minimum taxable income,” which is the taxpayer’s taxable income for the year modified by adjustments provided for in IRC §§ 56 and 58 and increased by the amount of the items of “tax preference” under IRC §57.

IRC §38(c)(1) places a limit on the credit based on the amount of the tax liability. The allowable credit shall not exceed the excess (if any) of the taxpayer's net income tax over the greater of:

- (A) the tentative minimum tax for the taxable year, or
- (B) 25% of so much of the taxpayer's net regular tax liability as exceeds \$25,000.

**Forms**

- Form 6251, Alternative Minimum Tax-Individuals, is used by individual taxpayers filing Form 1040 to compute the AMT amount.
- Form 4626, Alternative Minimum Tax-Corporations, is used by corporate taxpayers to compute the AMT amount. There is an exemption for small corporations under IRC §55(e).

**Buildings Placed in Service Before January 1, 2008**

For buildings placed in service before January 1, 2008, the IRC §42 credit was subject to the limitations described in IRC §38(c)(1). The limitations were applied when computing the allowable credit on Form 3800, General Business Credit, and accounted for in Part I of the form.



**Buildings  
Placed in  
Service After  
December 31,  
2007**

Section 3022 of the Housing Assistance Tax Act of 2008 repealed the Alternative Minimum Tax limitations for the IRC §42 credit. IRC §38(c)(4)(A) now reads:

- (4) Special rules for specified credits.
- (A) In general. In the case of specified credits—
- (i) IRC §38 and IRC §39 shall be applied separately with respect to such credits, and
  - (ii) in applying IRC §38(c)(1) to such credits--
    - (I) the tentative minimum tax shall be treated as being zero, and
    - (II) the limitation under IRC §38(c)(1) (as modified by subclause (I)) shall be reduced by the credit allowed under IRC §38(a) for the taxable year (other than the eligible small business credits and the specified credits).

IRC §38(c)(4)(B)(ii) specifies “the credit determined under IRC §42 to the extent attributable to buildings placed in service after December 31, 2007.”

**Form 3800,  
General  
Business  
Credit**

For taxable years ending in 2008 or later, Form 3800 accounts for AMT and the IRC §42 credit based on when the buildings were placed in service:

- For buildings placed in service before January 1, 2008, the credit continues to be accounted for in Part I.
- For buildings placed in service after December 31, 2007, the credit is accounted for in Part II.

**Flow-Through Adjustments from Partnership Audits: Current Year Adjustments**

An adjustment to the credit at the partnership level will result in a parallel adjustment to the current year credit at the partner level, based on the partner’s proportionate share of the related depreciation deduction or loss. See CCA 200812023. The adjustment will be composed of:

1. Reduction of any carryforward of the credit to the subsequent year, and
2. Disallowance of the current year credit.

**Example 1: Current Year Adjustment**

For 2010, the taxpayer’s allowable IRC §42 credit from a partnership owning an IRC §42 project was \$50,000. The taxpayer used \$35,000 to reduce its 2010 tax liability to zero. The taxpayer had already reduced its tax liability for 2009 to zero. The remaining IRC §42 credit of \$15,000 was carried forward to 2011.

The partnership’s 2010 return was audited and the allowable credit was reduced. The taxpayer’s corrected allowable IRC §42 credit from the partnership was \$40,000. The adjustment to the taxpayer’s credit is \$10,000.

The \$10,000 adjustment is first applied against the \$15,000 carry-forward, which is reduced to \$5,000. No adjustment is made to the credit used to reduce the taxpayer's 2010 tax liability.

### Flow-Through Adjustments from Partnership Audits: The Recapture Amount

The IRC §42(j) recapture amount is determined after the current year adjustment and any related adjustments to the carrybacks and carryforwards of credit are accounted for.

The maximum recapture amount will be determined when the partnership is audited. The adjustment at the partner level, however, may be less, depending on how the partner applied the credit against its tax liability.

When computing the recapture amount and computing any additional tax liability, consideration must be given to:

- The ordering rules under IRC §38 and the credit carryforward and carryback rules under IRC §39.
- The passive activity limitations under IRC §469.
- The alternative minimum tax under IRC §55.
- The Tax Benefit Rule under IRC §42(j)(4)(A).

### IRC §38 Ordering Rules

The IRC §38 ordering rules are demonstrated in the following example.

For 2007, the taxpayer claimed \$15,000 as an IRC §47 Rehabilitation Credit, which is included in the IRC §46 Investment Credit identified in IRC §38(b)(1) and reflected in column (b) in the chart below.

For 2008, the taxpayer claimed \$15,000 as an IRC §41(a) Research Credit, which is identified in IRC §38(b)(4), which is reflected in column (b) in the chart below.

For 2007 through 2011, the taxpayer's allowable IRC §42 credit from a partnership owning an IRC §42 project was \$50,000. The taxpayer used the IRC §42 credit to reduce its tax liability only after exhausting the allowable IRC §§ 47 and 41(a) credits as shown below.

(a) Credit Period Year	(b) Other Credits	(c) Tax Liability	(d) Other Credit Claimed	(e) Reduced Tax Liability	(f) IRC §42 Credit Allowable	(g) IRC §42 Credit Available	(h) IRC §42 Credit Claimed	(i) IRC §42 Credit C/F
2007	\$15,000	\$30,000	\$15,000	\$15,000	\$50,000	\$50,000	\$15,000	\$35,000
2008	\$15,000	\$50,000	\$15,000	\$35,000	\$50,000	\$85,000	\$35,000	\$50,000
2009		\$25,000		\$25,000	\$50,000	\$100,000	\$25,000	\$75,000
2010		\$52,000		\$52,000	<u>\$50,000</u>	\$125,000	<u>\$52,000</u>	\$73,000
Total					\$200,000		\$127,000	

Based on an audit of the partnership's 2011 tax return, there was a recapture event resulting in the total disallowance of the taxpayer's \$50,000 credit for 2011 and the recapture of accelerated credit in the amount of \$16,650 from each prior year; i.e., .333 x \$50,000.

Once the analysis of the ordering rules is completed, the tax benefit rule can be applied and recapture amount can be computed.

**Tax Benefit Rule**

Under IRC §42(j)(4)(A), a tax benefit rule is applied to account for credit not used to reduce the partner’s tax liability. The tax for the year the recapture is made is increased only with respect to credits allowed which reduced the taxpayer’s tax liability.

Treas. Reg. §1.1016-3(e)(1) offers the following insight regarding the tax benefit rule:

[T]here are situations in which it is necessary to determine ... the extent to which the amount allowed ... resulted in a reduction for any taxable year of the taxpayer’s taxes ... This amount (amount allowed which resulted in a reduction of the taxpayer’s taxes) is hereinafter referred to as the “tax-benefit amount allowed.” For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, *a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined.* If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable...” [Emphasis added.]

The taxpayer must provide sufficient documentation to establish how the credits were applied. If the taxpayer cannot provide sufficient documentation, then the recapture amount will be computed as if the entire credit was used to reduce the taxpayer’s tax liability in the year the credit was allowable.

**Applying the Tax Benefit Rule**

The tax benefit rule is demonstrated in the following example.

A taxpayer owns a 25% interest in a partnership owning an IRC §42 project. Based on the Schedules K-1 received each year, the taxpayer claimed credit as shown in the following table.

The available credit is computed as the sum of the current year allowable credit (b) and the carryforward of credit from the previous year (f). The credit claimed (e) is the amount used to reduce the taxpayer’s tax liability (d). The carryforward is the difference between the amount of credit available (c) and the amount of credit claimed (e).

(a) Credit Period Year	(b) Allowable IRC §42 Credit	(c) Available IRC §42 Credit	(d) Tax Liability	(e) IRC §42 Credit Applied Against Tax	(f) Carry Forward
2007	\$50,000	\$50,000	\$30,000	\$30,000	\$20,000
2008	\$50,000	\$70,000	\$50,000	\$50,000	\$20,000
2009	\$50,000	\$70,000	\$25,000	\$25,000	\$45,000
2010	<u>\$50,000</u>	\$95,000	\$52,000	<u>\$52,000</u>	\$43,000
Total	\$200,000			\$157,000	

Based on an audit of the partnership's 2011 tax return, there was a recapture event resulting in the total disallowance of the taxpayer's \$50,000 credit for 2011 and the recapture of accelerated credit from each prior year in the amount of \$16,650; i.e., .333 x \$50,000. After reducing the allowable credit in each prior year for the amount of the recaptured accelerated credit, apply taxpayer's remaining credit (\$50,000 - \$16,650 = \$33,350) as if the disallowed accelerated credit had never been allowed.

(a) Credit Period Year	(b) Allowable IRC §42 Credit	(c) Available IRC §42 Credit	(d) Tax Liability	(e) IRC §42 Credit Applied Against Tax	(f) Carry Forward
2007	\$33,350	\$33,350	\$30,000	\$30,000	\$3,350
2008	\$33,350	\$36,700	\$50,000	\$36,700	\$0
2009	\$33,350	\$33,350	\$25,000	\$25,000	\$8,350
2010	<u>\$33,350</u>	\$41,700	\$52,000	<u>\$41,700</u>	\$0
Total	\$133,400			\$133,400	

The entire accelerated credit to be accounted for is \$200,000 - \$133,400 = \$66,600.

To determine the amount of accelerated credit from which the taxpayer received tax benefit, subtract the corrected credit applied from the actual credit applied against tax in each prior year.

2007: \$30,000 - \$30,000 = \$0  
 2008: \$50,000 - \$36,700 = \$13,300  
 2009: \$25,000 - \$25,000 = \$0  
 2010: \$52,000 - \$41,700 = \$10,300

The taxpayer received benefit of \$23,600. The recapture amount is computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2007	April 15, 2008 - April 15, 2012	\$0	\$0	
2008	April 15, 2009 - April 15, 2012	\$13,300	\$3,029.00	\$16,329.00
2009	April 15, 2010 - April 15, 2012	\$0	\$0	
2010	April 15, 2011 - April 15, 2012	\$10,300	\$420.24	10,720.24
Total		\$23,600	\$3,449.24	27,049.24

The recapture interest under IRC §42(j)(2)(B) is computed at the overpayment rate established under IRC §6621 on the recaptured credit for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved. The interest rate is the federal short-term rate determined under subsection (b) plus 3 percentage points (2 percentage points in the case of a corporation). The flush language following IRC §6621(a)(1) is not applicable because there is no actual overpayment of tax.

The credit carryover must also be adjusted for the accelerated credit the taxpayer has not yet used to reduce its tax liability. The credit carryforward reported on the tax return was \$43,000. As corrected, the carryforward is zero. The adjustment to the credit carryforward is equal to \$43,000.

As a check, the recaptured credit and the disallowed credit carryforward must account for the entire amount of accelerated credit not allowable because of the recapture event. In this case:

$$\$23,600 + \$43,000 = \$66,600 = (.333)(\$50,000) \times 4 \text{ years}$$

The examiner will make three adjustments:

1. The \$50,000 credit for the current year is disallowed.
2. The \$43,000 credit carryforward is disallowed.
3. The recapture amount equaling \$27,049.24, as an addition to tax.

If the taxpayer cannot substantiate the amount of credit used to reduce its tax liability in prior years, then the maximum recapture amount should be assessed, as computed below.

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2007	April 15, 2008 - April 15, 2012	\$16,650	\$4,903.63	\$21,553.63
2008	April 15, 2009 - April 15, 2012	\$16,650	\$3,384.00	\$20,034.00
2009	April 15, 2010 - April 15, 2012	\$16,650	\$1,641.69	\$18,291.69
2010	April 15, 2011 - April 15, 2012	\$16,650	\$679.32	\$17,329.32
Total		\$66,600	\$10,608.64	\$77,208.64

**Large Partnership Rule**

The one exception to the tax benefit rule is the computation of the recapture amount when the partnership owning the IRC §42 project has 35 or more partners. Under IRC §42(j)(5), the partnership will be treated as the taxpayer for which the credit is allowable unless the partnership elects not to have the rule apply. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10b and is irrevocable.

If the taxpayer is a partner in a partnership subject to this rule, then the recapture amount is assessed against the partnership. The payment of the taxpayer's recapture amount by the partnership is income to the taxpayer and added to the taxpayer's capital account.

**No Credit Against Recapture Amount**

Under IRC §42(j)(4)(D), the recapture amount is treated as an "increase" in or "addition" to tax. The recapture amount is not a "tax" against which any credit under Title 26, Subtitled A, Chapter 1, can be applied.

**Disposition of Interest in Partnership Owning IRC §42 Project**

In the event a partner disposes of its partnership interest in a partnership owning an IRC §42 project, the taxpayer is not necessarily subject to recapture.

**Dispositions After July 30, 2008**

IRC §42(j)(6)(A), as amended by the Housing Assistance Tax Act of 2008, provides that the credit recapture provisions are not applicable solely by reason of the disposition of an interest in a qualified low-income building if it is reasonably expected that the building will continue to be operated as a qualified low-income

building for the remainder of the building's 15-year compliance period.

Instead, the taxpayer disposing of its interest in a low-income building remains subject to the credit recapture provisions should there be any reduction in the building's qualified basis resulting in the recapture of credit for the year of the disposition or any subsequent taxable year.

In addition, the taxpayer disposing of the low-income building (or interest therein) is required to notify the Secretary (IRS) if there is any reduction in qualified basis resulting in the application of the IRC §42(j) credit recapture provisions. The statutory period for the assessment of the credit recapture amount does not expire before the expiration of three years from the date the taxpayer notifies the IRS and such credit recapture amount may be assessed notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment. Rev. Proc. 2012-27 provides guidance for notifying the IRS.

**Dispositions  
Before  
July 31, 2008**

If a taxpayer disposed its interest in a low-income building before the 2008 amendment, credit recapture could be avoided if two conditions were met:

1. Under former IRC §42(j)(6)(B), the taxpayer reasonably expected that the building would continue to be operated as a qualified low-income building for the remainder of the 15-year compliance period, and
2. Under former IRC §42(j)(6)(A), the taxpayer furnished the IRS with a surety bond in an amount satisfactory to the Secretary and for the period required by the Secretary.

Bonds were posted with the IRS using Form 8693, Low-Income Housing Credit Disposition Bond, according to instructions provided in Rev. Proc. 90-60. As an alternative, taxpayers were allowed to provide Treasury securities as collateral instead of a bond (see Rev. Proc. 99-11). The bond or collateral remained in effect until 58 months after the end of the 15-year compliance period.

An owner who disposed of its interest in a low-income building on or before July 30, 2008, and timely posted a bond or collateral may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the collateral. Instructions for making the election are included in Rev. Proc. 2008-60.

The IRS can "call a bond" to recapture credit if it subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

**Audit Issues  
and  
Techniques**

1. Did the taxpayer have a reasonable expectation that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.

2. Is the building actually being operated in compliance with IRC §42 requirements? The building's current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation. If not in compliance, then the taxpayer currently owning the IRC §42 project is subject to the IRC §42(j) credit recapture provisions.
  - The audit should be expanded to include the tax returns of the related parties owning the IRC §42 project, or
  - If it is not feasible to expand the audit, an information report should be submitted to the IRC §42 program analyst.

### Example

#### Example 1: Taxpayer Timely Places Bond When Disposing of Partnership Interest

A taxpayer disposed of its interest in a partnership owning an IRC §42 project on December 15, 2007, during the 5<sup>th</sup> year of the credit period. Instead of recapturing a portion of the credit claimed in tax years 2003-2006, the taxpayer posted a \$26,000 bond with the IRS.

The partnership's 2010 return was audited. The examiner determined a decrease in qualified basis, resulting in a \$100,000 maximum recapture amount. The taxpayer's portion, as a flow-through item, was \$23,500.

The IRS may "call" the bond for the entire \$23,500 recapture amount.

### Summary

This chapter addressed possible issues arising at the partner level; i.e., a partner in a partnership owning an IRC §42 project is audited.

1. Taxpayers file Form 8586, Low-Income Housing Credit, with their tax returns to claim the credit. The credit flowing through from the partnership will be reported on either line 4 or line 11, depending on when the low-income buildings were placed in service.
2. The IRC §42 credit is a General Business Credit identified in IRC §38(b)(5). The taxpayer will file Form 3800, General Business Credit, and report the IRC §42 credit in either Part I or Part II, depending on when the low-income buildings were placed in service.
3. Taxpayers claiming the IRC §42 as a flow-through item from a partnership owning an IRC §42 project are subject to the Required Filing Checks as outlined in IRM 4.10.5.4.
4. Under IRC §6222, partners are required to treat partnership items the same way as the partnership treated the items. Under IRC §6231(a)(6), "computational adjustments" can be made to a partner's tax return to properly reflect the treatment of a partnership item for a taxable year. These computational adjustments are commonly referred to as "true-ups." Taxpayers commonly use "year-to-year" true-ups to correct discrepancies in the amount of credit claimed. These true-ups are not an acceptable accounting method and an adjustment to the true-

up is a change in accounting method.

5. The IRC §42 credit is subject to the IRC §38(d) ordering rules.
6. The IRC §42 credit is subject to the rules for carrybacks and carryforwards of unused credit under IRC §39.
7. The IRC §42 credit is subject to the passive activity limitations under IRC §469. Individuals file Form 8582-CR. Personal service corporations and closely held C corporations file Form 8810, Corporate Passive Activity Loss and Credit Limitations.
8. The IRC §42 credit is subject to limitations for purposes of the Alternative Minimum Tax (AMT) under IRC §55, if the building was placed in service before January 1, 2008. The limitation is accounted for on Form 3800, Part I. However, if the low-income building was placed in service after December 31, 2007, then the credit is not subject to the AMT limitation and the credit is accounted for on Form 3800, Part II. To compute the AMT, individuals use Form 6251 and corporations use Form 4626.
9. There are three possible adjustments related to changes in the allowable IRC §42 credit:
  - Current year adjustment,
  - Adjustment to any carryback or carryforward of credit, and
  - Additions to tax for recapture amount.
10. There is a tax benefit rule under IRC §42(j)(4)(A) applied when determining the recapture amount.
11. If the partnership owning the IRC §42 project is a large partnership (35 or more partners), then the partnership is treated as the taxpayer to which the credit is allowable and the tax benefit is not applied when computing the recapture amount at the partnership level. However, the large partnership can elect not to be treated as a large partnership.
12. A partner may dispose of its interest in an IRC §42 project and not be subject to the IRC §42(j) credit recapture provisions if certain requirements are met. The rules differ based on the date of the disposition.



## **Chapter 20**

### **Examination of Income**

**Introduction**      The examination of income is a required issue for all tax returns selected for audit. Even if a partnership owning an IRC §42 project is selected for specific IRC §42 issues, 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.

**Topics**

- IRM 4.10.4.3.3.1, Financial Status Analysis
- Balance Sheet Analysis
- Reconciliation of Schedules M-1 and M-2
- Related Parties
- Taxpayer Interview
- Tour the IRC §42 Project
- Internal Controls
- Reconciling Gross Receipts
- Business Ratio Analysis
- Summary

**Reference**      IRM 4.10.4, Examination of Income

#### **IRM 4.10.4.3.3.1, Financial Status Analysis**

While not required for partnership returns, a Financial Status Analysis (FSA) based on the rental schedule (Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation) included with the return can be helpful. The FSA is 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., are there more deductible expenses than income?
2. If generating a loss, is it a “tax” loss caused by depreciation or another noncash expense?

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 the bills and service debt should be identified. Negative cash flows are not suggestive that the business does not have a profit motive; i.e., under Treas. Reg. §1.42-4, the IRC §183 rules do not apply to qualified low-income buildings for which the IRC §42 credit is allowable.

#### **Balance Sheet Analysis**

Analyzing accounts that have significantly changed and/or activity in an 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 payment on existing debt, and
5. Increased or new debt.

For IRC §42 purposes, consider the postponement of payment on debt and increased debt. Key questions include:

1. If the terms of existing debt are so favorable that the taxpayer can indefinitely postpone payment, then is it bona fide 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?
2. Does the debt represent a developer's fee? If the payment is conditioned upon the on-going compliance of the IRC §42 project, then the fee is a management fee and payments should be expensed.
3. Does the debt support costs included in eligible basis? If debt is not bona fide debt, or is determined to be a current period cost, then the eligible basis will be affected.
4. Is the debt federally sourced? See Chapter 10.

## **Reconciliation of Schedules M-1 and M-2**

Schedule M-1 includes entries that are not part of the taxpayer's double-entry accounting system. Normal account controls do not exist and errors may occur. 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 partners' capital accounts can indicate whether monies have been distributed to a partner and where those funds originated

## **Related Parties**

The partnership return and the partners' tax returns are considered related for audit purposes when the tax returns are for entities over which a partner has control and could possibly manipulate to divert funds or camouflage transactions. Audit techniques include:

1. A review of the partnership agreement. This document will provide information regarding the rights, obligations, and powers of each partner.
2. Because the general partner is frequently the entity that developed the property, review the terms of the development contract and any contracts for on-going management of the project.

3. Identify transactions between the partnership and any individual or group of partners. If loans are made to the partnership from a partner, the source of the funds loaned should be evaluated.

## **Taxpayer Interview**

Specific to the reporting of taxable income, the taxpayer should be asked:

### **Rents**

1. Who collects rents? Who makes deposits? Who reconciles the bank accounts? Who maintains the financial records?
2. Regarding adequate supervision of employees, is there an on-site property manager or other employees?
3. 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 oversight authority. 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.

### **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 providing services in addition to housing?
3. Is the taxpayer receiving any rent subsidies from any federal, state, local, or private source?
4. Is the property being used for a commercial purpose that generates income?

### **Other Sources of Funds**

1. Did the taxpayer receive any federal grants or federal subsidies during the tax year under audit?
2. Have investors made additional contributions?
3. Did the taxpayer receive any loan proceeds during the tax year under audit?

## **Tour the IRC §42 Project**

For purposes of the minimum income probes, touring the IRC §42 project serves three fundamental purposes:

### **Observing Business Practices**

Observing the taxpayer's business practices is particularly important to (1) evaluate the internal controls, (2) observe day-to-day operations, and (3) confirm information provided during the interview with the taxpayer. This is particularly important if a management company is operating the IRC §42 project.

1. Observe the taxpayer's internal controls. How is rent collected, recorded, and deposited?
2. 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?

**Identify Potential Sources of Income**

In addition to the rent collected from households occupying the rental units, consider other sources that are not tenant specific. For example, vending machines in a laundry room or renting space for a radio or cell phone tower on the roof.

**Confirm the Existence of Assets**

Although frequently reviewed and inspected by the state agencies, the IRC §42 housing should be toured to confirm that the project exists and is currently suitable for occupancy.

**Internal Controls**

Internal controls are the taxpayer's policies and procedures used to identify, measure, and safeguard business operations and avoid material misstatements of financial information. As with all taxpayers, the evaluation must include gaining an understanding of the taxpayer's business practices and control features. Based on the results of that evaluation, the depth of the income probe can be established. See Chapter 3.

**Reconciling Gross Receipts**

Reconcile the income per the books and records to the income reported on the tax return. Base the depth of the reconciliation on the reliability of the internal controls:

1. Ask the taxpayer how income was computed and duplicate the taxpayer's steps.
2. Even if the taxpayer uses double-entry books, 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 is included in income.
4. Trace specific transactions. Do the books account for each month that each unit was occupied? For tenants that pay by cash, how is cash handled and how timely is cash deposited?
5. Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income. Test weaknesses to determine whether income was actually diverted.

**Business Ratio Analysis**

The initial reconciliation of income per the books and records to the tax return provides an understanding of how the taxpayer determined gross receipts. The books and records can also be used to evaluate the accuracy and reasonableness of the reported amount of income by analyzing ratios.

**Horizontal Analysis**

The tax return under audit should be compared to the prior and subsequent year tax 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 eligible basis, the impact on the credit needs to be considered. Another example is a significant decrease in gross receipts, which may indicate that a significant number of vacant units are not being made available to the public for rent.

## **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 net profit reported on the tax return.

Identifying a comparable industry standard is difficult, but IRC §42 offers an alternative. Instead of comparing the taxpayer's activities to industry standards, an analysis using the taxpayer's own analysis of anticipated operations can be completed.

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. Anticipated developmental and operational costs of the project (IRC §42(m)(2)(B)(iv)).

The techniques discussed 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.

## **Summary**

1. Although the scope and depth may be limited, the Examination of Income is a required issue for all tax returns selected for audit because of specific IRC §42 issues.
2. The Examination of Income should include:
  - A Financial Status Analysis based on the rental schedule,
  - An analysis of the balance sheet,
  - Reconciliation of Schedules M-1 and M-2,
  - Consideration of related returns,
  - Interviewing the taxpayer,
  - Touring the IRC §42 project,
  - Evaluating internal controls,
  - Reconciling Gross Receipts, and
  - Analysis of business ratios.

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## Appendix A Glossary of Terms

**-A-**

**Accelerated Portion of the Credit:** The excess of the aggregate allowable credit during the 10-year credit period under IRC §42 over the aggregate credit that would have been allowable ratably over the 15-year compliance period. IRC §42(j)(3).

**Additions to Qualified Basis:** Refers to increases in qualified basis after the end of the first year of the credit period because more residential rental units qualify as low-income units. If, as of the close of any table year in the 15-year compliance period (after the first year), the qualified basis of a low-income building exceeds the qualified basis as of the end of the first year of the credit period, then the applicable percentage used to compute the credit for the increase in qualified basis is two-thirds of the applicable percentage which would otherwise be applied. A rule similar to the special rule for the computation of the applicable fraction for the first year of the credit period is also applied. IRC §42(f)(3).

**Annual Report by Taxpayer to the State Agency:** See “Certification to State Agency.”

**Applicable Fraction:** The portion of rental units that are qualified low-income units; determined as the smaller of the unit fraction or square footage fraction. IRC §§42(c) & 42(f). See “Unit Fraction” and “Floor Space Fraction.”

**Applicable Fraction, Special Rule First Year of the Credit Period:** The applicable fraction for the first taxable year of the credit period is the sum of the applicable fractions as of the end of each full month of the first taxable year that the building was placed in service divided by 12. Any credit not allowable for the first year of the credit period because of the special rule is allowable for the first year following the credit period; i.e., year 11 of the 15-year compliance period. IRC §42(f)(2).

**Applicable Percentage:** The percentage that will yield the amount of credit 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. IRC §42(b).

**Area Gross Median Income:** Area median gross income (adjusted for family size) for IRC §42 purposes is consistent with the determination of estimates for median family income under section 8 of the United States Housing Act of 1937 (HUD section 8). Estimates are based on definitions of income that include some items of income that are not included in a taxpayer's gross income for purposes of computing federal income tax liability. Beginning in 2010, to accommodate the IRC §142(d)(2)(e) hold harmless rule when determining the area median gross income, HUD now refers to qualified residential rental projects under IRC §142(d) and qualified low-income housing projects under IRC §42 collectively as “Multi-family Tax Subsidy Projects” (MTSP) provides separate tables with income limits specifically calculated for MTSPs. Notice 1988-80, CCA 201046014, and IRC §42(g)(1).

**Available Unit Rule:** If the income of an existing tenant rises above a specified amount, the next available comparable unit in the building must be rented to an income-qualified tenant. Otherwise, the “over-income” unit ceases to be a low-income unit. IRC §42(g)(2)(D) and Treas. Reg. §1.42-15.

**-B-**

**Binding Commitment:** A commitment by a state agency to allocate a specified credit amount beginning in a specified later year. The commitment must be made no later than the close of the calendar year in which the building is placed in service. IRC §42(h)(1)(C).

**Building:** A discrete edifice or other man-made construction consisting of an independent foundation, outer walls, and roof. A single unit which is not an entire building but is merely a part of a building is not a building or structure...as such, while single townhouses are not buildings if their foundation, outer walls, and roof are not independent, detached houses and row houses are buildings.” Treas. Reg. §1.103-8(b)(8)(iv).

**Building, Existing:** Any building which is not a new building. IRC §42(i)(5).

**Building Identification Number:** A Building Identification Number (BIN) is assigned by the state agency to every building receiving an allocation of IRC §42 credit, or, as described in IRC §42(h)(4), financed with tax-exempt bonds subject to the volume cap under IRC §146. BINs consists of a two character state designation (the postal state abbreviation) followed by a two digit designation identifying the year the credit is allocated, and a five digit numbering designation. The BIN is unique to the building and must be used for all allocations of credit. Notice 1988-91.

**Building, Mixed Use:** A building including (1) low-income and market rate residential rent units, (2) low-income residential rental units and commercial property, or (3) low-income and market-rate residential rental units, and commercial property.

**Building, New:** A building for which original use begins with the taxpayer. IRC §42(i)(4).

**Building, Rehabilitated:** The expenditures associated with rehabilitating an existing building. The expenditures are treated as a new building and do not include the cost of acquiring the building. IRC §42(e)(1) and (2).

**-C-**

**Carry-Over Allocation:** An allocation of credit with respect to a qualified building which is placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made. IRC §42(h)(1)(E) and Treas. Reg. §1.42-6.

**Certificate of Occupancy:** Document providing a description of the property and identifying the date the property is placed in service. In some locations it also describes zoning and the type of units.

**Certification, Annual Report by Taxpayer to the IRS:** Taxpayers file Form 8609-A, Annual Statement for Low-Income Housing Credit, Part I, with their tax returns for each year of the 15-year compliance period. IRC §42(l)(2)

**Certification, First Year:** Taxpayers are required to complete a certification with respect to the first year of the credit period. The certification is made by completing Part II of the Form(s) 8609 executed by the state agency to document the allocation of low-income housing credits. IRC §42(l)(1).

**Certification to State Agency:** The taxpayer is required to certify at least annually to the state agency that the project met specified requirements. Treas. Reg. §1.42-5(c).



**Common Areas:** Property in a residential rental project subject to depreciation and (1) used in common areas or (2) to provide comparable amenities to all the residential rental units in the building(s). IRC §42(d)(4)(B).

**Community Service Facility:** A qualified low-income project located in a qualified census tract, as defined in IRC §42(d)(5)(B)(ii), may include a community service facility designed to service primarily nonresident individuals whose income is 60% or less of the area median income. The facility must be subject to depreciation, the cost includable in eligible basis is limited to a percentage of the total eligible basis, and the facility must be used throughout the year as a community service facility. IRC §42(d)(4)(C).

**Compliance Monitoring:** A procedure used by state agencies to monitor qualified low-income buildings for noncompliance with IRC §42 requirements and reporting noncompliance to the IRS. IRC §42(m)(1)(B)(iii) and Treas. Reg. §1.42-5.

**Compliance Period:** To qualify for the credit, the taxpayer must provide low-income housing for fifteen years, which is known as the compliance period, beginning with the first taxable year of the credit period with respect to the building. IRC §42(i)(1).

**Credit Ceiling:** See Housing Credit Ceiling.

**Credit Period:** In exchange for the investment in low-income housing, the taxpayer will receive tax credits for each of ten years, which is known as the credit period. The credit period begins with the taxable year in which the building is placed in service or, at the election of the taxpayer (which is irrevocable), the succeeding taxable year, but only if the building is a qualified low-income building as of the close of the first year of such period. IRC §42(f)(1).

**Credit Recapture Amount:** See “Recapture Amount.”

#### **-D-**

**Depreciation:** A reasonable allowance for the exhaustion, wear and tear (including obsolescence) of property used in the trade of business of a taxpayer, or of property held for the production of income. IRC §§ 167, 168, and 179(d)(9).

**Difficult to Develop Area:** A subset of “high cost area.” Any area designated by HUD as having high construction, land and utility costs relative to area median gross income. IRC §42(d)(5)(B)(iii)(I). Also, buildings designated by state agencies can be treated as located in a difficult to develop area as long as the building is not financed with tax-exempt bonds. IRC §42(d)(5)(B)(v).

**Disproportionate Standards of Units:** Generally, a low-income building’s eligible basis is reduced by the portion attributed to residential rental units in the building that (1) are not low-income units and (2) are above the average quality standard of the low-income units. However, this reduction of eligible basis can be avoided under certain circumstance. IRC §42(d)(3).

#### **-E-**

**Extended Low-Income Housing Commitment (“Extended Use Agreement”):** No credit is allowable for a taxable year unless the agreement is in effect as of the last day of such taxable year. The agreement is a contract entered into by the taxpayer (and binding on all subsequent owners) and the state agency, recorded in the land records, and enforceable under state law. The agreement must meet certain

requirements under IRC §4(h)(6). The agreement is also commonly referred to an “extended use agreement” or “land use restriction agreement.” IRC §42(h)(6).

**Extended Use Period:** The period of time that an extended low-income housing commitment is in effect, beginning on the first day in the compliance period and ending on the later of the date specified by the state agency in the commitment or the date which is 15 years after the close of the compliance period. There are exceptions if the building is acquired by foreclosure (or instrument in lieu of foreclosure) or if no buyer is willing to maintain the low-income status. Both exceptions are subject to certain restrictions. IRC §42(h)(6)(D) and (E).

**Eligible Basis:** The total costs (adjusted basis) associated with the depreciable residential rental property qualifying for the credit at the end of the first year of the credit period and without regard to any deduction for depreciation. If the building is located in a high cost area, the eligible basis may be increased to as much as 130% of the actual costs. IRC §§42(d) and 42(e).

**Eviction:** The act or process of legally dispossessing a person of land or rental property. A taxpayer owning an IRC §42 project and wishing to evict a tenant must comply with applicable state and/or local laws governing evictions. See also, Good Cause eviction and Lease, Nonrenewal. IRC §42(h)(6)(B)(i) and Rev. Rul. 2004-82, Q&A #5.

#### **-F-**

**Facility, Functionally Related:** Facilities that are functionally related, and subordinate to, residential rental projects; e.g., swimming pools, parking lots and other facilities reasonably required for the project such as a resident manager’s unit. Treas. Reg. §1.103-8(b)(4)(iii).

**Federally Subsidized:** A new building is treated as federally subsidized under IRC §42(b)(1) if, at any time during the taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under IRC §103, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof. IRC §42(i)(2). For new buildings placed in service before July 31, 2008, a “federally subsidized” building includes any below market Federal loan; i.e., any loan funded in whole or in part with federal funds if the interest rate payable on such loan is less than the applicable federal rate as of the date on which the loan was made. IRC §42(i)(2) prior to amendment by the Housing Assistance Tax Act of 2008.

**Final Cost Certification:** To ensure that the credit allocated to a project does not exceed the amount necessary to assure its feasibility and long-term viability, the state agency must evaluate the taxpayer’s sources and uses of funds and the total financing planned for the project, the proceeds (capital contributions) expected to be generated by the tax benefits, the percentage of the housing credit dollar amount used for project costs other than the cost of intermediaries, and the reasonableness of the developmental and operational costs of the project. The evaluation is completed when the taxpayer applies for the credit, when the credit is allocated (usually a credit carryforward allocation) and again when the project is placed in service. This last evaluation is commonly referred to as the Final Cost Certification and is based on actual costs incurred through the end of the first year of the credit period. IRC §42(m)(2) and Treas. Reg. §1.42-17(a)(5).

**First Year Certification:** See “Certification, First Year.”

**Floor Space Fraction:** Method for computing the applicable fraction; i.e., the fraction for which the numerator 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 such building. IRC §42(c)(1)(D). See “Applicable Fraction.”

**Form 8610, Annual Low-Income Housing Credit Agencies Report:** Annual report by each state agency to (1) transmit Forms 8609 issued during the year, reconcile the state’s credit ceiling, and report completion of compliance monitoring requirements. IRC §42(l)(3)

**Forms 8609, Low-Income Housing Credit Allocation and Certification:** Part I is completed by state agencies to document the allocation of credit for a qualified low-income building. A copy is sent to the IRS with the state agency’s annual report on Form 8610 and the original is sent to the building owner. The owner completes Part II of the form received from the state agency (with Part I executed) to document certain information and elections, and then makes a one-time filing to the IRS to complete the certification for the first year of the credit period. IRC §42(l)(1).

**Form 8609-A, Annual Statement for Low-Income Housing Credit:** Filed each year of the 15-year compliance period with the tax return for the taxpayer owning a low-income building. Part I satisfies the annual reporting requirement under IRC §42(l)(2) and Part II documents the computation of the allowable credit for the year. A separate Form 8609-A is filed for each allocation of credit; i.e., there is a one-to-one match of Forms 8609 issued by the state agency and Forms 8609-A filed by the taxpayer. IRC §42(l)(2).

**Form 8610, Schedule A, Carryover Allocation of Low-Income Housing Credit:** Documents the amount of credit allocated if the building(s) will be placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made, or if the credit allocation is made on a project basis. IRC §42(h)(1)(E) and (F).

**Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition:** Submitted to the IRS by state agency to report noncompliance with IRC §42 requirements or dispositions of property (or interests therein). Treas. Reg. §1.42-5(e)(3).

## **-G-**

**General Public Use:** Rental units must be available for use by the general public, which includes rental in a manner consistent with fair housing policy governing nondiscrimination. A determination that a taxpayer violated fair housing policy governing nondiscrimination may result in the loss of credit. IRC §42(g)(9) and Treas. Reg. §1.42-9.

**Good Cause Eviction:** Determined by state or local law. Examples may include nonpayment of rent, violations of the lease or rental agreement, destruction or damage to the property, interference with other tenants or creating a nuisance, or using the property for an unlawful purpose. See “Eviction.”

**Grant, Federal:** A low-income building’s eligible basis cannot include any costs financed with the proceeds of a federally funded grant. IRC §42(d)(5)(A).

**Gross Rent:** The rent charged before required adjustments. IRC §42(g)(2)(B).

## **-H-**

**High Cost Area:** For any new building located in a qualified census tract or difficult to developer area, the eligible basis can be increased by up to 130% of the eligible basis otherwise determined. The same holds true for rehabilitation expenses treated as a new building under IRC §42(e). IRC §42(d)(5)(B).

**Household, Low-Income:** A household whose combined income is less than or equal to the percentage of area median gross income elected by the taxpayer for purposes of the minimum set-aside requirement. A household is composed of all the occupants of a residential rental unit unless specifically excluded, whether or not legally related. A household's income is compared to the appropriate percentage of the median family income for a family with the same number of members. Rev. Rul. 90-89 and IRC §42(g)(1).

**Household, Student:** A household composed entirely of full-time students is not considered a qualified low-income household unless the household is "excepted" by satisfying certain conditions. IRC §42(i)(3)(D).

**Housing Credit Agency:** Any state (or local) agency authorized to carry out IRC §42. "State" includes possessions of the United States. IRC §42(h)(8).

**Housing Credit Ceiling:** The IRC §42 credit available to a state for allocation by its housing agencies to qualified low-income buildings within the state. IRC §42(h)(3). Buildings financed by tax-exempt bonds are eligible for IRC §42 credit under specified conditions, but are not allocations that reduce the housing credit ceiling. IRC §42(h)(4).

**-I-**

**Imputed Income Limit:** For purposes of restricting the rents under IRC §42(g)(2), an imputed income limitation is used. It is based on the number of bedrooms in the unit and uses the income limit that would apply if each separate bedroom was occupied by 1.5 individuals. For a unit that does not have a separate bedroom, one person is deemed to occupy the unit. IRC §42(g)(2)(C).

**Income-Qualified Household:** See Household, Low Income

**Inspections by State Agency:** Tenant records and the project are subject to physical inspection by the state agency. Treas. Reg. §1.42-5(c)(2).

**-J-**

**-K-**

**-L-**

**Lease, Nonrenewal:** A taxpayer is not obligated to renew a lease or enter into a new lease with an existing low-income tenant, and failure to do so does not, per se, constitute an eviction without good cause. However, the taxpayer must provide timely notice that the lease will not be renewed as required under state law and be prepared to demonstrate, if challenged in state court, that the nonrenewal of a lease is not a "termination of tenancy" for other than good cause under IRC §42.

**Low-Income Household:** See "Household, Low Income."

**Low-Income Housing Project:** See "Project."

**Low-Income Unit:** Any unit in the building if the unit is rent-restricted, the individuals occupying the unit meet the income limitation applicable under IRC §42(g)(1), the unit is suitable for occupancy, and the unit is not used on a transient basis. IRC §42(i)(3).

**-M-**

**Market Study:** A comprehensive market study of the housing needs of low-income individuals in the area to be served by a proposed IRC §42 project is conducted before the credit allocation. Generally, the developer pays for the study, which is completed by a disinterested party approved by the state agency. IRC §42(m)(1)(A)(iii).

**Material Participation of Qualified Nonprofit Organizations:** If the taxpayer received a credit allocation from the nonprofit set-aside, then the qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period. IRC 469(h) defines material participation as activity that is regular, continuous, and substantial. IRC §42(h)(5)(B). See “Nonprofit Set-Aside.”

**Maximum Qualified Basis:** Credit allocated to buildings is not to exceed the amount necessary to ensure financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. The state agency can limit the credit by specifying a “maximum qualified basis” less than the qualified basis that would otherwise be allowable on Form 8609 line 3a. Alternatively, the state agency can lower the applicable percentage, which is reflected on Form 8609 line 2. IRC §42(m)(2)(A).

**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)

**Mixed-Use Project:** See Project, Mixed Use

**Multifamily Tax Subsidy Projects (MTSP):** HUD’s designation for qualified residential rental projects under IRC §142(d) and qualified low-income housing projects under IRC §42 collectively. See also “Area Median Gross Income.”

**-N-**

**National Pool:** A state’s unused housing credit carryover for any calendar year that is assigned to the IRS for reallocation among qualified states for the succeeding year. IRC §42(h)(3)(D) and Treas. Reg. §1.42-14(h)(2)(i).

**Next Available Unit Rule:** See Available Unit Rule.

**Nonprofit Set-Aside:** The portion of the state’s housing credit ceiling set aside for projects involving qualified nonprofit organizations so that not more than 90 percent of the state’s credit ceiling is allocated to projects not involving qualified nonprofit organizations. IRC §42(h)(5).

**-O-**

**Owner Certification:** See “Certification to State Agency.”

**-P-**

**Placed-in-Service Date:** The placed-in-service date for a new or existing low-income building is the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. Generally, this date is documented on the certificates of occupancy. The placed-in-service date for rehabilitation expenditures treated as a separate new building under IRC §42(e)(4)(A) is at the

close of any 24-month period, over which such expenditures are aggregated. This placed-in-service date applies even if the building is occupied during the rehabilitation period. Notice 88-116.

**Project:** Each qualified low-income building is considered a separate project unless a taxpayer elects to treat the building as part of a multi-building project. The election is documented on Form 8609, Line 8b, with an attachment identifying all the buildings to be included in the project. Two or more qualified low-income buildings can be included in a project only if the buildings are: (1) located on the same tract of land, unless all of the dwelling units in all the buildings are low-income units (see IRC §42(g)(7)), (2) are owned by the entity for federal tax purposes, (3) are financed under a common plan of financing, and (4) have similarly constructed housing units. IRC §42(g)(3)(D) and Treas. Reg. §1.103-8(b)(4)(ii).

**Project Based Allocation:** An allocation of credit to a project without specifying the amount of credit allocated to specific qualified buildings within the project. IRC §42(h)(1)(F).

**Project, Deep Rent Skewed:** A low-income project financed with tax-exempt bonds and for which the taxpayer has elected (1) 15% or more of the low-income units are occupied by individuals whose income is 40% or less of area median gross income, (2) the gross rent for each low-income unit does not exceed 30% of the applicable income limit, and (3) the gross rent for each low-income unit does not exceed one half of the average gross rent of units of comparable size which are not occupied by individuals who meet the applicable income limit. IRC §142(d)(4)(B).

**Project, Mixed Use:** A project composed of (1) low-income and market rate residential rent units, (2) low-income residential rental units and commercial property, or (3) low-income and market-rate residential rental units, and commercial property.

**Project, Scattered Site:** Buildings which would, but for their lack of proximity, be treated as a project shall be treated as a project if all the dwelling units in all the buildings are rent-restricted residential rental units. IRC §42(g)(7).

#### **-Q-**

**Qualified Allocation Plan (QAP):** State agencies are required to have a QAP in place for determining which housing projects should receive allocations of IRC §42 credits. The QAP must (1) identify the selection criteria to be used for determining housing priorities that are appropriate to local conditions, (2) give preference to projects serving the lowest income tenants, for the longest periods, and located in qualified census tracts and which will contribute to a concerted community revitalization plan, and (3) provide procedures that the agency or an agent or other private contractor of such agency) will follow in monitoring for noncompliance with IRC §42 through regular site visits and in notifying the IRS of such noncompliance. IRC §42(m)(1)(B) and Treas. Reg. §1.42-5.

**Qualified Basis:** The qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction (determined at the end of such taxable year) of the eligible basis of such building. IRC §42(c)(1).

**Qualified Basis, Increases in:** See “Additions to Qualified Basis.”

**Qualified Census Tract:** A subset of “high cost area.” Any census tract designated by HUD and, for the most recent year for which census data are available on household income in such tract, for which either (1) 50% or more of the households have an income which is less than 60% of the area median gross income for such year or (2) has a poverty rate of at least 25%. IRC §42(d)(5)(B)(ii)(I). See “High Cost Area.”

**Qualified Contract:** A bona fide contract to acquire (within a reasonable period after the contract is entered into) the building(s), both the non low-income and low-income portions, after the end of the 15-year compliance period of the building(s) for an agreed upon purchase priced that meets prescribed requirements. IRC §42(h)(6)(F) and Treas. Reg. §1.42-18.

**Qualified Low-Income Building:** Any building which is part of a qualified low-income housing project at all times during the period beginning on the first day in the 15-year compliance period of which such building is part of the project and ending on the last day of the 15-year compliance period with respect to such building and the building is subject to depreciation under IRC §168. IRC §42(c)(2).

**Qualified Nonprofit Organization:** Any tax exempt organization qualified to receive a credit allocation from the nonprofit set-aside. IRC §42(h)(5)(C).

**Qualified Low-Income Project:** Any project for residential rental property if, as irrevocably elected by the taxpayer, (1) 20% or more of the residential rental units in the project are both rent restricted and occupied by individuals whose income is 50% or less of area median gross income, or (2) 40% or more of the residential rental units in the project are both rent restricted and occupied by individuals whose income is 60% or less of areas median gross income. See “Minimum Set-Aside.” IRC §42(g)(1).

## **-R-**

**Recapture Amount:** The portion of the accelerated credit recaptured from each prior year of the 15-year compliance period plus interest at the overpayment rate (IRC 6621) on the recaptured accelerated credit. The interest portion of the recapture amount is computed for each prior year beginning on the due date for filing such tax return to the due date for filing the tax return for the year in which the recapture provisions were triggered. IRC §42(j)(2).

**Recapture Percentage:** The portion of credit allowable in prior years of the 15-year compliance period subject to recapture if the recapture provisions are triggered. The recapture percentage is 33.3% for years 2 through 11, 26.7% for year 12, 20.0% for year 13, 13.3% for year 14, and 6.7% for year 15. IRC §42(j)(2)(A) and General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99<sup>th</sup> Congress; Public Law 99-514.

**Records, Keeping and Retention:** Taxpayers are subject to recordkeeping and record retention provisions specific to IRC §42. 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. The records for the first year of the credit period must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building. Treas. Reg. §1.42-5(b) and Rev. Rul. 2004-82, Q&A #6. See Appendix E.

**Rehabilitation Expenses:** Amounts chargeable to capital account and incurred for property (or additions or improvements to property) of a character subject to depreciation in connection with the rehabilitation of a building. IRC §42(e)(2).

**Rent Restricted:** The rent paid by low-income households must be restricted; i.e., the rent cannot exceed 30 percent of the imputed income limit for that unit. IRC §42(g)(2).

**Resident Manager's Unit:** Residential rental unit occupied by a full-time resident manager and treated as a functionally related facility. The adjustment basis of a resident manager's unit is included in eligible basis, but the unit is excluded from the determination of the applicable fraction and the minimum set-aside. Treas. Reg. §1.103-8(b)(4)(iii) and Rev. Rul. 92-61.

**Residential Rental Property:** Generally, a residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly constructed units. IRC §168(e)(2)(A) and Treas. Reg. §1.103-8(b)(4)(i).

**Residential Rental Unit:** 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. Certain single-room occupancy units also qualify as residential rental units even though such housing may provide eating, cooking and sanitation facilities on a shared basis. Treas. Reg. §1.103-8(b)(4)(i) and IRC §42(i)(3)(B)(iv).

## **-S-**

**Single Room Occupancy Unit (SRO):** Residential rental units providing eating, cooking and sanitation facilities on a shared basis. SROs can qualify as low-income units. Treas. Reg. §1.103-8(b)(8)(i) and IRC §42(i)(3)(B)(iv).

**State Housing Credit Agency:** See “Housing Credit Agency.”

**Suitable for Occupancy:** 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. IRC § 42(i)(3)(B), Treas. Reg. §1.42-5(d)(2), Instructions for Form 8823, and CCA 201042025.

## **-T-**

**Tax Benefit Rule:** The increase in tax under IRC §42(j)(1) for the credit recapture amount is increased only with respect to credits under IRC §42 which were used to reduce tax liability. Otherwise, the carry-forwards and carrybacks are appropriately adjusted. IRC §42(j)(4)(A).

**Tax-Exempt Bond Project:** A low-income housing project financed with loans financed through private activity bonds issued under IRC §146, and for which interest earned by the lender is exempt from federal taxation. IRC §142(d).

**Termination of Tenancy:** See “Eviction.”

**Transitional Housing for the Homeless:** A unit is considered to be used other than on a transient basis if the unit contains sleeping accommodations and kitchen and bathroom facilities and is located in a building which is used exclusively to facilitate the transition of homeless individuals to independent living within 24 months, and in which a government entity or qualified nonprofit organization provides individuals with temporary housing and supportive services. IRC §§ 42(i)(3)(B)(iii) and 42(c)(1)(E).

## **-U-**

**Unit Fraction:** Method for computing the applicable fraction; i.e., the fraction for which the numerator 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. IRC §42(c)(1)(C).

**Unit, Low-Income:** See “Low-Income Unit.”

**Unit, Market Rate:** A residential rent unit for which the rent is not restricted.



**Utility Allowance:** A portion of the gross rent. If the tenant pays the utility cost directly to the utility provider, gross rent must include an allowance for the utility. IRC §42(g)(2)(B)(ii) and Treas. Reg. §1.42-10.

**-V-**

**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. Treas. Reg. §1.42-5(c)(1)(ix).

**-W-**

**-X-**

**-Y-**

**-Z-**

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## **Exhibit B References**

### **Audit Technique Guides**

Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition - Training 23092-001 (Rev. 01-2011)

### **Chief Counsel Advisories**

CCA 200134006. Treatment of Casualty Losses Under IRC §42(j)(4)(E). Chief Counsel addressed three points: (1) the meaning of "casualty loss" under IRC §42(j)(4)(E) should be consistent with generally accepted tax principles under IRC §165, (2) state housing credit agencies must, as required by Treas. Reg. §1.42-5(e)(3), report to the Service via Form 8823 any casualty loss that takes low-income property in whole or in part out of service and results in a reduction in qualified basis, and (3) there is no support for allowing property owners to continue to claim credits on units while the units are not in service because of a casualty event.

CCA 200137044. Clarifications of IRC §42(l)(1), Certification With Respect to 1st Year of Credit Period. Chief Counsel responded to five questions: (1) When is a building placed in service and how can this be documented? (2) Once a Form 8609 is first issued by an applicable allocating authority, can the taxpayer file an amended return to claim credits for taxable years in a building's compliance period prior to the issuance of the Form 8609? (3) If a taxpayer has claimed IRC §42 credits for any year prior to the issuance of the Form 8609, can all credits claimed prior to the issuance of the Form 8609 be disallowed? (4) Can a taxpayer satisfy the certification requirements of IRC §42(l) during the examination process? (5) If a revenue agent finds that the first year certification requirements of IRC §42(l)(1) have not been met, can the entire credit amount for the first and all successive years be disallowed?

CCA 200812023. Allocation of IRC §42 Tax Credits. The IRC §42 credit must be allocated among a partnership's partners in the same proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year.

CCA 200913012. Chief Counsel Advice regarding three casualty loss issues under IRC §42(j)(4)(E). (1) IRC §42(j)(4)(E) only provides recapture relief for casualty events; it does not provide the allowance of credits during the period of time that the building is being restored. (2) Regarding the relief provided in Rev. Proc. 95-28 and Rev. Proc. 2007-54, if the statute of limitations is closed, whether for the casualty event or credits claimed during the restoration period, and the taxpayer fails to restore the building, then the taxpayer's first open taxable year in the compliance period should be treated as the year of the taxpayer's reduction in qualified basis. (3) If a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, or initiated continual and verifiable measures to rent restored vacant units to low-income tenants, then there is no recapture and no loss of credits.

CCA201042025. Suitability for Occupancy. (1) The suitable for occupancy requirement under IRC §42(i)(3)(B) does not have to be determined on a unit-by-unit basis if the facts exist that the condition of the exterior components of the building (e.g., wall, roof, etc.) are so poor as to lead to a factual determination that all the units in a building are not suitable for occupancy. (2) A violation of the HUD physical condition standard alone is sufficient for a violation of §42(i)(3)(B). However, a taxpayer, in response to the IRS finding a violation, may raise an affirmative defense by proving that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result where as the HUD standard does not reach a taxpayer favorable result.

CCA 201046014. Income Limits. Chief Counsel confirmed that the published 50% and 60% income limitations for the HUD section 8 program should be used to determine whether households are qualifying low-income households. IRC §142(d)(2)(B)(i), through IRC §42(g)(4), controls income limits for IRC §42(g)(1) purposes and the Secretary of Treasury (not the Secretary of HUD) that makes the determination of what income limitations control for IRC §42 purposes in a manner consistent with determinations of lower income limits under HUD section 8.

CCA 201106008. Treatment of TCAP Funds. Chief Counsel concluded that the TCAP grants are includible in a recipient's gross income for federal income tax purposes.

CCA 201136023. Application of Recapture Provisions of IRC §42(j)(1), considering *Bentley Court II Limited Partnership v. Commissioner*, T.C. Memo 2006-113 (Bentley). The recapture provisions of IRC §42(j)(1) apply if the Service's adjustment of a building's eligible basis under IRC §42(d) as a result of an audit of a taxable year subsequent to a closed taxable year results in a decrease in the qualified basis used to compute the credit. The Service may rely on the qualified basis as reported in a closed taxable year when applying the recapture provisions of IRC §42(j)(1). The Service may also recalculate the qualified basis in a closed taxable year in appropriate circumstances.

CCA 201146016. Foreclosure and Recapture. The termination of a building's extended use period under IRC §42(h)(6)(E)(i)(I) upon foreclosure (or instrument in lieu of foreclosure) does not result in automatic recapture of credits under IRC §42(j).

CCA 201352009. The failure to comply with the requirement of IRC §42(h)(5)(B) to maintain the involvement of a qualified nonprofit organization in the development and operation of the project (as of the close of a taxable year) is the disallowance of the credit for that taxable year. However, noncompliance with IRC §42(h)(5)(B) does not, in and of itself, result in an actual (or an imputed) decrease in the qualified basis of a building that results in recapture under IRC §42(j)(1). The taxpayer may claim the credit for the taxable year that the violation is corrected (assuming the taxpayer is otherwise eligible to claim credit for that taxable year).

Chief Counsel Advice dated June 2, 2014 (POSTN-111812-14). Charging resident managers, maintenance personnel, or security officers rents, utilities, or both for units in a qualified low-income building does not make the units residential rental units and not facilities reasonably required for the project under Treas. Reg. §1.103-8(b)(4)(iii). Whether or not the owner of the project charges rents, utilities, or both for the units are not relevant for treating the units as facilities that are reasonably required for the project. In other words, charging rents, utilities, or both for units occupied by resident managers, maintenance personnel, or security officers in a qualified low-income building does not make such units residential rental units for purposes of the applicable fraction. The character and size of the project are, among other things, relevant in determining whether any property, including an employee-occupied unit, is functionally related and subordinate to the project, as indicated by Treas. Reg. §1.103-8(a)(3).

## **Court Cases**

Bentley - *Bentley Court II*, T.C. Memo 2006-113. See Appendix H.

Boyle – *United States v. Boyle, Executor of the Estate of Boyle*, 469 U.S. 241. See Appendix F.

Carp & Zuckerman – *Richard E. Carp and Minda G. Carp, and Franklin D. and Lois Zuckerman, Petitioners v. Commissioner of Internal Revenue, Respondent*, T.C. Memo 1991-436. See Appendix I.

Corbin West – *Corbin West Limited Partnership, CDC Equity Corporation, Tax Matter Partner, Petitioner v. Commissioner of Internal Revenue, Respondent*, T.C. Memo 1999-7. See Appendix G.

Eastwood Mall – *Eastwood Mall, Inc. v. U.S.*, 95-1 USTC Paragraph 50,236 (N.D. Ohio 1995), aff'd by unpublished disposition, 59 F.3d 170 (Table) (6th Cir. 1995), the issue was whether the taxpayer, a developer, could depreciate the cost of reshaping land as part of the cost of a building. The court stated that costs for land preparation may or may not be depreciable depending on whether the costs incurred are inextricably associated with the land (nondepreciable) or with the buildings constructed thereon (depreciable). It further asserted that the key test for determining whether land preparation costs are associated with nondepreciable land or the depreciable building thereon is whether these costs will be reincurring if the building were replaced or rebuilt. Land preparation costs for improvements that will continue to be useful when the existing building is replaced or rebuilt are considered inextricably associated with the land and, therefore, are to be added to the taxpayer's cost basis in the land and are not depreciable. On the other hand, land preparation costs for improvements that are so closely associated with a particular building that they necessarily will be retired, abandoned, or replaced contemporaneously with the building are considered associated with the building and, therefore, are added to the taxpayer's cost basis in the building and are depreciable. See *Southern Natural Gas Co. v. United States* [69-2 ustr ¶ 9473], 412 F.2d 1222, 1231 (Ct.Cl.1969); Rev. Rul. 74-265, 1974-1 C.B. 56; see also, *A. Duda & Sons, Inc. v. United States* [77-2 ustr ¶ 9678], 560 F.2d 669, 679 & n. 15 (5th Cir.1977); *Rudolph Investment Corp. v. Commissioner* [CCH Dec. 31,421(M) ], 31 T.C.M. (CCH) 573, 578 (1972); 1 *B. Bittker & L. Lokken*, *Federal Taxation of Income, Estates and Gifts*, ¶ 23.2.5 at 23-34 (2d ed. 1989).

Housing Pioneers – *Housing Pioneers, Inc. v. Commissioner*, 58 F.3d 401 (9<sup>th</sup> Cir. 1995). See Appendix J.

Von-Lusk – *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995). The Court held that certain expenses incurred by a real estate developer before actual physical work began on undeveloped land are subject to IRC §263A. The Court found that the developer's activities, such as obtaining building permits and zoning variances, negotiating permit fees, and similar activities, represent the “first steps of the development of the property.” The Court noted that the pursuit of building permits and zoning variances, negotiating permit fees, and similar activities “are ancillary to actual physical work on the land and are as much a part of a development project as digging a foundation or completing a structure's frame. The project cannot move forward if these steps are not taken.”

### **Field Service Advisories**

FSA 200125014 – Chief Counsel advised that IRC §6222(a) provides that a partner shall, on the partner's return, treat a partnership item in a manner which is consistent with the treatment of the partnership item on the partnership return. Under IRC §6222(c), if a partnership item is treated inconsistently on the partner's return, the IRS may assess any resulting deficiency without regard to the restriction on an assessment attributable to a partnership item under IRC §6225. A “true-up” under IRC §6222(a) is a type of computational adjustment. Because the provisions of IRC §6225 and 6211 do not apply, a true-up may be immediately assessed by the IRS.

### **Law and Legislative History**

- Tax Reform Act of 1986 (P.L. 990154, 100 Stat. 100). Included enactment of IRC §42
- General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99<sup>th</sup> Congress; Public Law 99-514. Commonly referred to as the “Blue Book,” this document provides an in-depth discussion of the original implementation of IRC §42.

## Notices

Notice 88-80; 1988-30 I.R.B. 28. Determination of Income for Purposes of IRC §42(g)(1). Income of individuals and area median gross income are made in a manner consistent with the determination of annual income and the estimates for median family income under section 8 of the United States Housing Act of 1937 (HUD section 8) and are not made by reference to items of income used in determining gross income for purposes of computing Federal income tax liabilities.

Notice 88-91; 1988-2 C.B. 414; 1988-36 I.R.B. 28. Additional Certification Requirements. Low-income buildings that have or will be allocated a low-income housing tax credit under IRC §42 must be assigned a building identification number (BIN) consisting of a two character state designation (identical to a postal state abbreviation) followed by a two digit designation representing the year the credit is allocated, and a five digit numbering designation.

Notice 88-116; 1988-2 C.B. 449; 1988-44 I.R.B. 22. Carryover of 1989 Credits for Certain Projects in Progress, Description of Construction, Reconstruction or Rehabilitation, Placed in Service. Notice discusses (1) what costs will be considered construction, reconstruction, or rehabilitation costs; (2) when such costs will be considered to be incurred, and (3) when a building will be considered to be placed in service for IRC §42 purposes.

Notice 94-47; 1994-1 C.B. 25. Debt/Equity Issues in Recent Financing Transactions. Upon examination, the Service will scrutinize instruments designed to be treated as debt for federal income tax purposes but as equity for regulatory, rating agency, or financial accounting purposes to determine if their purported status as debt for federal income tax purposes is appropriate. Of particular interest to the Service are instruments that contain a variety of equity features, including an unreasonably long maturity or an ability to repay the instrument's principal with the issuer's stock. Analysis of these instruments must take into account the cumulative effect of these features and other equity features.

Notice 2008-79; 2008 I.R.B. 726. Tax-Exempt Housing Bonds and 2008 Housing Legislation. Section 6 of the Notice provides list of military basis affected by §3005 of the 2008 Housing Act, which amends IRC §142(d)(2) to disregard basic housing allowance payments to military members at certain military basis for purposes of determining whether a household is income-qualified under IRC §§ 42 and 142.

Notice 2008-106; 2008-2 C.B. 1239; 2008-49 I.R.B. 1239. Applicable Percentage under Section 3002(A)(1) of the Housing Assistance Tax Act of 2008. 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, enacted pursuant to section 3002 of the Housing Assistance Tax Act of 2008, applies notwithstanding an irrevocable election by the taxpayer under former IRC §42(b)(2)(A)(ii) (now IRC §42(b)(1)(A)(ii), as amended by the Act) made on or before July 30, 2008.

Notice 2009-44; 2009-21 I.R.B. 1037. Low-Income Housing Credit. Clarifies that, under Treas. Reg. §1.42-10, the utility allowance regulations, utility costs paid by a tenant based on actual consumption in a sub-metered rent-restricted unit are treated as paid directly by the tenant for purposes of IRC §42(g)(2)(B)(ii).

Notice 2010-18; 2010-14 I.R.B. 525. American Recovery and Reinvestment Tax Act of 2009 Clarifications. Among the topics, the Notice clarifies that subawards of grants under §1602(c) of the American Recovery and Reinvestment Tax Act of 2009 are excluded from the gross income of recipients and are exempt from taxation. Neither the depreciable basis nor eligible basis of a qualified building is reduced by any §1602 grant.

Notice 2010-62; 2010-40 I.R.B. 411. Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions of the Health Care and Education Reconciliation Act of 2010. Provides interim guidance regarding the economic substance doctrine under IRC §7701(o) and the related amendments to the penalties under IRC §§ 6662, 6662A, 6664, and 6676 by §1409 of the Health Care and Education Reconciliation Act of 2010 (Act), Pub. L. No. 111-152. The notice applies with respect to transactions entered into on or after March 31, 2010, which is the effective date for the amendments made by section 1409 of the Act.

### **Private Letter Rulings**

PLR 200703024. As part of the ruling, it was concluded that the right of first refusal granted to tenants as part of a condominium home ownership plan to purchase their units after the close of the compliance period applicable to each unit satisfied the requirements of IRC §42(i)(7)(A).

PLR 200916007. Ruling that the taxpayer's costs for infrastructure improvements for a project were dedicated improvements within the meaning of IRC §263A and Treas. Reg. §1.263A-4(d)(8)(iv) and, therefore, not capitalizable as amounts paid to create an intangible under Treas. Reg. §1.263(a)-4(d)(8)(i). The costs to construct the dedicated infrastructure improvements were indirect costs within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) for purposes of IRC §263A and were capitalizable to the bases of the project's residential rental buildings, using a reasonable allocation method under Treas. Reg. §1.263A-1(f) to allocate the costs amount the residential rental buildings. Assuming that the project's residential rental buildings would be depreciated as residential rental property under IRC §168, the ruling concluded the eligible basis of the project's residential rental buildings under IRC §42(d)(1) includes the cost of the infrastructure improvements. The PLR cites Rev. Rul. 2002-9 as part of its analysis.

PLR 201049018. Ruling concluded, based on the taxpayer's representations and relevant law, that the redemption of all or any portion of the bonds used to satisfy the 50% test of IRC §42(h)(4)(B) after the project has been placed in service and after the 50% test has been met (taking into account bond proceeds expended after the project has been placed in service), but before the end of the first year in the credit period, will not, in and of itself, result in a determination that project was not financed with tax-exempt bonds under IRC §42(h)(4)(B).

### **Regulations**

1. Treas. Reg. §1.42-1. Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency.
2. Treas. Reg. §1.42-1T. Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency.
3. Treas. Reg. §1.42-2. Waiver of requirement that an existing building eligible for the low-income housing credit was last placed in service more than 10 years prior to acquisition by the taxpayer.
4. Treas. Reg. §1.42-3. Treatment of buildings financed with proceeds from a loan under an Affordable Housing Program established pursuant to section 721 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).
5. Treas. Reg. §1.42-4. Application of not-for-profit rules of section 183 to low-income housing credit activities.
6. Treas. Reg. §1.42-5. Monitoring compliance with low-income housing credit requirements.

7. Treas. Reg. §1.42-6. Buildings qualifying for carryover allocations.
8. Treas. Reg. §1.42-7. Substantially bond-financed buildings (reserved).
9. Treas. Reg. §1.42-8. Election of appropriate percentage month.
10. Treas. Reg. §1.42-9. For use by the general public.
11. Treas. Reg. §1.42-10. Utility allowances.
12. Treas. Reg. §1.42-11. Provision of services
13. Treas. Reg. §1.42-12. Effective dates and transitional rules.
14. Treas. Reg. §1.42-13. Rules necessary and appropriate; housing credit agencies correction of administrative errors and omissions.
15. Treas. Reg. §1.42-14. Allocation rules for post-2000 State housing credit ceiling amounts.
16. Treas. Reg. §1.42-15. Available unit rule.
17. Treas. Reg. §1.42-16. Eligible basis reduced by federal grants.
18. Treas. Reg. §1.42-17. Qualified allocation plan.
19. Treas. Reg. §1.42-18. Qualified contracts.

### **Revenue Procedures**

Rev. Proc. 87-56, 1987-2 C.B. 674, 677. This revenue procedure specifies class lives and recovery periods for property subject to depreciation under the general depreciation system provided in IRC §168(a) or the alternative depreciation system provided in IRC §168(g).

Rev. Proc. 94-9, 1994-1 C.B. 555; 1994-2 I.R.B. 25. Instructions for making the election provided by §13142(c)(1) of the Revenue Reconciliation Act of 1993. The election is available to owners of low-income buildings not covered by §7108(e)(1) of the Revenue Reconciliation Act of 1989 and allows these owners to determine the gross rent limitation for rent-restricted units using the number of bedrooms method under IRC §42(g)(2)(C).

Rev. Proc. 94-57, 1994-2 C.B. 744; 1994-37 I.R.B. 6. Except for a low-income building financed with tax-exempt bonds, the IRS will treat the gross rent floor in IRC §42(g)(2)(A) as taking effect on the date a state agency initially allocates a housing credit dollar amount to the building under IRC §42(h)(1) unless the owner designates the date that the building was placed in service as the date on which the gross rent floor will take effect for the building. An owner must make this designation to use the placed in service date and inform the state agency that made the allocation to the building no later than the date on which the building is placed in service. For a bond-financed building, the IRS will treat the gross rent floor in IRC §42(g)(2)(A) as taking effect on the date a state agency initially issues a determination letter to the building unless the owner designates the date that the building was placed in service as the date on which the gross rent floor will take effect for the building. The owner must make this designation to use the placed in service date and inform the agency that issues the determination letter to the building no later than the date on which the building is placed in service.



Rev. Proc. 94-64, 1994-2 C.B. 797. Procedures for obtaining the waiver of the annual income recertification referenced in IRC §42(g)(8)(B). Note: Superseded by Rev. Proc. 2004-38. The waiver was entirely obsolete beginning July 31, 2008, because, under IRC §142(d)(3)(A), if all the low-income buildings in the project are 100% low-income buildings, owners are not required to complete annual tenant income recertifications. IRC §142(d)(3)(A) was amended by section 3010 of the Housing Assistance Tax Act of 2008 and is effective for taxable years ending after July 30, 2008. IRC §142(d)(3)(A) is made applicable to IRC §42 low-income projects in IRC §42(g)(4).

Rev. Proc. 94-65, 1994-2 CB 798. Procedures for when a signed, sworn statement by a low-income tenant will satisfy the documentation requirements of Treas. Reg. §1.42-5(b)(1)(vii).

Rev. Proc. 95-28, 1995-1 C.B. 704. Provides procedures for granting temporary relief from certain IRC §42 provisions to owners of low-income housing projects and state agencies in major disaster areas. Note: superseded by Rev. Proc. 2007-54.

Rev. Proc. 96-32, 1996-1 C.B. 717. Guidance on qualification for tax exemption under IRC §501(c)(3) is provided for organizations that provide low-income housing. The guidance includes a safe harbor procedure to determine qualification.

Rev. Proc. 97-22, 1997-1 C.B. 652. 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. Records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of IRC §6001.

Rev. Proc. 98-25, 1998-1 C.B.689. Specifies the basic requirements that the IRS considers essential when a taxpayer's records are maintained within an Automatic Data Processing system (ADP). This revenue procedure updates and supersedes Rev. Proc. 91-59.

Rev. Proc. 99-11 1999-1 C.B. 275. Procedures for providing a Treasury Direct Account as an alternative to providing a surety bond to avoid or defer recapture of low-income housing tax credits under IRC §42(j)(6). Under this program, taxpayers were able to establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security. These procedures are no longer in effect due to amendment of IRC §42(j)(6) in 2008. See Rev. Proc. 2008-60.

Rev. Proc. 2003-82, 2003-47 I.R.B. 1097. Provides safe harbors under which the IRS will treat a residential unit in a building as a low-income unit under IRC §42(i)(3)(A) if the incomes of the individuals occupying the unit are at or below the applicable income limitation under IRC §42(g)(1) or §142(d)(4)(B)(i) before the beginning of the first taxable year of the building's credit period, but their incomes exceed the applicable income limitation at the beginning of the first taxable year of the building's credit period.

Rev. Proc. 2004-38, 2004-27 I.R.B. 10. Instructions for obtaining the waiver from the IRS of the annual recertification of tenant income provided in IRC §42(g)(8)(B). Note: Supersedes Rev. Proc. 94-64. The waiver was entirely obsolete beginning July 31, 2008. See explanation for Rev. Proc. 94-64.

Rev. Proc. 2005-37, 2005-28 I.R.B. 79. Establishes a safe harbor under which housing credit agencies and project owners may meet the requirements of IRC §42(h)(6)(B)(i) as described in Rev. Rul. 2004-82, Q&A #5 regarding extended use agreements

Rev. Proc. 2007-20, 2007-7 I.R.B. 517. Provides that certain transactions with contractual protection are not reportable transactions for purposes of the disclosure rules under Treas. Reg. §1.6011-4(b)(4). However, these transactions may be reportable transactions for purposes of the disclosure rules under Treas. Reg. §1.6011-4(b)(2),(b)(3), (b)(5), (b)(6), or (b)(7). Paragraph 4.02(4) specifies “transactions in which the refundable or contingent fee is related to the low-income housing credit under IRC §42(a).”

Rev. Proc. 2007-54, 2007-31 I.R.B. 293. Procedures for temporary relief from certain IRC §42 requirements for owners of low-income housing buildings and housing credit agencies of states or possessions of the United States in major disaster areas declared by the President. This revenue procedure is effective for a major disaster declaration issued by the President under the Stafford Act on or after July 2, 2007, and before August 21, 2014. This revenue procedure superseded the relief provisions of Rev. Proc. 95-28 and was superseded by Rev. Proc. 2014-49.

Rev. Proc. 2008-60, 2008-2 C.B. 1006. Procedures for taxpayers maintaining surety bonds or Treasury Direct Accounts (TDA) to follow when making the election under §3004(i)(2)(B)(ii) of the Housing Assistance Tax Act of 2008 (Pub. L. 110-289) to no longer maintain a surety bond or a TDA to avoid recapture.

Rev. Proc. 2012-27, 2012-21 I.R.B. 940. Procedures for notifying the IRS, under IRC §42(j)(6)(B)(i), of any increase in tax resulting from a reduction in the qualified basis of a low-income housing tax credit building in order to begin the 3-year statutory period for assessing a deficiency with respect to that taxpayer.

Rev. Proc. 2014-49, I.R.B. 2014-37. Procedures for temporary relief from certain IRC §42 requirements for owners of low-income housing buildings and housing credit agencies of states or possessions of the United States in major disaster areas declared by the president. This revenue procedure is effective for major disasters declared on or after August 21, 2014. This revenue procedure supersedes the relief provisions of Re. Proc. 2007-54.

## **Revenue Rulings**

Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79. Provides that the costs attributable to general grading of the land are capital expenditures and become a part of the cost basis of the land, which is not subject to depreciation allowances. The costs attributable to excavation, grading, and removing soil necessary for the proper setting of the building and paving of the roadways are part of the cost of those assets and should be included in the depreciable basis for the buildings and roadways.

Rev. Rul. 68-193, 1968-1 C.B., clarifies Rev. Rul. 65-265, 1965-2 C.B. 52. Costs attributable to general grading of the land are capital expenditures and are generally not subject to depreciation allowances. However, the cost of grading for roadways may be depreciable where it can be established that the grading is associated with a depreciable asset and that the grading will be retired, abandoned, or replaced contemporaneously with the asset.

Rev. Rul. 74-265, 1974-1 C.B. 56. Landscaping consisting of perennial shrubbery and ornamental trees immediately adjacent to the buildings in a newly constructed apartment complex is property depreciable over the life of the buildings if the replacement of the buildings at the expiration of their useful lives will destroy the landscaping; other landscaping on the grounds of the complex is considered general land improvements, the costs of which is to be added to the taxpayer’s basis in the land.

Rev. Rul. 80-93, 1980-1 C.B. 50. Amounts paid by the developer of a mobile home park to the public utility for underground electric and gas distribution systems are capital expenditures that are included in the developer’s cost basis of the land. Examples illustrate which land preparation costs may be depreciated by

the developer and which must be included in the basis of the land. Excavation and backfilling required for the construction of a laundry facility and storm sewer system were so closely associated with those depreciable assets that replacement of the depreciable assets will require the physical destruction of the land preparation. However, the land preparation costs (clearing, grubbing, cutting, filling and rough grading) are unaffected by replacement of the depreciable assets and will not be replaced contemporaneously. Therefore, they are nonrecurring general land improvement costs that are inextricably associated with the land. The amounts paid for electrical and natural gas distribution systems are nonrecurring costs for betterments that increase the value of the land and are also includible in the taxpayer's cost basis of the land. The taxpayer pays for the distribution system, but the utility company retained full ownership and repairs/replaces the systems as needed.

Rev. Rul. 85-32, 1985-1 C.B. 186. Syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

Rev. Rul. 89-24, 1989-1 C.B. 24. Provides instructions for computing the income limits applicable both to exempt facility bonds issued to provide for qualified residential rental projects under IRC §142 and to low-income housing credits under IRC §42. The income limits are required to be made in a manner consistent with determinations of lower income families under section 8 of the United States Housing Act of 1932. With respect to the 20-50 requirement of IRC §§ 142(d)(1)(A) and 42(g)(1)(A), 20% or more of the applicable units must be occupied by individuals or families having incomes equal to or less than the income limit for a "very low-income" family of the same size. With respect to the 40-60 requirement of §§ 142(d)(1)(B) and 42(g)(1)(B), 40 percent of the applicable units must be occupied by individuals or families having incomes equal to 120% or less of the income limit for a very low-income family of the same size. With respect to certain deep rent skewed projects, as described in IRC §142(d)(4), the determination of whether 15% of the low-income units are occupied by individuals having incomes equal to 40% or less of the area median gross income shall be made by determining whether 15% of such units are occupied by individuals or families having incomes equal to or less than 80% of the income limit for a very low-income family of the same size. See Rev. Rul. 94-57, which later modified and superseded this revenue ruling.

Rev. Rul. 90-60, 1990-2 C.B.4. Guidance for determining the amount of bond considered satisfactory by the Secretary and the period of the bond required under former IRC §42(j)(6). Note: Applicable only to dispositions of low-income buildings (or interests therein) on or before July 30, 2008.

Rev. Rul. 90-89, 1990-2 C.B. 8. For purposes of determining whether a building meets the minimum set-aside requirements of IRC §42(g)(1), the combined income of all occupants of a residential rental unit, whether or not legally related, is compared to the appropriate percentage of the median family income for a family with the same number of members.

Rev. Rul. 91-38, 1991-2 C.B. 3. This ruling answers 12 frequently asked questions about the low-income housing credit.

Rev. Rul. 91-38, 1991-2 C.B. 3, Q&A #5. A building's credit period is determined by reference to the tax year (at the time of placement in service) of the owner who placed the building in service, and is not affected by differing tax years of succeeding owners. However, the amount of credit that a particular owner may claim on a return for a tax year is determined on the last day of that owner's tax year. For purposes of IRC §42(f)(4), the owner who has held the property for the longest period during the month in which a transfer occurs is deemed to have held the property for the entire month and may claim a credit accordingly. In cases in which the transferor and transferee have held the property for the same amount of time during the month of the transfer, the transferor is deemed to have held the property for the entire month and the transferee's ownership of the property is deemed to begin the first day of the following month.

Rev. Rul. 92-61, 1992-2 C.B. 7. The adjusted basis of 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) for purposes of determining the building's qualified basis.

Rev. Rul. 94-57, 1994-2 C.B. 5. This ruling modifies and supersedes Rev. Rul. 89-24 referenced above. This ruling concludes that (1) the income limitation used to initially qualify tenants in a low-income unit fluctuates with changes in area median gross income, and (2) owners must use the current area median gross income to determine when the available unit rule of IRC §42(g)(2)(ii) applies. Rev. Rul. 89-24 modified and superseded. Taxpayers may rely on a list of income limits released by HUD until 45 days after HUD releases a new list of income limits, or until HUD's effective date for this new list, whichever is later.

Rev. Rul. 95-49, 1995-2 C.B. 7. This ruling concludes that an extended use agreement satisfies IRC §42(h)(6) even though its provisions may be suspended or terminated after the compliance period when a tenant exercises a right of first refusal to purchase a low-income unit.

Rev. Rul. 96-35, 1996-2 C.B. 4. Below market loan provided by the Federal Emergency Management Agency (FEMA) to the owner of a qualified low-income building damaged by a disaster to repair, reconstruct, or restore the building to its pre-casualty condition does not result in a reduction in characterizing the building as federally subsidized under IRC §42(i)(2). A grant provided by FEMA to the owner of a qualified low-income building damaged by a disaster does not cause a reduction of the building's eligible basis under IRC §42(d)(5) to the extent that the grant funds are used to repair, reconstruct, or restore the building to its pre-casualty condition.

Rev. Rul. 98-49, 1998-2 C.B. 453. Under Treas. Reg. §1.42-16(b)(3), the IRS determined that payments made to a building owner on behalf or in respect of a tenant under the Section 8 Assistance For Single-Room Occupancy Dwellings Program (42 U.S.C. 11301, 11401-11402) or under the Shelter Plus Care Program (42 U.S.C. 11301, 11403-11407b) are not grants made with respect to a building or its operation under IRC §42(d)(5).

Rev. Rul. 2002-9, 2002-1 C.B. 614. "Impact fees" incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under IRC §§ 263(a) and 263A.

Rev. Rul. 2003-77, 2003-29 I.R.B. 75. The issue was whether a described facility qualified as a community service facility under IRC §42(d)(4)(C)(iii). The ruling found the requirement that a community service facility must be designed to serve primarily individuals whose income is 60 percent or less of area median gross income (AMGI) was satisfied for the following reasons: (1) the services provided at the facility improved the quality of life for community residents, (2) the taxpayer demonstrated (market study) that the services provided at the facility will be appropriate and helpful to individuals in the area of the project whose income is 60 percent or less of AMGI, (3) the facility must be located within the building, and (4) the services provided at the facility were affordable to individuals whose income is 60 percent or less of AMGI.

Rev. Rul. 2004-82, 2004-35 I.R.B. 350. Generally, this revenue ruling is presented in a "Q&A" format and provides guidance for the following topics: (A) Eligible Basis and Qualified Basis Issues, (B) First Year Low-Income Unit Issue, (C) Extended Low-Income Housing Commitment Issue, (D) Home Investment Partnership Act Loan Issues, (E) Vacant Unit Rule Issues, and (F) Recordkeeping and Record Retention Issues. The following Q&As are specifically referenced in the ATG:

- Q&A #2 provides an example of a qualifying community service facility under IRC §42(d)(4)(C)(iii).
- Q&A #3 explains that credit application and allocation fees assessed by a state agency are not includable in eligible basis.
- Q&A #5 explains that IRC §42(h)(6)(B)(i) requires that an extended use commitment 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 IRC §42.
- Q&A #6 explains that IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnerships Act (HOME) or the Native American Housing and Assistance and Self-Determination Act (NAHASDA) of 1996 with respect to any building will not be treated as a below market Federal loan if 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of the Average Median Gross Income (AMGI). However, the rent restrictions for restriction for all the low-income units in the building, including the units used to satisfy the rules under IRC §42(i)(2)(E)(i), is based on the applicable income limitation under IRC §42(g). Applies to buildings placed in service on or before July 20, 2008.
- Q&A #9 explains that an owner of an IRC §42 project must use reasonable attempts to rent a vacant low-income unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project are rented to tenants not having a qualifying income. What constitutes reasonable attempts to rent a vacant unit is based on facts and circumstances. Examples included in the ruling.
- Q&A #11 explains that a taxpayer can comply with the recordkeeping and record retention provisions under Teas. Reg. §1.42-5(b) using an electronic storage system instead of maintaining hardcopy (paper) books and records, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97-22. However, 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 credit agency. For example, the housing credit agency may require the taxpayer to maintain hardcopy books and records. For additional information, see Rev. Proc. 98-25, 1998-1 C.B. 689.

Rev. Rul. 2008-6 , 2008-3 I.R.B. 271. Pursuant to Treas. Reg. §1.42-16(b)(3), the IRS determined that certain rental assistance payments made to a building owner 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, 25 U.S.C.S. 4101 et seq., are not grants made with respect to a building or its operation under IRC §42(d)(5). The rental assistance payments were provided under 24 C.F.R. 1000.103(b).

### **Technical Advice Memoranda**

TAM 200021509. Costs includable in eligible basis under IRC §42(d)(1). Specifically, is the amount of a “Developer Fee Note,” provided in part payment for services rendered for the taxpayer by the developer includable in eligible basis?

TAM 200021510. Costs includable in eligible basis under IRC §42(d)(1). Specifically, are certain land preparation costs, costs for obtaining a construction loan, and construction contingency costs incurred by the Taxpayer in constructing Project included in eligible basis under section 42(d)(1)?

TAM 200043015. Costs includable in eligible basis under IRC §42(d)(1). Specifically, are certain land preparation costs and bond issuance costs includable in eligible basis?

TAM 200043017. Costs includable in eligible basis under IRC §42(d)(1). Specifically addresses certain partnership syndication and formation costs, land preparation costs, developer fees, construction loan costs, construction contingency and rent-up costs incurred by the taxpayer. NOTE: information on the treatment of impact fees should be disregarded; superseded by Rev. Proc. 2002-9 and PLR 200916007.

TAM 200044004. Costs includable in eligible basis under IRC §42(d)(1). Specifically addresses the amount of a “Developer Fee Note” provided in part payment for services rendered for the Taxpayer by the Developer.

TAM 200044005. Costs includable in eligible basis under IRC §42(d)(1). Specifically addresses certain land preparation costs, costs for obtaining a construction loan, and construction contingency costs incurred by the taxpayer.

TAM 200203014. Involves a taxpayer request that IRC §7805(b) be applied to taxpayer’s situation so that the conclusions of TAM 200043017 could be applied without retroactive effect. The taxpayer asserted that it should be granted IRC §7805(b)(8) relief because it relied upon Agency's award of credits pursuant to IRC §42(h) that included the costs at issue. However, a state housing credit agency's responsibility under IRC §42(m)(2)(A) to determine the financial feasibility and viability of a project in no way abrogates the Service's authority and responsibility to administer the low-income housing tax credit and its various provisions.

TAM 200523023. Chief Counsel responded to question regarding purported loans of HOME Investment Partnerships Act (HOME) funds and Affordable Housing Program (AHP) funds between General Partner and Taxpayer. The purported loan of HOME funds between General Partner and Taxpayer was treated for purposes of IRC §42 as a below market federal loan under IRC §42(i)(2)(D) and the purported loan of AHP funds between General Partner and Taxpayer was treated for purposes of IRC §42 as a below market loan under Treas. Reg. §1.42-3(a), and not as a below market federal loan under IRC §42(i)(2)(D).

## **Appendix C**

### **Treatment of Assets/Costs for IRC §42 Purposes**

**Introduction** This appendix provides a list of the types of costs taxpayers typically incur when developing low-income housing and how the cost should be treated for IRC §42 purposes. The list is not exclusive.

- Assets/Costs Associated with Low-Income Buildings
- Assets/Costs Associated with Land
- Costs Associated with Land Improvements
- Financing Costs
- Costs Excluded from Eligible Basis
- Miscellaneous

#### **Assets/Costs Associated with Low-Income Buildings**

**Developer Fees** Developer fees are paid for services provided to develop the project from its initial inception to its completion when the project is placed in service. Only the portion of the developer fee paid/accrued for providing services associated with the low-income buildings is includable in eligible basis.

**Building Permits** These costs are usually associated with payments to local governments for construction plan reviews and building inspections needed to ensure conformance with local building codes and requirements.

**Consulting Fees** Fees paid to consultants for development-related services may be included in eligible basis if the service is associated with the low-income building.

**Accounting Costs** Costs incurred during the construction period to account for the costs of construction are indirect costs that directly benefit, or are incurred by reason of, the taxpayer's improvement and, therefore, are capitalized to the basis of the property improved under IRC §§ 263(a) and 263A. The accounting costs should be allocated among the property improved, and to the extent the cost of the improved property is includable in eligible basis, the improved property's allocated share of the accounting costs are also includable in eligible basis. Accounting costs include, for example, accounting for costs according to the construction contract, securing advances from a construction loan, or submitting documentation to HUD for reimbursement.

**Land Preparation** The grading of land involves moving soil for the purpose of changing the ground surface. It produces a more level surface and generally provides an improvement that adds value to the land. However, costs attributable to grading land that is done to provide a proper setting for a building become a part of the cost basis of the building. See *Algernon Blair, Inc. v. Commissioner*, 29 T.C. 1205 (1958), acq., 1958-2 C.B. 4, and Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193. 1968-1 C.B. 79.

**Foundations and Utilities**

- Excavating
- Backfilling
- Removal Costs

Earth-moving costs incurred for digging spaces and trenches for a building's foundation and utilities are generally considered to be inextricably associated with the building, are added to the cost of the building and, therefore, are depreciable. Similarly, costs incurred for fill dirt used to set the foundation of a depreciable asset are generally considered to be inextricably associated with the depreciable asset and are depreciable. Rev. Rul. 65-265, as clarified by Rev. Rul. 68-193, holds that excavating, grading, and removal costs directly associated with the construction of buildings and paved roadways are not inextricably associated with the land and should be included in the depreciable basis of the buildings and roadways.

**Utilities:  
Tap Fee**

Fees paid to a local government for the right to tap into an existing local utility are usually building-specific and capitalized to the building.

**Impact Fees and Dedicated Improvements**

**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.

Rev. Rul. 2002-9 provides guidance for including impact fees for determining the eligible basis. Impact fees are assessed because of the taxpayer's plans to construct a new residential building. Impact fees are indirect costs under IRC §263A because they directly benefit, and are incurred by reason of, the construction of the project. Under Treas. Reg. 1.263A-1(e)(3)(i), 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.

**Dedicated Improvements:** Similar to the treatment of impact fees, costs to construct dedicated infrastructure improvements are indirect costs under IRC §263A because they directly benefit, or are incurred by reason of, the construction of the project. Infrastructure improvements include, for example, streets, curbs, sidewalks, and storm water drainage required by the local government and constructed according to the local government's specifications. To qualify, the improvements must be dedicated to the state or local government for public use after completion. Upon acceptance of the dedication, the state or local government will own and maintain the infrastructure assets. Treas. Reg. §1.263(a)-4(d)(8)(iv). See PLR 200916007. Under Treas. Reg. §1.263A-1(e)(3)(i), the taxpayer must allocate the costs to the property produced. If the project encompasses multiple buildings, the costs must be allocated among the buildings constructed using a reasonable method of allocation under Treas. Reg. §1.263A-1(f). See PLR 200916007

**Personal Property:**

- Fixtures
- Furniture
- Appliances

Personal property (e.g., fixtures, furniture and appliances) may be included in eligible basis. Treas. Reg. §1.103-8(b)(4)(iii).



## Assets/Costs Associated with Land

Expenses related to acquiring the land are excluded from eligible basis. These costs are capitalized under IRC §§ 1016 and 263.

### Land Acquisition

- Developer Activities
- Finders Fees
- Brokerage Fees
- Legal Fees
- Professional Fees
- Assumed Liabilities

Generally, land acquisition involves the purchase of unimproved land for the construction of IRC §42 projects.

Activities normally performed by a developer and associated with the acquisition of land, which should be capitalized to the land, include (but are not limited to):

1. Analysis of the Qualified Allocation Plan (QAP) for targeted areas within a state;
2. Identification of potential land sites;
3. Analysis of population demographics for potential sites;
4. Analysis of a site's economy and forecast future growth potential;
5. Determining a site's zoning status and possible rezoning actions;
6. Contacting local government officials concerning access to utilities, public transportation, impact fees and local ordinances;
7. Performing environmental tests on selected sites; and
8. Negotiating the purchase of the land and its related financing.

The list above is not meant to be comprehensive and each activity may have underlying tasks.

Finders fees and brokerage fees paid for assistance in acquiring title to a property are also included in land basis and excluded from eligible basis. See *M. A. Mathiasen*, 20 T.C.M. 1681, Dec. 25,155(M), T.C. Memo., 1961-325, 63-1 USTC 9153; *J.H. Vestal*, CA-8, 74-1 USTC 9407, 498 F.2d 487.

Legal and professional fees related to the acquisition of land are also included in land basis and excluded from eligible basis. See:

1. *P.W. Havener*, 23 T.C.M. 539, Dec. 26,735(M), T.C. Memo. 1964-91; Expenditures as attorneys' fees paid for services rendered in connection with the acquisition of the ...estate, the cost of constructing roads on the property, the cost of drilling two water wells, the payment of delinquent real estate taxes ..., interest paid to mortgage participation holders at the time of acquisition in 1938, etc. These expenditures may be added to his cost basis in the property.
2. *J.M. Haddock*, 57 T.C.M. 274, Dec. 45,654(M), T.C. Memo. 1989-200; [The legal fee] was incurred in connection with improvements to a capital asset, the 41 lots. The costs associated with construction of the roads include the legal fee incurred in defending the road contractor's lawsuit. Thus the fee of \$1,265 must be capitalized and added to petitioners' cost basis in the lots.
3. *P.W. Davis, Est.*, 79 T.C. 503, Dec. 39,361; Petitioner's legal fees thus were not incurred in the conservation of property she "held," within the meaning of IRC §212. They were, rather, incurred in an effort to establish her right to, or perfect her title to, assets, and the expenditures are not deductible under IRC §212. They must be capitalized as part of her basis for any property she ultimately acquires

or to which her title is finally perfected. *Boagni v. Commissioner*, 59 T.C. 708, 712 (1973).

4. *V.M. Cramer*, 55 T.C. 1125, Dec. 30,697; The legal fees constitute amounts “paid...in connection with the reacquisition” of property within the meaning of IRC §1038 and, therefore, are not deductible but are added to petitioner's basis in the reacquired property.

**Interests in Land**

- Air rights
- Zoning Variances

Treas. Reg. §1.197-2(c)(3), Interests in Land, provides that IRC §197 intangibles do not include an interest in land. An interest in land includes a fee interest, life interest, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base.

**Land Acquisition**

- Assumed Liabilities

Unpaid real estate taxes and similarly assumed costs are added to the land's basis. See *P. W. Havener*, 23 T.C.M. 539, Dec. 26,735(M), T.C. Memo. 1964-91.

**Demolition & Tenant Relocation**

IRC §280B states that in the case of the demolition of any structure, no deduction is allowed to the owner or lessee of such structure for any amount expended for the demolition, or any loss sustained on account of the demolition. The costs should be added to the capital account for the land on which the demolished structure was located. Therefore, these costs are excluded from eligible basis.

The costs of relocating tenants out of an acquired building that will be demolished may be associated with the demolition and, if so, are capitalized to the land.

**Land Preparation**

- Costs:**
- Clearing
  - Grubbing
  - Cutting
  - Filling
  - Rough Grading

Rev. Rul. 80-93 addresses whether a taxpayer is allowed to take a depreciation deduction for costs incurred for the clearing, grubbing, cutting, filling and rough and finish grading necessary to bring the land to a suitable grade for constructing certain depreciable assets. These costs will not be repeated when the depreciable asset is replaced. This revenue ruling holds that the land preparation costs are unaffected by replacement of the depreciable assets and will not be replaced contemporaneously.

Therefore, they are nonrecurring general land improvement costs that are inextricably associated with the land and are to be added to the taxpayer's cost basis in the land. These land preparation costs are not depreciable and, therefore, are excluded from eligible basis.

**Land Preparation**

- Costs:**
- Grading

The grading of land involves moving soil for the purpose of changing the ground surface. It produces a more level surface and generally provides an improvement that adds value to the land. Rev. Rul. 65-265, clarified by Rev. Rul. 68-193, holds that such expenditures are inextricably associated with the land and, therefore, fall within the rule that land is a nondepreciable asset. Costs attributable to the general grading of the land (not done to provide a proper setting for a building or a paved roadway) become a part of the cost basis of the land and, therefore, are not subject to a depreciation allowance. See *Algernon Blair, Inc. v. Commissioner*, 29 T.C. 1205 (1958), acq., 1958-2 C.B. 4. As such, the costs are not includable in eligible basis under IRC §42(d)(1).

**Land Surveys**

- Boundary
- Mortgage

Land and environmental surveys are generally conducted over the entire property of the development, not just where the buildings and improvements will be specifically placed. Some surveys, such as boundary or mortgage surveys help to define the property. Costs incurred for these types of survey are inextricably associated with the land, are not depreciable, and are excluded from eligible basis. See TAM 200043017.

**Environmental Surveys**

- Percolation Tests
- Contamination Studies
- Soil Borings
- Geotechnical Inspections
- Wetland Studies
- Groundwater Investigations

Environment surveys such as percolation tests and contamination studies are used to determine if the land is suitable for the construction of the contemplated improvements. Other similar surveys include soil borings, geotechnical investigations, suitability studies, wetland reviews, mapping of wetland, and inspections of wetland, wetland characterization, and groundwater investigations. If this type of survey will not necessarily need to be redone contemporaneously when the depreciable improvement is replaced, the costs incurred for the survey are inextricably associated with the land and are not depreciable and are excluded from eligible basis. A survey is considered to be redone contemporaneously with the replacement of the depreciable improvement if the physical replacement of the depreciable improvement (which is included in eligible basis) mandates a reperformance of the survey. Although an ordinance may require reperformance of the survey, such requirement is irrelevant as to whether the physical replacement of a depreciable improvement necessarily mandates a reperformance of the survey.

If necessary, the cost should be allocated between nondepreciable property (for example, land) and depreciable property (for example, buildings) using any reasonable method. For example, if staking costs are incurred to demarcate sidewalks (depreciable) and landscaping not immediately adjacent to buildings (nondepreciable), the staking costs should be allocated between the sidewalks and the landscaping.

See TAM 200043017

**Costs Associated with Land Improvements**

Generally, land preparation and improvement costs are excluded from eligible basis. For a land cost to be included in eligible basis, it must be so closely associated with a particular depreciable asset includable in eligible basis that the land improvement will be retired, abandoned, or replaced contemporaneously with that depreciable asset; i.e., the cost will be reincurred if the depreciable asset is replaced or rebuilt. Whether a specific land cost will be retired, abandoned, or replaced contemporaneously with the depreciable asset is a question of fact. *Eastwood Mall, Inc. v. U.S.*, 95-1 USTC 50,236 (N.D. Ohio 1995), aff'd without published opinion, 59 F.3d 170 (6<sup>th</sup> Cir. 1995).

**Water Retention Ponds**

Costs incurred by a taxpayer to haul dirt and fill to an area to raise the level of the land surrounding a creek to make the area useful as an industrial site is an improvement to the land itself and must be capitalized to land basis. *Coors v. Commissioner*, 60 T.C. 368, (1973).

The costs incurred in construction of steel cellular revetments and a stable slope berm outward from a lake shoreline, as part of a project to enclose and fill in an area of the lake to provide additional land for industrial facilities, and the costs of filling

in the enclosed area are nondepreciable land acquisition costs and, therefore, are excluded from eligible basis. Rev. Rul. 77-270, 1977-2 C.B. 79.

**Landscaping:**

- Clearing
- General Grading
- Top soil
- Seeding
- Finish Grading
- Planting of Perennial Shrubbery and Trees

Landscaping immediately adjacent to a low-income building is depreciable property if the replacement of the building will destroy the landscaping. In such a case, these costs are considered inextricably associated with the building and, therefore, are a depreciable land improvement. These costs are included in eligible basis. Otherwise, landscaping that will be unaffected by the replacement of the low-income building and, therefore, will not be replaced contemporaneously, is a nondepreciable land improvement. These costs are excluded from eligible basis. See Rev. Rul. 74-265.

**Engineering and Architectural Services**

Engineering and architectural services may include (but are not limited to) the preparation of erosion control plan, grading plan, utility plans, general details, easement descriptions, sewer and sanitary plans, and traffic engineering. Such services associated with nondepreciable land are excluded from eligible basis.

The services associated with a tangible depreciable asset includable in eligible basis, such as detailed construction drawings, are includable in eligible basis.

While it is a case-by-case factual determination, engineering and architectural services should be characterized consistently with the subject of the service. Services that may be associated with both nondepreciable property (e.g., land) and depreciable property should be allocated among the nondepreciable property and the depreciable property using a reasonable method.

**Financing Costs**

**Fee, Cash Flow Guarantee**

A “cash flow guarantee fee” paid by a partnership to secure agreement that its general partner would make loans to the partnership to fund any operating deficits is excluded from eligible basis. See Appendix G, Corbin West Limited Partnership v. Commissioner.

**Fee, Tax Credit Guarantee**

A “tax credit guarantee fee” paid to ensure that the project is operated in compliance with IRC §42 and guarantee that the taxpayer is entitled to claim the IRC §42 credit is excluded from eligible basis. See Appendix G, Corbin West Limited Partnership v. Commissioner.

**Tax-Exempt Bonds:**

- Issuance Costs

Notwithstanding the general rule of IRC §263A, bond issuance costs are excluded from eligible basis under the specific requirements of IRC §42(d)(1). The legislative history of IRC §142 provides that bond issuance costs cannot be paid from the 95% portion of the issue. 2 H.R. Conf. Rep. No. 841, 99<sup>th</sup> Cong., 2d Sess. II-686, 729 (1986), 1986-3 (Vol. 4) C.B. 868, 729. Since bond issuance costs are not costs included in the 95% used for qualified residential rental projects, the bond issuance costs are not residential rental property or costs used to provide residential rental property within the meaning of IRC §§142 or 42. Characterizing a certain portion of bond issuance costs as includable in eligible basis under IRC §263A is directly contrary to this specific congressional determination. Permitting an IRC §263A characterization of the bond issuance costs for purposes of

IRC §42 would result in the disparate treatment of the term residential rental property between IRC §§42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42 that requires that residential rental property have the same meaning for purposes of both sections.

Accordingly, notwithstanding the general rule under IRC §263A, no portion of bond issuance costs are included in eligible basis. See TAM 200043015.

**Loans:**

- **Origination Fees**
- **Legal Fees**
- **Closing Costs**
- **Title Searches**
- **Recordation Fees**

Costs incurred in obtaining a loan are capitalized and amortized over the life of the loan. See *Enoch v. Commissioner*, 57 T.C. 781, 794-5 (1972), acq. on this issue, 1974-2 C.B. 2. See also Rev. Rul. 70-360, 1970-2 C.B. 103, Rev. Rul. 75-172, 1975-1 C.B. 145, and Rev. Rul. 81-160, 1981-1 C.B. 312. The cost of securing financing includes costs such as origination fees, legal fees, closing costs, title searches and recordation fees.

**Construction Loans:** The costs and fees incurred in obtaining a construction loan are not capitalized to depreciable property, but are treated as an amortizable IRC §167 intangible. The costs for obtaining a construction loan relate to the land acquired as well as the land improvements, in addition to the buildings. IRC §263A requires the amortization deductions relating to the construction loan be capitalized to the produced property during the construction period. The deductions must be reasonably allocated to all property produced. See TAM 200044005.

**Permanent Financing:** The cost of securing permanent financing is excluded from eligible basis, but to the extent the loan is associated with the building, capitalization of the amortization during the construction period may be required under IRC §263A. However, permanent financing is not usually in place during the construction period. Bridge loans are treated the same way.

**Loans:  
Reserves and  
Escrows  
Required by  
Lender**

Funds held in escrow accounts or required by a lender to be held in reserve are not depreciated and are excluded from eligible basis.

**Construction  
Contingency  
Amounts**

Amounts in a construction contingency account created for unexpected construction overruns are excluded from eligible basis because no cost was incurred.

**Loans:  
Interest Paid  
or Incurred**

Interest paid or incurred during the “production” period of a low-income building that is allocable to the production expenditures of the building is capitalized to the building under IRC §263A(f) and includable in eligible basis. Generally, the production period begins when physical activity on the site begins and ends when the produced property is placed in service. Physical production excludes planning and architectural design, soil testing, or securing permits. Treas. Reg. §1.263A-12(f). The determination of whether interest is allocable to the production of the building is made using the “avoided cost” method. See Treas. Reg. §1.263A-8(a).

Interest attributable to a completed low-income building that is paid or incurred after the production period for the building for purposes of IRC §263A(f) has ended, is expensed as an ordinary and necessary business expense.

If dwelling units within a low-income building are separately placed in service, interest attributable to these dwelling units that is paid or incurred after the production period for the dwelling units for purposes of IRC §263A(f) has ended, is expensed as an ordinary and necessary business expense. However, if the dwelling units are separately placed in service before the development of the low-income building or construction of the improvement to the low-income building has been completed for purposes of IRC §266, a taxpayer may elect under IRC §266 and Treas. Reg. §1.266-1(b)(1)(ii) to capitalize to the building the interest attributable to these dwelling units that is incurred after the production period for the dwelling units for purposes of IRC §263A(f) has ended but before the development of the low-income building or construction of the improvement to the low-income building has been completed for purposes of IRC §266. See Treas. Reg. §1.266-(1)(a)(2).

### **Costs Excluded from Eligible Basis**

**IRC §42 Credit: Application & Allocation Fees** A state agency may charge a fee for submitting and processing the application for an allocation of IRC §42 credit, and if successful, may impose an allocation fee. These fees are excluded from eligible basis because the fees are not capitalizable into the adjusted basis of the building. See IRC §§263 and 263A. 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. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections. Rev. Rul. 2004-82.

**IRC §42 Credit: Cost Certifications** Under IRC §42(m)(2), the credit allocated by a state agency is not to exceed amount necessary to assure project feasibility and viability as a qualified low-income housing project throughout the credit period. To make sure only the credit necessary is allocated, the state agencies perform evaluations of the sources and uses of funds at three critical points of the development process: (1) when the taxpayer applies for the credit, (2) when the credit allocation is made, and (3) when the building is placed in service. The cost of preparing the cost certifications is excluded from eligible basis because this cost is incurred to secure an allocation of the IRC §42 credit and, therefore, is not capitalized to the basis of the building under IRC §263(a) or IRC §263A. The cost of preparing cost certifications may be associated with the creation of an intangible asset. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections.

**Compliance Monitoring** State agencies may charge taxpayers a fee to offset the cost of compliance monitoring under Treas. Reg. §1.42-5. The fees are an ordinary and necessary business expense under IRC §162 in the year the fee is incurred or paid. The cost is not depreciable and, therefore, is excluded from eligible basis.

**Management Fee**

“Rental management” is the continuing day-to-day management of the property, including all dealings with the tenants, leasing and renewal of current leases, procurement of new tenants for any vacancies, etc. Rental management fees are usually a set amount plus a percentage for any lease renewals and incentives for new tenants obtained to fill vacancies. Amounts paid for the original leasing of the units and continued management of the project should be expensed on a yearly basis and matched against current rental income. These fees are excluded from eligible basis.

**Partnership Organizational Costs**

The cost of organizing a partnership may be amortized over a period of time not less than 60 months under IRC §709(b). These costs are not included in adjusted basis for depreciation purposes and are, therefore, excluded from eligible basis.

Treas. Reg. §1.709-2(a) defines “organizational expenses” as expenses that are: (1) incident to the creation of the partnership; (2) chargeable to capital account; and (3) of a character that, if expended incident to the creation of a partnership having an ascertainable life, would (but for IRC §709(a)) be amortized over that life. An expenditure that fails to meet one or more of the three tests does not qualify as an organizational expense for purposes of IRC §709(b) and Treas. Reg. §1.709-2(a).

Examples of organizational expenses include legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. Examples of expenses that are not organizational expenses include costs to acquire assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

See TAM 200043017.

**Partnership Syndication Costs**

Treas. Reg. §1.709-2(b) defines “syndication expenses” as expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material.

These expenses are not subject to the election under IRC §709(b) and must be capitalized, and are not includable in adjusted basis for depreciation purposes. Therefore, partnership syndication costs are excluded from eligible basis. Rev. Rul. 85-32 explains that syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

See TAM 200043017.

**Acquiring Occupied Building: Tenant Relocation Costs**

**Cost Incurred to Permanently Relocate Nonqualifying Tenants:** A determination may be made that an existing tenant is not a qualified low-income household. In which case, the taxpayer may decide to move the tenant out of the unit permanently. In some cases, the taxpayer may rehabilitate the vacant unit. The costs attributable to moving out the tenant permanently (e.g.; legal costs, tenant moving expenses, and compensation paid to the tenant) are expensed as an ordinary and necessary business expense under IRC §162, even if the vacated unit is rehabilitated.

**Costs Incurred to Temporarily Relocate Qualifying Tenants During the Rehabilitation:** A determination may be made that an existing tenant is a qualified low-income household. In which case, the taxpayer will move the tenant and provide temporary housing while the tenant's unit is being rehabilitated. The temporary housing may be another unit within the project or off-site. The tenant is expected to occupy the rehabilitated unit after the rehabilitation is completed. The costs attributable to moving the tenant and providing temporary housing for the tenant during the rehabilitation (e.g.; legal costs, tenant moving expenses, costs for temporarily storing a tenant's property, and temporary housing costs) are expensed as ordinary and necessary business expenses under IRC §162.

**"Rent-Up" Marketing and Advertising Costs**

"Rent up" or "lease up" costs are the costs necessary to initially rent out a newly placed in service low-income housing building or project. Costs may include advertising, maintaining a model unit, providing housing for on-site rental managers and staff, and any other costs to fully rent out the buildings. Rent-up costs are not related to the construction of the buildings, but for securing tenants. These costs do not establish or add to the basis of depreciable property and are excluded from eligible basis.

See TAM 200043017.

**Miscellaneous Costs**

**Real Estate Taxes**

**Assumed Liability:** Delinquent real estate taxes assumed at acquisition are included in the basis of the land. *P.W. Havener*, 23 T.C.M. 539, Dec. 26,735(M), T.C. Memo. 1964-91. Therefore, the cost of delinquent real estate taxes assumed at acquisition is excluded from eligible basis.

**Incurred During Pre-Production Period:** When real property is acquired with the intent to develop it, real estate taxes paid are required to be capitalized under IRC §263A, even if no positive steps to begin developing the property has occurred. *Reichel v. Commissioner*, 112 T.C. 14 (1999).

**Incurred During Construction Period:** Real estate taxes incurred during the construction period and capitalizable to the low-income buildings under IRC §263A are included in eligible basis.

**Incurred After Buildings are Placed in Service:** Real estate taxes incurred after the buildings are placed in service are expensed as ordinary and necessary business expenses and are excluded from eligible basis.



**Carrying  
Charges Other  
Than Interest**

IRC §266 permits taxpayers to elect to capitalize certain otherwise deductible carrying charges paid or incurred with respect to improved but unproductive real property. A low-income building that has been placed in service may contain vacant units that have been rehabilitated and are available for rent but have not yet been rented out. A taxpayer may pay or incur payroll and utility costs attributable to those vacant units during the first year of the credit period. Under Rev. Rul. 71-475, 1971-2 C.B. 304, advertising expenses attributable to unproductive property, and maintenance and upkeep costs attributable to improved and unproductive real property, are not carrying charges chargeable to a capital account under IRC §266. Thus, payroll and utility costs attributable to those vacant units are not carrying charges for purposes of IRC §266.

However, carrying charges (other than interest) that are attributable to vacant units that have been rehabilitated for which the production period for purposes of IRC §263A(f) has ended, that are available for rent but have not yet been rented out, and are located in a low-income building that has been placed in service are capitalized to the building under IRC §263A as post-production costs. See Treas. Reg. §1.263A-2(a)(3)(iii).

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## Appendix D

### Treas. Reg. §1.103-8(b), Residential Rental Property

#### § 1.103-8(b) Residential Rental Property

**(b) Residential rental property** -- (1) General rule for obligations issued after April 24, 1979. Section 103(b)(1) [26 USCS § 103(b)(1)] shall not apply to any obligation which is issued after April 24, 1979, and is part of an issue substantially all of the proceeds of which are to be used to provide a residential rental project in which 20 percent or more of the units are to be occupied by individuals or families of low or moderate income (as defined in paragraph (b)(8)(v) of this section). In the case of a targeted area project, the minimum percentage of units which are to be occupied by individuals of low or moderate income is 15 percent. See generally § 1.103-7 for rules relating to refunding issues.

(2) Registration requirement. Any obligation (including any refunding obligation) issued after December 31, 1981, to provide a residential rental project must be issued as part of an issue, each obligation of which is in registered form (as defined in paragraph (b)(8)(ii) of this section).

(3) Transitional rule. For purposes of this section, obligations issued after April 24, 1979, may be treated as issued before April 25, 1979, if the transitional requirements of section 1104 of the Mortgage Subsidy Bond Tax Act of 1980 (94 Stat. 2670) are satisfied.

**(4) Residential rental project.** (i) In general. A residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly constructed units --

(a) Which are used on other than a transient basis, and

(b) Which satisfy the requirements of paragraph (b)(5)(i) of this section and are available to members of the general public in accordance with the requirement of paragraph (a)(2) of this section.

Substantially all of each project must contain such units and functionally related and subordinate facilities. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks and courts for use on a transient basis are not residential rental projects.

(ii) Multiple buildings. (a) Proximate buildings or structures (hereinafter "buildings") which have similarly constructed units are treated as part of the same project if they are owned for Federal tax purposes by the same person and if the buildings are financed pursuant to a common plan.

(b) Buildings are proximate if they are located on a single tract of land. The term "tract" means any parcel or parcels of land which are contiguous except for the interposition of a road, street, stream or similar property. Otherwise, parcels are contiguous if their boundaries meet at one or more points.

(c) A common plan of financing exists if, for example, all such buildings are provided by the same issue or several issues subject to a common indenture.

(iii) **Functionally related and subordinate facilities.** Under paragraph (a)(3) of this section, facilities that are functionally related and subordinate to residential rental projects include facilities for use by the tenants, for example, swimming pools, other recreational facilities, parking areas, and other facilities which are reasonably required for the project, for example, heating and cooling equipment, trash disposal equipment or units for resident managers or maintenance personnel.

(iv) Owner-occupied residences. For purposes of section 103 (b)(4)(A) [26 USCS § 103(b)(4)(A)] and this paragraph (b), the term "residential rental project" does not include any building or structure which contains fewer than five units, one unit of which is occupied by an owner of the units.

(5) **Requirement must be continuously satisfied** -- (i) Rental requirement. Once available for occupancy, each unit (as defined in paragraph (b)(8)(i) of this section) in a residential rental project must be rented or available for rental on a continuous basis during the longer of --

(a) The remaining term of the obligation, or

(b) The qualified project period (as defined in paragraph (b)(7) of this section).

(ii) Low or moderate income occupancy requirement. Individuals or families of low or moderate income must occupy that percentage of completed units in such project applicable to the project under paragraph (b)(1) of this section continuously during the qualified project period. For this purpose, a unit occupied by an individual or family who at the commencement of the occupancy is of low or moderate income is treated as occupied by such an individual or family during their tenancy in such unit, even though they subsequently cease to be of low or moderate income. Moreover, such unit is treated as occupied by an individual or family of low or moderate income until reoccupied, other than for a temporary period, at which time the character of the unit shall be redetermined. In no event shall such temporary period exceed 31 days.

(6) Effect of post-issuance noncompliance -- (i) In general. Unless corrected within a reasonable period, noncompliance with the requirements of this paragraph (b) shall cause the project to be treated as other than a project described in section 103 (b)(4)(A) [26 USCS § 103(b)(4)(A)] and this paragraph (b) as of the date of issue. After an issue to provide such project ceases to qualify, subsequent conformity with the requirements will not alter the taxable status of such issue.

(ii) Correction of noncompliance. If the issuer corrects any noncompliance arising from events occurring after the issuance of the obligation within a reasonable period, such noncompliance (e.g., an unauthorized sublease) shall not cause the project to be a project not described in this paragraph (b). A reasonable period is at least 60 days after such error is first discovered or would have been discovered by the exercise of reasonable diligence.

(iii) Involuntary loss. (a) The requirements of paragraph (b) shall cease to apply to a project in the event of involuntary noncompliance caused by fire, seizure, requisition, foreclosure, transfer of title by deed in lieu of foreclosure, change in a Federal law or an action of a Federal agency after the date of issue which prevents an issuer from enforcing the requirements of this paragraph, or condemnation or similar event but only if, within a reasonable period, either the obligation used to provide such project is retired or amounts received as a consequence of such event are used to provide a project which meets the requirement of section 103 (b)(4)(A) [26 USCS § 103(b)(4)(A)] and this paragraph (b).

(b) The provisions of paragraph (b)(6)(iii)(a) of this section shall cease to apply to a project subject to foreclosure, transfer of title by deed in lieu of foreclosure or similar event if, at anytime during that part of the qualified project period subsequent to such event, the obligor on the acquired purpose obligation (as defined in § 1.103-13(b)(4)(iv)(a)) or a related person (as defined in § 1.103-10(e)) obtains an ownership interest in such project for tax purposes.

(7) Qualified project period. The term "qualified project period" means --

(i) For obligations issued after April 24, 1979, and prior to September 4, 1982, a period of 20 years commencing on the later of the date that the project becomes available for occupancy or the date of issue of the obligations. The requirement of paragraph (b)(5)(ii) of this section shall be deemed met if the owner of the project contracts with a Federal or state agency to maintain at least 20 percent (or 15 percent in the case of targeted areas) of the units for low or moderate income individuals or families (as defined in paragraph (b)(8)(v) of this section) for 20 years in consideration for rent subsidies for such individuals or families for such period.

(ii) For obligations issued after September 3, 1982, a period beginning on the later of the first day on which at least 10 percent of the units in the project are first occupied or the date of issue of an obligation described in section 103(b)(4)(A) [26 USCS § 103(b)(4)(A)] and this paragraph and ending on the later of the date --

(a) Which is 10 years after the date on which at least 50 percent of the units in the project are first occupied,

(b) Which is a qualified number of days after the date on which any of the units in the project is first occupied, or

(c) On which any assistance provided with respect to the project under section 8 of the United States Housing Act of 1937 terminates.

For purposes of this paragraph (b)(7)(ii), the term "qualified number of days" means 50 percent of the total number of days comprising the term of the obligation with the longest maturity in the issue used to provide the project. In the case of a refunding of such an issue, the longest maturity is equal to the sum of the period the prior issue was outstanding and the longest term of any refunding obligations.

(8) Other definitions. For purposes of this paragraph --

(i) **Unit. 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. Thus, 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.

(ii) In registered form. The term "in registered form" has the same meaning as in section 6049 [26 USCS § 6049]. With respect to obligations issued after December 31, 1982, such term shall have the same meaning as prescribed in section 103(j) [26 USCS § 103(j)] (including the regulations thereunder).

(iii) Targeted area project. The term "targeted area project" means a project located in a qualified census tract (as defined in § 6a.103A-2(b)(4)) or an area of chronic economic distress (as defined in § 6a.103A-2(b)(5)).

(iv) **Building or structure.** The term "building or structure" generally means a discrete edifice or other man-made construction consisting of an independent foundation, outer walls, and roof. A single unit which is not an entire building but is merely a part of a building is not a building or structure within the meaning of this section. As such, while single townhouses are not buildings if their foundation, outer walls, and roof are not independent, detached houses and rowhouses are buildings.

(v) Low or moderate income. Individuals and families of low or moderate income shall be determined in a manner consistent with determinations of lower income families under section 8 of the United States Housing Act of 1937, as amended, except that the percentage of median gross income which qualifies as low or moderate income shall be 80 percent. Therefore, occupants of a unit are considered individuals or families of low or moderate income only if their adjusted income (computed in the manner prescribed with § 1.167(k)-3(b)(3)) does not exceed 80 percent of the median gross income for the area. Notwithstanding the foregoing, the occupants of a unit shall not be considered to be of low or moderate income if all the occupants are students (as defined in section 151(e)(4) [26 USCS § 151(e)(4)]), no one of whom is entitled to file a joint return under section 6013 [26 USCS § 6013]. The method of determining low or moderate income in effect on the date of issue will be determinative for such issue, even if such method is subsequently changed. In the event programs under § 8(f) of the Housing Act of 1937, as amended, are terminated prior to the date of issue, the applicable method shall be that in effect immediately prior to the date of such termination.

(9) Examples. The following examples illustrate the application of this paragraph (b).

Example (1). In August 1982, City X issues \$ 10 million of registered bonds with a term of 20 years to be used to finance the construction of an apartment building to be available to members of the general public. X loans the proceeds of the bonds to Corporation M, the tax owner of the project. The loan is secured by a promissory note from M and a mortgage on the project. The mortgage requires annual payments sufficient to amortize the principal and interest on the bonds. Corporation M maintains 20 percent of the units in the project for low or moderate income individuals and meets all of the requirements of this section until 2002, at which time M converts the project to offices. The bonds are industrial development bonds, but because the proceeds are used for construction of residential rental property, which is an exempt facility under section 103(b)(4)(A) [26 USCS § 103(b)(4)(A)] and paragraph (b) of this section, section 103(b)(1) [26 USCS § 103(b)(1)] does not apply.

Example (2). The facts are the same as in example (1), except that the building is constructed adjacent to a factory, and the factory employees are to be given preference in selecting tenants. The bonds are industrial development bonds and the facility is not an exempt facility under section 103(b)(4)(A) [26 USCS § 103(b)(4)(A)] and paragraph (b) of this section because it is not a facility constructed for use by the general public.

Example (3). The facts are the same as in example (1), except that the proceeds of the obligation are provided to N, a cooperative housing corporation, to finance the construction of a cooperative housing project. N sells stock in such cooperative to shareholders, some of whom occupy the units in the cooperative and some of whom rent the units to other persons. Such project is not a residential rental project within the meaning of section 103(b)(4)(A) [26 USCS § 103(b)(4)(A)] and § 1.103-8(b) because less than all of the units in the building are used for rental. Further, the bonds are mortgage subsidy bonds under section 103A [26 USCS § 103A] because more than a significant portion of the proceeds are used to provide financing for residences, some of which are owner-occupied and some of which are used in the trade or business of rental.

Example (4). On February 1, 1984, County Z issues registered obligations with a term of 3 years and loans the proceeds to Corporation V to construct a garden apartment project for tenants who are 65 years or older. The mortgage on the project secures the loan. At the end of 3 years, V obtains permanent financing for the project from a commercial lender. The project is not a targeted area project. V has not contracted with any Federal or state agency to provide rental assistance under section 8 of the United States Housing Act of 1937. As a condition for providing financing for construction, Z requires that the deed to the project contain a covenant that requires the project be used for elderly tenants and restricts occupancy of 20 percent of the units in the project to individuals or families of low or moderate income. Further, the deed provides that "Such covenant shall run with and bind the land, from the date that ten percent of the units in the project are first occupied until ten years after the date that at least half the units are first occupied. The right to enforce these restrictions is vested in County Z." In 1990, however, less than 20 percent of the units are occupied by families or individuals of low or moderate incomes, and three months after learning of this condition County Z had not commenced enforcement of the covenant. Although on the date of issue the proceeds of the obligation were used to provide a residential rental project, the obligation will not be treated as providing a residential rental project within the meaning of section 103(b)(4)(A) [26 USCS § 103(b)(4)(A)] as of February 1, 1984, because the project did not meet the requirements of this paragraph for at least 10 years after at least 50 percent of the units are first occupied.

Example (5). On January 15, 1983, State X issues registered obligations with a term of 15 years, the proceeds of which are loaned to Corporation P to construct an apartment building. The project will be a "targeted area project", within the meaning of § 1.103-8(b)(8)(iii). Corporation P intends to rent all the units to individuals for their residences, maintaining 15 percent of the units in the project for individuals having low or moderate incomes, for 15 years. In 1988, however, Corporation P converts 80 percent of the units to condominiums. Corporation P repays the loan to State X which, in turn, redeems the obliga-

tions. The obligations are not used to provide a residential rental project within the meaning of section 103(b)(4)(A) [26 *USCS* § 103(b)(4)(A)], and all the interest paid or to be paid on such obligations will be includable in gross income.

Example (6). On January 15, 1984, State Z issues registered obligations with a term of 15 years the proceeds of which will be used to acquire and renovate a residential apartment building. Z sells the project to Corporation U and receives a 30-year mortgage. On June 1, 1985, the first occupants of the project commence their tenancies. At least 50 percent of the units in the project are occupied on July 1, 1985. On January 15, 1988, Z issues 35-year refunding bonds the proceeds of which are used to retire the obligations issued in 1984. The prior issue will be discharged by March 15, 1988. In order to meet the requirement of § 1.103-8(b)(5)(ii), at least 20 percent of such units must be occupied by individuals of low or moderate income until January 1, 2005.

Example (7). The facts are the same as in example (6) except that in 1987, the apartment building is substantially destroyed by fire. The building was insured at its fair market value. U does not intend to reconstruct the building but uses a portion of the insurance proceeds to repay the unpaid balance of the mortgage. Z uses this amount to redeem the outstanding bonds at the first available call date. Since the project was substantially destroyed by fire and the outstanding bonds are retired at the first available call date, the requirements of section 103(b)(4)(A) [26 *USCS* § 103(b)(4)(A)] and this paragraph (b) are satisfied with respect to the obligations.

Example (8). The facts are the same as in example (6) except that in 1987 U defaults on the mortgage, and Z obtains title to the project without instituting foreclosure proceedings. Z sells the project to S and uses the proceeds to retire the outstanding bonds. Since S did not obtain the project with obligations described in section 103(b)(4) [26 *USCS* § 103(b)(4)], S is not required to meet the requirements of section 103(b)(4)(A) [26 *USCS* § 103(b)(4)(A)] and this paragraph. Further, the 1984 obligations are obligations described in section 103(b)(4)(A) [26 *USCS* § 103(b)(4)(A)].

Example (9). In September 1983, State W issues \$ 10 million of registered bonds with a term of 3 years, the proceeds of which are to be loaned to Corporation V to finance the construction of an apartment building in a rural community. At the end of 3 years, V obtains permanent financing from Federal Agency T. Agency T will not allow the deed to contain any restrictive covenant relating to the use of the project. Under Federal law, however, T requires that V maintain all of the units in the project for rental to low-income farmworkers for the term of the mortgage, which is 20 years. Further, the mortgage between T and V provides that if T determines that low-income housing is no longer required in the community in which the project is constructed then the repayment of the mortgage may be accelerated. T determines as of the date of issue that low-income housing will be needed in the community for at least 20 years. In 1987, the project fails to meet the requirements of section 1.103-8(b)(5)(ii), relating to occupancy by individuals or families of low or moderate income. Further, T does not require V to correct the failure. Based on the foregoing, the bonds issued by W will be treated as described in section 103(b)(4)(A) [26 *USCS* § 103(b)(4)(A)].

Example (10). The facts are the same as in example (9) except that in 1987, the Federal law is amended to provide that Agency T may not enforce its low-income occupancy requirement. The result is the same.

Example (11). The facts are the same as in example (9) except that in 1987 Agency T determines that due to a change in circumstances in the community in which the project is located low-income rental housing is no longer required. As such, T requires V to repay the mortgage. Since the obligations have been repaid, W has no legal right to enforce the requirements of paragraph (b) with respect to the project. Subsequent nonconformity of the project with the requirements of § 1.103-8(b) under these circumstances will not cause the obligations issued by W to be industrial development bonds within the meaning of section 103(b)(1) [26 *USCS* § 103(b)(1)].

(10) Obligations issued before April 25, 1979 -- (i) General rules. Section 103(b)(1) [26 USCS § 103(b)(1)] shall not apply to obligations issued before April 25, 1979, which are part of an issue substantially all of the proceeds of which are to be used to provide residential real property for family units. In order to qualify under this paragraph (b) as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public.

(ii) Family units defined. For purposes of this paragraph (b) the term "family unit" means a building or any portion thereof which contains complete living facilities which are to be used on other than a transient basis by one or more persons, and facilities functionally related and subordinate thereto. Thus, an apartment which is to be used on other than a transient basis as a residence by a single person or by a family and which contains complete facilities for living, sleeping, eating, cooking, and sanitation, constitutes a family unit. Such a unit may be served by centrally located machinery and equipment as in a typical apartment building. To qualify as a family unit, the living facilities must be a separate, self-contained building or constitute one unit in a building substantially all of which consists of similar units, together with functionally related and subordinate facilities and areas. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, sanitariums, rest homes, and trailer parks and courts for use on a transient basis do not constitute residential real property for family units.

(iii) Functionally related and subordinate facilities. Under paragraph (a)(3) of this section, facilities which are functionally related and subordinate to residential real property actually used for family units include, for example, facilities for use by the occupants such as a swimming pool, a parking area, and recreational facilities.



## **Appendix E**

### **Recordation and Documentation Requirements**

This appendix provides an overview of recordation and documentation requirements applicable to taxpayers owning IRC §42 projects.

#### **General Documentation Requirement**

**IRC §6001**      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. §1.6001-1(a)**      Treas. Reg. §1.6001-1(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.

#### **IRC §42 Documentation Requirements**

**Treas. Reg. §1.42-5**      The IRS has also provided guideline for retaining records specific to claiming IRC §42 credit in Treas. Reg. §1.42-5(b)(1). 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:

1. 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);
2. The percentage of residential rental units in the building that are low-income units;
3. The rent charged on each residential rental unit in the building (including any utility allowances);

4. The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under IRC §42(g)(2) (as in effect before the amendments made by the Omnibus Budget Reconciliation Act of 1989);
5. The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;
6. The annual income certification of each low-income tenant per unit. There is an exception to this requirement under IRC §42(g)(8)(B), which provides a special rule for a 100% low-income building. 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.
7. 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 IRC §42(g)(8)(B) and the note for (6) above. In the case of a tenant receiving housing assistance payments under section 8 of the United States Housing Act of 1937, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit.
8. The eligible basis and qualified basis of the building at the end of the first year of the credit period; and
9. The character and use of the nonresidential portion of the building included in the building's eligible basis under IRC §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, facilities reasonably required by the project, or community service facilities).

**Record Retention**

Treas. Reg. §1.42-5(b)(2) is the record retention provision under which a taxpayer owning 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), taxpayers are subject to an inspection record retention provision. The owner of a low-income housing project is 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.

**Utility Allowances**

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).

**Electronic Records**

**Storing Records Electronically**

The IRS has also addressed the feasibility of using electronic storage options. In Rev. Rul. 2004-82, Q&A #11 (immediately below), 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 Treas. Reg. §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 IRC §6001.

However, complying with the Service's recordkeeping and record retention requirements does not exempt a taxpayer 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.

**Alternative Sources of Information**

**Alternative Sources of Information**

In cases where a taxpayer does not have its own books and records created concurrently with a transaction, consideration should be given to using alternative sources of information, accepting credible oral testimony, or relying on documentation from third parties. Examiners should evaluate whether the source of the information is credible, as well as whether the facts and information gathered from alternative sources make sense and are sufficient.

**Accountant's Workpapers**

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.

However, the accountant's workpapers may be unavailable or simply not include information about the issue being considered. Further, the accountant's audit workpapers may not be 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 are sufficiently detailed. 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 the services provided, and were development costs properly allocated between land, land improvements, and the low-income buildings.

**Appendix F**  
**Supreme Court of the United States**  
**United States v. Boyle, Executor of the Estate of Boyle**  
**469 U.S. 241**

**Summary and  
Relevance**

This case involves the failure to timely file an estate tax return. Under IRC §6075(a) the deadline for all estate tax returns is within 9 months of the decedent's death. Late filing incurs a penalty. To escape the penalty, the taxpayer bears the burden of proving under IRC §6651(a)(1) both (1) that the failure did not result from willful neglect, and (2) that the failure was due to reasonable cause.

The United States Supreme Court granted certiorari to this case to resolve a conflict among the Circuits. The Supreme Court ultimately reversed the United States Court of Appeals for the Seventh Circuit. 710 F.2d 1251 (7<sup>th</sup> Cir. 1983), which had affirmed the decision of the United States District Court for the Central District of Illinois granting a summary judgment to the taxpayer. In the Supreme Court's majority opinion, it was held that a taxpayer's reliance on an attorney to prepare and file a tax return does not constitute "reasonable cause" under IRC §6651(a)(1) which will excuse the taxpayer from payment of a penalty for late filing.

This case is relevant in the IRC §42 context because the same principle applies when considering a taxpayer's filing requirement under IRC §42(l)(1); i.e., the First-Year Certification. See Chapter 4. The flush language following IRC §42(l)(1)(E) reads:

In the case of a failure to make the certification required by the preceding sentence on the date prescribed therefore, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable by reason of subsection (a) with respect to such building for any taxable year ending before such certification is made.

**Majority  
Opinion**

We granted certiorari to resolve a conflict among the Circuits on whether a taxpayer's reliance on an attorney to prepare and file a tax return constitutes "reasonable cause" under IRC §6651(a)(1), so as to defeat a statutory penalty incurred because of a late filing.

Respondent, Robert W. Boyle, was appointed executor of the will of his mother, Myra Boyle, who died on September 14, 1978; respondent retained Ronald Keyser to serve as attorney for the estate. Keyser informed respondent that the estate must file a federal estate tax return, but he did not mention the deadline for filing this return. Under IRC §6075(a), the return was due within nine months of the decedent's death; i.e., not later than June 14, 1979.

Although a businessman, respondent was not experienced in the field of federal estate taxation, other than having been executor of his father's will 20 years earlier. It is undisputed that he relied on Keyser for instruction and guidance. He cooperated fully with his attorney and provided Keyser with all relevant information and records. Respondent and his wife contacted Keyser a number of times during the spring and summer of 1979 to inquire about the progress of the proceedings and the preparation of the tax return; they were assured that they

would be notified when the return was due and that the return would be filed “in plenty of time.” When respondent called Keyser on September 6, 1979, he learned for the first time that the return was by then overdue. Apparently, Keyser had overlooked the matter because of a clerical oversight in omitting the filing date from Keyser's master calendar. Respondent met with Keyser on September 11, and the return was filed on September 13, three months late.

Acting pursuant to IRC §6652(a)(1), the Internal Revenue Service assessed against the estate an additional tax of \$ 17,124.45 as a penalty for the late filing, with \$1,326.56 in interest. IRC 6651(a)(1) reads in pertinent part:

“In case of failure . . . to file any return . . . on the date prescribed therefore . . . , *unless it is shown that such failure is due to reasonable cause and not due to willful neglect*, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate. . . .” (Emphasis added.)

A Treasury Regulation provides that, to demonstrate “reasonable cause,” a taxpayer filing a late return must show that he “exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time.” Treas. Reg. §301.6651-1(c)(1) (1984). [See Footnote 1]

Respondent paid the penalty and filed a claim for a refund. He conceded that the assessment for interest was proper, but contended that the penalty was unjustified because his failure to file the return on time was “due to reasonable cause;” i.e., reliance on his attorney. Respondent brought suit in the United States District Court, which concluded that the claim was controlled by the Court of Appeals’ holding in *Rohrbaugh v. United States*, 611 F.2d 211 (CA7 1979). In *Rohrbaugh*, the United States Court of Appeals for the Seventh Circuit held that reliance upon counsel constitutes “reasonable cause” under IRC §6651(a)(1) when: (1) the taxpayer is unfamiliar with the tax law; (2) the taxpayer makes full disclosure of all relevant facts to the attorney that he relies upon, and maintains contact with the attorney from time to time during the administration of the estate; and (3) the taxpayer has otherwise exercised ordinary business care and prudence. 611 F.2d at 215, 219.

The District Court held that, under *Rohrbaugh*, respondent had established “reasonable cause” for the late filing of his tax return; accordingly, it granted summary judgment for respondent and ordered refund of the penalty. A divided panel of the Seventh Circuit, with three opinions, affirmed. 710 F.2d 1251 (1983).

We granted certiorari, 466 U.S. 903 (1984), and we reverse.

Congress’ purpose in the prescribed civil penalty was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly. The relevant statutory deadline provision is clear; it mandates that all federal estate tax returns be filed within nine months from the decedent's death, IRC §6075(a). [See Footnote 2.] Failure to comply incurs a penalty of 5 percent of the ultimately determined tax for each month the return is late, with a maximum of 25 percent of the base tax. To escape the penalty, the taxpayer bears the heavy burden of proving

both (1) that the failure did not result from “willful neglect,” and (2) that the failure was “due to reasonable cause.” IRC §6651(a)(1).

The meaning of these two standards has become clear over the near-70 years of their presence in the statutes. [See Footnote 3] As used here, the term “willful neglect” may be read as meaning a conscious, intentional failure or reckless indifference. See *Orient Investment & Finance Co. v. Commissioner*, 83 U.S. App. D.C. 74, 75, 166 F.2d 601, 602 (1948); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628, 634 (CA3 1947); *Janice Leather Imports Ltd. v. United States*, 391 F. Supp. 1235, 1237 (SDNY 1974); *Gemological Institute of America, Inc. v. Riddell*, 149 F. Supp. 128, 131-132 (SD Cal. 1957).

Like “willful neglect,” the term “reasonable cause” is not defined in the Code, but the relevant Treasury Regulation calls on the taxpayer to demonstrate that he exercised “ordinary business care and prudence” but nevertheless was “unable to file the return within the prescribed time.” [See Footnote 4.] Treas. Reg. §301.6651(c)(1) (1984); accord, e.g., *Fleming v. United States*, 648 F.2d 1122, 1124 (CA7 1981); *Ferrando v. United States*, 245 F.2d 582, 587 (CA9 1957); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 770 (CA2 1950); *Southeastern Finance Co. v. Commissioner*, 153 F.2d 205 (CA5 1946); *Girard Investment Co. v. Commissioner*, 122 F.2d 843, 848 (CA3 1941); see also Footnote 1, supra. The Commissioner does not contend that respondent’s failure to file the estate tax return on time was willful or reckless. The question to be resolved is whether, under the statute, reliance on an attorney in the instant circumstances is a “reasonable cause” for failure to meet the deadline.

In affirming the District Court, the Court of Appeals recognized the difficulties presented by its formulation but concluded that it was bound by *Rohrbaugh v. United States*, 611 F.2d 211 (CA7 1979). The Court of Appeals placed great importance on the fact that respondent engaged the services of an experienced attorney specializing in probate matters and that he duly inquired from time to time as to the progress of the proceedings. As in *Rohrbaugh*, see *id.*, at 219, the Court of Appeals in this case emphasized that its holding was narrowly drawn and closely tailored to the facts before it. The court stressed that the question of “reasonable cause” was an issue to be determined on a case-by-case basis. See 710 F.2d at 1253-1254; *id.*, at 1254 (Coffey, J., concurring).

Other Courts of Appeals have dealt with the issue of “reasonable cause” for a late filing and reached contrary conclusions. [See Footnote 5.] In *Ferrando v. United States*, 245 F.2d 582 (CA9 1957), the court held that taxpayers have a personal and nondelegable duty to file a return on time, and that reliance on an attorney to fulfill this obligation does not constitute “reasonable cause” for a tardy filing. *Id.*, at 589. The Fifth Circuit has similarly held that the responsibility for ensuring a timely filing is the taxpayer’s alone, and that the taxpayer’s reliance on his tax advisers -- accountants or attorneys -- is not a “reasonable cause.” *Millette & Associates v. Commissioner*, 594 F.2d 121, 124-125 (per curiam), cert. denied, 444 U.S. 899, 62 L. Ed. 2d 135, 100 S. Ct. 207 (1979); *Logan Lumber Co. v. Commissioner*, 365 F.2d 846, 854 (1966). The Eighth Circuit also has concluded that reliance on counsel does not constitute “reasonable cause.” *Smith v. United States*, 702 F.2d 741, 743 (1983) (per curiam); *Boeving v. United States*, 650 F.2d 493, 495 (1981); *Estate of Lillehei v. Commissioner*, 638 F.2d 65, 66 (1981) (per curiam).

We need not dwell on the similarities or differences in the facts presented by the conflicting holdings. The time has come for a rule with as “bright” a line as can be drawn consistent with the statute and implementing regulations. [See Footnote 6.] Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. [See Footnote 7.] Prompt payment of taxes is imperative to the Government, which should not have to assume the burden of unnecessary ad hoc determinations. [See Footnote 8.]

Congress has placed the burden of prompt filing on the executor, not on some agent or employee of the executor. The duty is fixed and clear; Congress intended to place upon the taxpayer an obligation to ascertain the statutory deadline and then to meet that deadline, except in a very narrow range of situations. Engaging an attorney to assist in the probate proceedings is plainly an exercise of the “ordinary business care and prudence” prescribed by the regulations, Treas. Reg. §301.6651-1(c)(1) (1984), but that does not provide an answer to the question we face here. To say that it was “reasonable” for the executor to assume that the attorney would comply with the statute may resolve the matter as between them, but not with respect to the executor’s obligations under the statute. Congress has charged the executor with an unambiguous, precisely defined duty to file the return within nine months; extensions are granted fairly routinely. That the attorney, as the executor’s agent, was expected to attend to the matter does not relieve the principal of his duty to comply with the statute.

This case is not one in which a taxpayer has relied on the erroneous advice of counsel concerning a question of law. Courts have frequently held that “reasonable cause” is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken. See, e. g., *United States v. Kroll*, 547 F.2d 393, 395-396 (CA7 1977); *Commissioner v. American Assn. of Engineers Employment, Inc.*, 204 F.2d 19, 21 (CA7 1953); *Burton Swartz Land Corp. v. Commissioner*, 198 F.2d 558, 560 (CA5 1952); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d at 771; *Orient Investment & Finance Co. v. Commissioner*, 83 U.S. App. D.C. at 75, 166 F.2d at 603; *Hatfried, Inc. v. Commissioner*, 162 F.2d at 633-635; *Girard Investment Co. v. Commissioner*, 122 F.2d at 848; *Dayton Bronze Bearing Co. v. Gilligan*, 281 F. 709, 712 (CA6 1922). This Court also has implied that, in such a situation, reliance on the opinion of a tax adviser may constitute reasonable cause for failure to file a return. See *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 88 L. Ed. 684, 64 S. Ct. 511 (1944) (remanding for determination whether failure to file return was due to reasonable cause, when taxpayer was advised that filing was not required). [See Footnote 9.]

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a “second opinion,” or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. See *Haywood Lumber*, supra.. “Ordinary business care and prudence” do not demand such actions.



By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute. Among the first duties of the representative of a decedent's estate is to identify and assemble the assets of the decedent and to ascertain tax obligations. Although it is common practice for an executor to engage a professional to prepare and file an estate tax return, a person experienced in business matters can perform that task personally. It is not unknown for an executor to prepare tax returns, take inventories, and carry out other significant steps in the probate of an estate. It is even not uncommon for an executor to conduct probate proceedings without counsel.

It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for a late filing under IRC §6651(a)(1). The judgment of the Court of Appeals is reversed. It is so ordered.

**Concurring  
Opinion**

[T]he judgment must be reversed. Although the standard of taxpayer liability found in IRC §6651(a)(1) might plausibly be characterized as ambiguous, [See Footnote 10.] courts and the Internal Revenue Service have for almost 70 years interpreted the statute as imposing a standard of "ordinary business care and prudence." I agree with the Court that we should defer to this longstanding construction. [See Footnote 4.] I also agree that taxpayers in the exercise of ordinary business care and prudence must ascertain relevant filing deadlines and ensure that those deadlines are met. As the Court correctly holds, a taxpayer cannot avoid the reach of IRC §6651(a)(1) merely by delegating this duty to an attorney, accountant, or other individual. [See Footnote 11.]

I write separately, however, to underscore the importance of an issue that the Court expressly leaves open. Specifically, I believe there is a substantial argument that the "ordinary business care and prudence" standard is applicable only to the "ordinary person" -- namely, one who is physically and mentally capable of knowing, remembering, and complying with a filing deadline. In the instant case, there is no question that the respondent not only failed to exercise ordinary business care in monitoring the progress of his mother's estate, but also made no showing that he was unable to exercise the usual care and diligence required of an executor. The outcome could be different if a taxpayer were able to demonstrate that, for reasons of incompetence or infirmity, he understandably was unable to meet the standard of ordinary business care and prudence. In such circumstances, there might well be no good reason for imposing the harsh penalty of IRC §6651(a)(1) over and above the prescribed statutory interest penalty. See IRC §§ 6601(a), 6621(b).

The Court proclaims the need "for a rule with as "bright" a line as can be drawn," and it stresses that the Government "should not have to assume the burden of unnecessary ad hoc determinations." On the other hand, it notes that the "bright line" might not cover a taxpayer who is "incapable by objective standards of meeting the criteria of "ordinary business care and prudence," reasoning that "the disability alone could well be an acceptable excuse for a late filing." [See Footnote 6.]

I share the Court's reservations about the sweep of its "bright line" rule. If the Government were determined to draw a "bright line" and to avoid the "burden" of "ad hoc determinations," it would not provide for any exemptions from the penalty provision. Congress has emphasized, however, that exemptions must be made where a taxpayer demonstrates "reasonable cause." IRC §6651(a)(1). Accordingly, the IRS already allows dispensations where, for example, a taxpayer or a member of his family has been seriously ill, the taxpayer has been unavoidably absent, or the taxpayer's records have been destroyed. Internal Revenue Manual (CCH) §4350, (22) para. 22.2(2) (Mar. 20, 1980) (Audit Technique Manual for Estate Tax Examiners). Thus the Government itself has eschewed a bright-line rule and committed itself to necessarily case-by-case decision making. The gravamen of the IRS's exemptions seems to be that a taxpayer will not be penalized where he reasonably was unable to exercise ordinary business care and prudence. The IRS does not appear to interpret its enumerated exemptions as being exclusive, see *id.*, para. 22.2(3), and it might well act arbitrarily if it purported to do otherwise. [See Footnote 12.] Thus a substantial argument can be made that the draconian penalty provision should not apply where a taxpayer convincingly demonstrates that, for whatever reason, he reasonably was unable to exercise ordinary business care.

Many executors are widows or widowers well along in years, and a penalty against the "estate" usually will be a penalty against their inheritance. Moreover, the principles we announce today will apply with full force to the personal income tax returns required of every individual who receives an annual gross income of \$1,000 or more. See IRC §6651(a)(1); see also §6012. Although the overwhelming majority of taxpayers are fully capable of understanding and complying with the prescribed filing deadlines, exceptional cases necessarily will arise where taxpayers, by virtue of senility, mental retardation, or other causes, are understandably unable to attain society's norm. The Court today properly emphasizes the need for efficient tax collection and stern incentives. But it seems to me that Congress and the IRS already have made the decision that efficiency should yield to other values in appropriate circumstances.

Because the respondent here was fully capable of meeting the required standard of ordinary business care and prudence, we need not decide the issue of whether and under what circumstances a taxpayer who presents evidence that he was unable to adhere to the required standard might be entitled to relief from the penalty.

**Footnotes from  
the Opinion**

1. The Internal Revenue Service has articulated eight reasons for a late filing that it considers to constitute "reasonable cause." These reasons include unavoidable postal delays, the taxpayer's timely filing of a return with the wrong IRS office, the taxpayer's reliance on the erroneous advice of an IRS officer or employee, the death or serious illness of the taxpayer or a member of his immediate family, the taxpayer's unavoidable absence, destruction by casualty of the taxpayer's records or place of business, failure of the IRS to furnish the taxpayer with the necessary forms in a timely fashion, and the inability of an IRS representative to meet with the taxpayer when the taxpayer makes a timely visit to an IRS office in an attempt to secure information or aid in the preparation of a return. Internal Revenue Manual (CCH) §4350, (22) para. 22.2(2) (Mar. 20, 1980) (Audit Technique Manual for Estate Tax Examiners). If the cause asserted by the taxpayer does not implicate any of these eight reasons, the district director determines whether the asserted cause is

reasonable. “A cause for delinquency which appears to a person of ordinary prudence and intelligence as a reasonable cause for delay in filing a return and which clearly negatives willful neglect will be accepted as reasonable.” *Id.*, para. 22.2(3).

2. IRC 6081(a) authorizes the IRS to grant “a reasonable extension of time,” generally no longer than six months, for filing any return.
3. Congress added the relevant language to the tax statutes in 1916. For many years before that, IRC §3176 mandated a 50 percent penalty “in case of a refusal or neglect, except in cases of sickness or absence, to make a list or return, or to verify the same. . . .” Rev. Stat. §3176 (emphasis added). The Revenue Act of 1916 amended this provision to require the 50 percent penalty for failure to file a return within the prescribed time, “except that, when a return is voluntarily and without notice from the collector filed after such time and it is shown that the failure to file it was *due to a reasonable cause and not due to willful neglect*, no such addition shall be made to the tax.” Revenue Act of 1916, ch. 463, §16, 39 Stat. 756, 775 (emphasis added). No committee reports or congressional hearings or debates discuss the change in language. It would be logical to assume that Congress intended “willful neglect” to replace “refusal” - - both expressions implying intentional failure -- and “[absence of] reasonable cause” to replace “neglect” -- both expressions implying carelessness.
4. Respondent contends that the statute must be construed to apply a standard of willfulness only, and that the Treasury Regulation is incompatible with this construction of the statute. He argues that the Regulation converts the statute into a test of “ordinary business care,” because a taxpayer who demonstrates ordinary business care can never be guilty of “willful neglect.” By construing “reasonable cause” as the equivalent of “ordinary business care,” respondent urges, the IRS has removed from consideration any question of willfulness. We cannot accept this reasoning. Congress obviously intended to make absence of fault a prerequisite to avoidance of the late-filing penalty. [See Footnote 3, *supra*.] A taxpayer seeking a refund must therefore prove that his failure to file on time was the result neither of carelessness, reckless indifference, nor intentional failure. Thus, the Service’s correlation of “reasonable cause” with “ordinary business care and prudence” is consistent with Congress’ intent, and over 40 years of case law as well. That interpretation merits deference. See, e.g., *Chevron U. S. A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844, 81 L. Ed. 2d 694, 104 S. Ct. 2778, and n. 14 (1984).
5. Although at one point the Court of Appeals for the Sixth Circuit held that reliance on counsel could constitute reasonable cause, see *In re Fisk’s Estate*, 203 F.2d 358, 360 (1953), the Sixth Circuit appears now to be following those courts that have held that the taxpayer has a nondelegable duty to ascertain the deadline for a return and ensure that the return is filed by that deadline. See *Estate of Geraci v. Commissioner*, 1973 T.C. Memo 94, 32 T.C.M. (CCH) 424, 425 (1973), *aff’d*, 502 F.2d 1148 (CA6 1974), *cert. denied*, 420 U.S. 992, 43 L. Ed. 2d 673, 95 S. Ct. 1428 (1975); *Estate of Duttonhofer v. Commissioner*, 49 T.C. 200, 205 (1967), *aff’d*, 410 F.2d 302 (CA6 1969) (*per curiam*).

6. The administrative regulations and practices exempt late filings from the penalty when the tardiness results from postal delays, illness, and other factors largely beyond the taxpayer's control. [See Footnote 1.] The principle underlying the IRS regulations and practices -- that a taxpayer should not be penalized for circumstances beyond his control -- already recognizes a range of exceptions which there is no reason for us to pass on today. This principle might well cover a filing default by a taxpayer who relied on an attorney or accountant because the taxpayer was, for some reason, incapable by objective standards of meeting the criteria of "ordinary business care and prudence." In that situation, however, the disability alone could well be an acceptable excuse for a late filing. But this case does not involve the effect of a taxpayer's disability; it involves the effect of a taxpayer's reliance on an agent employed by the taxpayer, and our holding necessarily is limited to that issue rather than the wide range of issues that might arise in future cases under the statute and regulations. Those potential future cases are purely hypothetical at the moment and simply have no bearing on the issue now before us. The concurring opinion seems to agree in part. After four pages of discussion, it concludes: "Because the respondent here was fully capable of meeting the required standard of ordinary business care and prudence, we need not decide the issue of whether and under what circumstances a taxpayer who presents evidence that he was unable to adhere to the required standard might be entitled to relief from the penalty." This conclusion is unquestionably correct. See also, e.g., *Reed v. Ross*, 468 U.S. 1, 8, n. 5, 82 L. Ed. 2d 1, 104 S. Ct. 2901 (1984); *Heckler v. Day*, 467 U.S. 104, 119, 81 L. Ed. 2d 88, 104 S. Ct. 2249, nn. 33 and 34 (1984); *Kosak v. United States*, 465 U.S. 848, 853, n. 8, 79 L. Ed. 2d 860, 104 S. Ct. 1519 (1984); *Bell v. New Jersey*, 461 U.S. 773, 779, n. 4, 76 L. Ed. 2d 312, 103 S. Ct. 2187 (1983).
7. Many systems that do not collect taxes on a self-assessment basis have experienced difficulties in administering tax collection. See J. Wagner, France's Soak-the-Rich Tax, Congressional Quarterly (Editorial Research Reports), Oct. 12, 1982; Dodging Taxes in the Old World, Time, Mar. 28, 1983, p. 32.
8. A number of courts have indicated that "reasonable cause" is a question of fact, to be determined only from the particular situation presented in each particular case. See, e.g., *Estate of Mayer v. Commissioner*, 351 F.2d 617 (CA2 1965) (per curiam), cert. denied, 383 U.S. 935, 15 L. Ed. 2d 852, 86 S. Ct. 1065 (1966); *Coates v. Commissioner*, 234 F.2d 459, 462 (CA8 1956). This view is not entirely correct. Whether the elements that constitute "reasonable cause" are present in a given situation is a question of fact, but what elements must be present to constitute "reasonable cause" is a question of law. See, e.g., *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 772 (CA2 1950); *Daley v. United States*, 480 F. Supp. 808, 811 (ND 1979). When faced with a recurring situation, such as that presented by the instant case, the courts of appeals should not be reluctant to formulate a clear rule of law to deal with that situation.
9. Courts have differed over whether a taxpayer demonstrates "reasonable cause" when, in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available. Compare *Sanderling, Inc. v. Commissioner*, 571 F.2d 174, 178-179 (CA3 1978) (finding "reasonable cause" in such a situation); *Estate of*

*Rapelje v. Commissioner*, 73 T.C. 82, 90, n. 9 (1979) (same); *Estate of DiPalma v. Commissioner*, 71 T.C. 324, 327 (1978) (same), acq., 1979-1 Cum. Bull. 1; *Estate of Bradley v. Commissioner*, 1974 T.C. Memo 17, 33 T.C.M. (CCH) 70, 72-73 (1974) (same), aff'd, 511 F.2d 527 (CA6 1975), with *Estate of Kerber v. United States*, 717 F.2d 454, 454-455, and n. 1 (CA8 1983) (per curiam) (no "reasonable cause"), cert. pending, No. 83-1038; *Smith v. United States*, 702 F.2d 741, 742 (CA8 1983) (same); *Sarto v. United States*, 563 F. Supp. 476, 478 (ND Cal. 1983) (same). We need not and do not address ourselves to this issue.

10. For each month or fraction of a month that a tax return is overdue, IRC §6651(a)(1) provides for a mandatory penalty of 5% of the tax (up to a maximum of 25%) "...unless it is shown that [the failure to file on time] is due to reasonable cause and not due to willful neglect." As Judge Posner observed in his dissent below, "in making "willful neglect" the opposite of "reasonable cause" the statute might seem to have modified the ordinary meaning of "reasonable"..." 710 F.2d 1251, 1256 (CA7 1983).
11. As the Court emphasizes, this principle of nondelegation does not extend to situations in which a taxpayer reasonably relies on expert advice concerning substantive questions of tax law, such as whether a liability exists in the first instance.
12. It is difficult to perceive a material distinction, for example, between a filing delay that results from a serious illness in the taxpayer's immediate family or a taxpayer's unavoidable absence -- situations in which the IRS excuses the delay -- and a filing delay that comes about because the taxpayer is infirm or incompetent. The common thread running through all these unfortunate situations is that the taxpayer, for reasons beyond his control, has been unable to exercise ordinary business care and prudence.

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**Appendix G**  
**Tax Court Case**  
**Corbin West Limited Partnership v. Commissioner**  
**T.C. Memo 1999-7**

**Summary and  
Relevance**

In Corbin West, the Tax Court analyzed the treatment of a variety of costs included by Corbin West in adjusted basis for purposes of depreciation and eligible basis under IRC §42 credit. The court focused on the economic substance behind the transactions generating the costs, examined the parties' practices, and evaluated the partnership's justifications under the Internal Revenue Code for each specific cost included in basis. The Court held as follows:

1. The note at issue lacks economic substance and is not includable in the property's basis. Corbin West is not entitled to depreciation deductions or IRC §42 credit related to the note;
2. Corbin West is not entitled to interest deductions associated with the note;
3. The Court allowed the partnership to capitalize an acquisition fee and developer's fee based on its finding that these costs were incident to the partnership's acquisition of the property. The court noted a number of services performed in return for the fee, including the evaluation of zoning and environmental requirements and the securing of an option to acquire the property;
4. The Court held that the partnership was not entitled to capitalize a \$90,000 tax credit guarantee fee into the property's basis. The Court did not allow the taxpayer to capitalize the fee to the property's basis because the partnership failed to demonstrate that this cost was associated with the acquisition of the property, citing Treas. Reg. §1.263(a)-2.
5. Similar to the treatment of tax guarantee fees, the Court held that the partnership was not entitled to capitalize a cash flow guarantee fee to the basis of the property. The fee was paid to the general partner in return for agreeing to make loans to the partnership to fund any operating deficits. Again, the Court cited the absence of a specific rationale and support in the Code.

**Facts**

Corbin West (a TEFRA partnership) consisted of one general partner, CDC Equity Corp. (CDC), and 29 limited partners. CDC, the tax matters partner, was the wholly owned subsidiary of CDC Financial Corp. (Financial). Corbin West was formed to purchase, manage, and syndicate the Corbin West Apartments (the property).

- I. Acquisition of the Property
  - From approximately March 17, 1970, until December 23, 1988, Norman Associates (Norman) owned the property.
  - On December 8, 1987, Corbin West entered into an option agreement (the first option) with Norman to purchase the property for \$1,760,000.

- On or about December 9, 1987, CDC, acting on behalf of Corbin West, applied for a reservation of a federal low-income housing tax credit relating to the property with the Connecticut Housing Finance Authority (CHFA application). The CHFA application reflected a total acquisition cost of \$1,760,000 plus estimated development and/or rehabilitation costs of \$1,698,315.

Corbin West was unable to obtain the financing required for rehabilitation of the property and allowed the first option to lapse on April 1, 1988. The taxpayer remained interested in obtaining the property and devised a new plan to acquire the property. Under the plan,

- Norman would sell the property to a charitable organization for a price below an alleged fair market value and take a charitable contribution deduction for the difference between the sale price and the alleged fair market value.
- The charitable organization in turn would sell the property to Corbin West. Corbin West would reimburse the charitable organization for the cash paid to Norman to acquire the property and execute a promissory note for the difference between the alleged fair market value and the cash paid (the same amount as Norman's charitable contribution deduction).

The bargain sale would be advantageous to Norman because it would provide him with, in addition to the proceeds from the sale of the property, a large charitable contribution deduction. The bargain sale would provide Corbin West a high basis in the property.

On or about November 30, 1988, Financial (CDC's parent) approached the New Britain Housing Authority (NBHA) and asked if NBHA would participate in Corbin West's bargain sale plan. NBHA officials believed this was a strange request but nonetheless agreed to participate. NBHA requested that Financial indemnify NBHA against any and all loss, cost, claim, demand, or damage arising out of or in connection with NBHA's purchase of the property (hold harmless agreement). Financial provided the request indemnifications.

On or about December 23, 1988, NBHA entered into an agreement with Norman to purchase the property for \$1,808,500. Norman took a charitable contribution deduction for the difference between the alleged fair market value of \$3,150,000 and the sale price of \$1,808,500 (i.e., \$1,341,500). The IRS denied Norman's charitable contribution deduction, and Norman never challenged respondent's determination in court.

On or about December 23, 1988, NBHA entered into an option agreement (the second option) with Corbin West under which Corbin West acquired the right to purchase the property. Corbin West exercised the second option and purchased the property from Norman pursuant to the option with NBHA for \$1,808,500. Corbin West paid the \$1,808,500 by assuming the existing first mortgage of \$873,000, obtaining a second mortgage of \$920,000, and paying the balance from the limited partners' contributions. Corbin West also gave NBHA a promissory note (the note) for \$1,341,500, the difference between the alleged



fair market value of \$3,150,000 and the \$1,808,500 already paid. NBHA did not record the note as an asset on its financial statements.

The terms of the note were particularly favorable to the taxpayer.

1. The note was recourse against Corbin West but not against the general partner or any of the limited partners.
2. The note was not secured by the property.
3. Interest and principal on the note were not payable until the earlier of the sale of the property or January 1, 2011.
4. The note was subordinated to repayment of the first and second mortgages, repayment of loans from the general partner plus interest, and repayment of the limited partners' capital contributions and loans plus 8% interest.

On its federal income tax returns for 1990, 1991, 1992, and 1993, Corbin West included the note in the property's basis for purposes of determining its depreciation deductions and low-income housing credits. Corbin West also claimed accrued interest deductions related to the note of \$135,000, \$147,492, \$160,719, and \$175,323, respectively.

## II. Fees Paid

Corbin West paid CDC substantial fees related to the property. The fees included (1) an "acquisition fee" of \$157,000, (2) a "developer fee" of \$87,213, (3) a "tax credit guarantee fee" of \$90,000, and (4) a "no negative cash flow guarantee fee" of \$35,000.

Corbin West paid the "tax credit guarantee fee" for CDC's guaranty that the property would be operated in a manner which would comply with the requirements of IRC §42 and ensure the availability of the IRC §42 credit. CDC guaranteed that if the property failed to qualify for the IRC §42 credit, then CDC would advance Corbin West an amount equal to any loss of credit. To date, CDC has not made any payments under this provision.

On its federal income tax returns for 1990, 1991, 1992, and 1993, Corbin West included the "acquisition fee," the "developer's fee," and the "tax credit guarantee fee" in the property's basis.

Corbin West paid CDC the "no negative cash flow guarantee fee" for CDC's promise to make loans up to \$250,000 to Corbin West to fund any operating deficits that might arise through December 31, 2995. On the same tax returns described above, Corbin West capitalized the fee and claimed the amortization deductions related to that fee of \$7,571, \$7,571, and \$7,574.

### **IRS Position as to the Note**

The IRS argued that the \$1,341,500 note lacks economic substance; therefore, Corbin West should not include the note in the property's basis for purposes of computing depreciation deductions or low-income housing credits.

**Court's Opinion** In determining whether there is a likelihood of repayment, courts look at the facts and circumstances of each case. In this case:

1. The purchase price greatly exceeded the fair market value of property. Corbin West reported the purchase price of the property as \$3,150,000. The IRS argued that the fair market value of the property at the time of Corbin West's acquisition was only \$1,808,500; therefore, the purchase price greatly exceeds the fair market value.

In this case, the most significant indicator of the fair market value of the property is the first option entered into by Corbin West and Norman one year before the acquisition of the property through the bargain sale. The first option allowed Corbin West to purchase the property for \$1,760,000. The evidence suggests that this price was negotiated at arm's length. Therefore, it appears that the purchase price greatly exceeded the fair market value of the property at the time of Corbin West's acquisition, and the note was unlikely to be repaid from its inception.

2. The repayment of the note was subordinate to repayment of loans totaling \$3,257,500, which included:
  - The existing first mortgage of approximately \$873,000,
  - the second mortgage of \$920,000,
  - the limited partners' loans of \$705,600 at 8% interest,
  - the limited partners' capital contributions of \$258,900, and
  - the general partners' loans of \$500,000 plus interest.
3. The preexisting debt on the property and the obligations to the partners already exceeded by a large amount the fair market value of the property at the time of Corbin West's purchase, and, as noted above, the repayment of the note was subordinate to repayment of that debt and those partner obligations. Therefore, there was no reasonable likelihood that the note would be repaid.
4. The property was the sole asset held by Corbin West; therefore, even if Corbin West decided to pay off the note, it is unlikely that Corbin West would have the financial ability to pay off the note and the interest thereon when due.

The Court also considered the nature of the dealings between the parties and concluded that NBHA did not expect the note to be repaid and never treated the note as genuine debt.

- NBHA was chosen by Corbin West to execute its bargain sale plan and NBHA was not a negotiating party in the transaction.
- There was no evidence that NBHA made any independent analysis concerning the fair market value of the property or the likelihood of repayment of the note by Corbin West.
- NBHA had nothing at risk in the transaction because Financial gave NBHA a hold harmless agreement. NBHA received the note for allowing itself to be used by Corbin West and Norman in their attempt to ensure advantageous tax positions.

- NBHA did not treat the note as genuine debt. There is no evidence that the NBHA considered the credit rating of Corbin West before agreeing to accept the note and NBHA never recorded the note as an asset on its financial statements. At the time of trial, NBHA could not locate the note. In total, the facts indicate that NBHA did not expect the note to be repaid.

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**Appendix H**  
**Tax Court Case**  
**Bentley Court II Limited Partnerships, B.F. Bentley, Inc., Tax Matters Partner,**  
**Petitioner v. Commissioner of Internal Revenue, Respondent**  
**T.C. Memo 2006-113**

**Summary and  
Relevance**

In Bentley Court II L.P., the issue was whether a taxpayer must recapture credits under IRC §42(j). The taxpayer agreed that the credit claimed for the years under audit was not allowable, but disagreed that the IRC §42(j) credit provisions were applicable. The taxpayer contended that it was not entitled to the credit taken in closed taxable years, and because the units never qualified as low-income units, there was no difference in qualified basis in the first-open taxable year and the prior closed taxable year (i.e., qualified basis was always zero). The Court found that the duty of consistency applied to the taxpayer and held that the IRC §42(j) recapture provisions did apply.

CCA 201136023 addresses the application of the recapture provisions of IRC §42(j)(1) considering this case.

**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:

<u>Year</u>	<u>Credits</u>
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 IRC §42 credit 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 credits claimed in 1990, 1991 and 1992; \$9,493, \$233,027 and \$286,228 respectively.

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 taxpayer's 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 specified tenant files.

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

**Issue**

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.

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 statutes 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 the taxpayer:

1. offered no evidence to show that the apartment complex was not a qualified low-income building for the 1990, 1991 and 1992 tax years; and
2. 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 years.

**The "Duty of Consistency" Doctrine**

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 *Beltzer v. United States*, 495 F.2d 211, 212 (8<sup>th</sup> 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 the taxpayer 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) the taxpayer reported low-income credits in 1990 to 1995, and the government “disallowed” those credits in all years 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) the taxpayer was compelled to change its initial representation or claim of credits due to the criminal prosecution of the general partner.

As 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.

#### **Tax Court’s Decision**

The Tax Court upheld the Government’s position. In framing its decision, the Court addressed the three criteria presented in Beltzer.

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. The taxpayer 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].”

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**Appendix I**  
**Tax Court Case**  
**Richard E. Carp and Minda G. Carp, Petitioners v.**  
**Commissioner of Internal Revenue, Respondent;**  
**Franklin D. Zuckerman and Lois Zuckerman, Petitioners v.**  
**Commissioner of Internal Revenue, Respondent**  
**T.C. Memo 1991-436**

**Summary and  
Relevance**

In *Carp and Zuckerman v. Commissioner*, the Court considered when an amount designated as a developer fee paid to Mr. Carp and Mr. Zuckerman constituted a qualified rehabilitation expenditure for purposes of the IRC §48, Rehabilitation Credit.

The Court found that the taxpayer failed to prove that they performed the development services specified in the development agreement.

The taxpayer bears the burden of proving that the amount constitutes a qualified rehabilitation expenditure under IRC §48. Except for the negotiation of the sales contract and the supervision of construction and renovation, the taxpayers contracted with the seller to perform the services enumerated in the development agreement.

There was no objective evidence submitted by the taxpayers to detail the time and effort spent by the taxpayers on any of the services. The Court also explained that it was inappropriate to apply the rule of *Cohan v. Commissioner*, 39 F.2d 540 (1930), to estimate whether part of the expenses would be deductible where the taxpayer who has “ready access” to support evidence fails to produce such evidence.

The taxpayers did not submit evidence which would allow the Court to allocate the amount to the various services specified in the development agreement, some of which are specifically excluded from the definition of qualified rehabilitation expense under IRC §48.

The analysis made in the case related to whether the amount paid was a qualified rehabilitation expenditure is similar to the analysis that should occur under IRC §42 to determine if a fee paid should be included in eligible basis.

**IRS Position**

The IRS argued:

1. the taxpayers had not proved that the services enumerated in the development agreement had been performed,
2. the services were duplicative of services of those which another person was to perform as part of the sales agreement,
3. the development agreement was not a bona-fide agreement with a legitimate business purpose. Instead, the agreement was in substance for the performance of other services that would not qualify for the IRC §48 credit.

4. the development fee was a cost of acquiring the building, and as such was not a qualified rehabilitation expenditure.

**Taxpayer's  
Position**

The taxpayers asserted that:

1. The fee amount was intended as a development fee “for all purposes, including its legal substance and effect,” as supported by its characterization in the private placement memorandum and the developers note.
2. The contracts, submitted as stipulated exhibits, spoke for themselves in establishing that Mr. Carp and Mr. Zuckerman performed qualifying development services and that no further evidence was necessary.
3. The taxpayers “spent many hours in meetings” regarding various aspects of the renovation and made all decisions relating to the common areas, such as selecting carpet.

**Court's  
Decision**

The Court concluded, without addressing other IRS contentions, that the taxpayers failed to prove that they performed the development services specified in the agreement. The Court explained:

1. The taxpayers bear the burden of proving that the amount constituted qualified rehabilitation expenditure.
2. Except for the negotiation of the sales contract and the supervision of construction and renovation, the taxpayers contracted with the seller to perform the services enumerated in the development agreement.
3. There was no objective evidence submitted by the taxpayers to detail the time and effort spent by the taxpayers on any of the services. The Court also explained that it was inappropriate to apply the rule of *Cohan v. Commissioner* to estimate whether part of the expenses would be deductible where the taxpayer who has “ready access” to supportive evidence fails to produce such evidence.

The “Cohan Rule” originated in the decision of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). In *Cohan*, the court made an exception to the rule requiring taxpayers to substantiate their business expenses. The taxpayer was disallowed a deduction for travel and business expenses because he was unable to substantiate any of the expenses. The judge wrote that “absolute certainty in such matters is usually impossible and is not necessary, the Board should make as close an approximation as it can.” In general, the Tax Court has interpreted this ruling to mean that in certain situations “best estimates” are acceptable in order to approximate expenses. The Cohan Rule is a discretionary standard and can be used to support a reasonable estimate of compliance requirements.

4. The taxpayers did not submit evidence which would allow the Court to allocate the amount to the various services specified in the development agreement, some of which are specifically excluded from the definition of qualified rehabilitation expenses under IRC §48.

The Court stated:

“Petitioners state in their brief that “There was no evidence submitted with regard to the [many hours of meetings, etc. spent by Mr. Carp and Mr. Zuckerman] because these services are typical and self-evident in any rehabilitation project, and therefore further evidence was not necessary.” However, in our view such evidence is necessary, and is lacking here.”

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**Appendix J**  
**United States Court of Appeals for the Ninth Circuit**  
**Housing Pioneers, Inc., Petitioner-Appellant, v.**  
**Commissioner, Internal Revenue Service, Respondent-Appellee.**  
**No. 93-70583, 58 F.3d 401 (9<sup>th</sup> Cir. 1995)**

**Summary and  
Relevance**

This case involves the determination of whether Housing Pioneers, Inc. (Pioneers) qualifies as an IRC §501(c)(3) organization. Pioneers appealed the decision of the Tax Court denying it IRC § 501(c)(3) status and in its opinion, the Ninth Circuit Court affirms the judgment of the Tax Court.

This determination is relevant to the extent that IRC §42(h)(5) is applicable to allocation of low-income credit.

**Facts**

Pioneers was incorporated March 21, 1989 as a “nonprofit public benefit corporation” under California law. Its articles of incorporation announced its “specific purpose” to be “to provide innovative and affordable housing to low income and handicapped persons, including providing housing for pre-release and post-release persons who are or have been incarcerated in prisons.” The articles of incorporation further declared the corporation to be organized and operated exclusively for charitable purposes “within the meaning of IRC §501(c)(3).” The incorporator was Jerry L. Harris.

Pioneers duly applied for exemption to the Internal Revenue Service (the IRS). In response to questions, Jerry L. Harris informed the IRS on January 30, 1990 that Pioneers had no facilities or office space and had published no information about itself. He added that on April 1, 1989 Pioneers had signed a joint management agreement with Grant Square Properties (Grant Square) to participate in a project by which Grant Square’s property would be exempt from property tax. As part of the agreement, Grant Square had lent Pioneers \$5,000 to buy an interest in Grant Square of 1% and become a general partner in Grant Square.

A subsequent letter from Harris informed the government that the Grant Square partnership was divided as follows: General partners: Towne Centre Investment, Inc. (9%) and Pioneers (1%); Limited partners: Jerry L. Harris (30%), Howard R. Harris (40%), David Harris (5%), Richard Harris (5%) and J.M. Hepps (10%). David and Richard Harris were Jerry Harris's brothers; Howard was his father; and Hepps was his grandfather. Towne Centre Investment, Inc. was wholly owned by Jerry and Howard. In addition to Jerry and Howard, the board of directors of Pioneers included nine persons not related to the Harris family and chosen for their interest in housing and social services.

Pioneers’ plan of operation was keyed to the property tax exemption afforded by IRC 214(g) of the California Revenue and Taxation Code. According to §214(a), if “the managing general partner” of a partnership in property used for low-income rental housing is a nonprofit meeting the criteria set out in §214, the property is entitled to a tax exemption. Among these criteria are that at least 20% of the tenants meet certain low income requirements and that “the owner of the property is eligible for and receives low-income housing tax credits pursuant to IRC §42, as added by Public Law 99-514.”

Pioneers' plan was to form partnerships in which the other partners would benefit from the property tax exemption obtained by Pioneers' participation. Part of the property tax savings would be retained by the partnership and used to keep the rents low; part of the savings would be paid to Pioneers and be used by Pioneers for its charitable purposes. In the Grant Square partnership, the first year of savings was to be divided 40% to Towne Centre Investment, Inc. for arranging the transaction, 60% to the Grant Square partnership; in subsequent years, Grant Square would keep 50% and Pioneers would receive cash from Grant Square equal to 50% of the savings. Although Pioneers was a co-general partner, its partnership duties were restricted by the agreement to assuring that the savings were applied to the reduction of the rents charged by the partnership and to assuring that the properties owned by the partnership complied with the requirements IRC §42 and California Revenue and Taxation Code §214(g).

In March 1990 Pioneers entered into an agreement with Hidden Cove Associates similar to that with Grant Square but distinguished by the absence among the Hidden Cove partners of any relative of the Harrises.

### **IRS Audit and Tax Court Decision**

The Commissioner of Internal Revenue determined that Pioneers was not an organization described in IRC §501(c)(3). Pursuant to IRC §7428, Pioneers invoked the jurisdiction of the Tax Court and sought a declaratory judgment to the contrary.

In accordance with Rule 217(b) of the Tax Court Rules of Practice and Procedure, the case was decided on the administrative record. The Tax Court upheld the Commissioner on two grounds.

- Pioneers was disqualified because its proposed activities included at least one non-exempt purpose which was “substantial in nature.” See *Better Business Bureau v. United States*, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945) (interpreting exemption from the Social Security tax). This non-exempt purpose was to provide the benefit of both the California §214 exemption and the federal IRC §42 credit to partnerships that were not exclusively charitable.
- The benefits inured in part to private individuals; the Harrises in the case of Grant Square and the limited partners in the case of Hidden Cove. The Tax Court declared: “the California property tax reductions, even though they are to be used exclusively for the purpose of reducing the rents or otherwise maintaining the affordability of the residential units, inure indirectly at least to the benefit of the non-exempt partners in that the partnerships are thereby relieved of the necessity of maintaining rents at a level sufficient to cover operating expenses which would otherwise have to be paid out of partnership capital.” The forbidden purpose and the private benefits were, the Tax Court found, “inextricably” meshed.

Pioneers appealed.

### **Court's Analysis**

Pioneers presents an argument that is ultimately unpersuasive but is nonetheless attractive enough to deserve elaboration and powerful enough to require refutation. The argument, fully expanded, is paraphrasable as follows (quotation marks are employed not to indicate verbatim quotation but to distinguish the argument from any holding of this court):

“Not only §214 of the California Tax and Revenue Code but federal tax law intended that in the production of low-income housing there will be collaboration between an

exempt entity and for-profit partners. Specifically, IRC §42(h)(5) provides that ‘not more than 90 per cent of the State housing credit ceiling for any State for any calendar year shall be allowed to projects other than qualified low-income housing projects described in subparagraph (B).’ Subparagraph B describes a qualified low-income housing project as one in which ‘a qualified nonprofit organization owns an interest in the project’ and ‘materially participates’ in the development and operation of the project. To be qualified, a nonprofit must fit within IRC §501(c)(3) or (4). The statutory language implies that there will be other, for-profit partners who share with the IRC §501(c) organization in the ownership, development, and operation of the property. Fairly clearly, Congress sought to encourage low-income housing by encouraging nonprofits to join with for-profits in providing it. The inescapable corollary of such projects is that participation by the qualified nonprofit will bestow a tax credit on its for-profit partners. Indeed, once a partnership is formed by a nonprofit with for-profits, one purpose - surely substantial - will be for the nonprofit to make a go of the partnership; and such purposeful endeavor will inescapably in part inure to the benefit of the private investors. If the Commissioner’s position were correct, IRC §42(h)(5) would never work.

“The Commissioner has not refuted Pioneers’ statutory argument or its logic. So what is different about Pioneers? It is a nonprofit yoked in partnership with private parties who stand to get something out of the partnership. The benefit to the private partners as found by the Tax Court consists in relieving them ‘of the necessity of maintaining rents at a level sufficient to cover operating expenses’ - in other words, of allowing them to provide low-income housing cheaply; that result is what federal tax law aims in IRC §42 to achieve.”

“The Commissioner contends that the appropriate standard of review of the Tax Court’s findings of a substantial non-exempt purpose and of activity inuring to private benefit is clear error. Under the court’s precedents these findings are treated as factual and so the clear error standard applies. *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1317 (9th Cir. 1987), cert. denied, 486 U.S. 1015, 100 L. Ed. 2d 214, 108 S. Ct. 1752 (1988). The Commissioner contends there is no clear error here. The difficulty with the Commissioner’s argument is that the factual findings of the Tax Court are not enough to carry the day for the Commissioner. Under IRC §42(h) a nonprofit is expected to have a substantial purpose to benefit a non-charitable partnership and part of the savings achieved are expected to inure to individuals without destroying the IRC §501(c)(3) status of the nonprofit and making IRC §42(h) inoperable. It is the court’s job to interpret the Internal Revenue Code harmoniously; so the court must recognize that as a matter of law IRC §42(h) limits the requirements of IRC §501(c)(3).”

So runs Pioneers’ argument as we understand it. It might well be a successful argument but we need not, and do not, rule upon it. A crucial factual foundation is missing. Pioneers has failed to show that it qualifies as an IRC §42(h) nonprofit. To be such an entity, according to IRC §42(h)(5)(B), Pioneers has to “materially participate (within the meaning of IRC §469(h)) in the development and operation of the project.” Section 469(h), setting out “the passive loss rule,” defines material participation as activity that is “regular,” “continuous,” and “substantial.” Pioneers flunks the test by all three criteria. It has shown no regular, no continuous, no substantial activity in developing or operating the projects. Moreover, under IRC §42(h)(5)(c) to qualify as an IRC §42(h) nonprofit, Pioneers had to be “determined

by a State housing credit agency not to be affiliated with or controlled by a for-profit organization.” Nothing in the record establishes such a determination by a State housing credit agency.

As Pioneers has not shown itself to be an IRC §42(h) nonprofit, we have no reason to decide the relation between IRC §42(h) and IRC §501(c)(3) and no need to decide if the former modifies the latter. The usual rules for applying IRC §501(c)(3) apply.

The Tax Court has found that one substantial purpose of Pioneers was a non-exempt purpose and that carrying out that purpose would inure to private benefit. We are given no reason to hold these factual findings clearly erroneous.

As Pioneers explains its argument on rehearing, it is all by way of analogy. Pioneers is not an IRC §42(h) entity and has never sought to be one; Pioneers simply points to IRC §42(h) as a sign that Congress meant some IRC §501(c)(3) entities to be yoked with for profit entities.

We need not address this contention as it is not the case presented. The case of Pioneers is governed by a single statute, IRC §501(c)(3). Pioneers invokes *Plumstead Theatre Society, Inc. v. CIR*, 675 F.2d 244 (9th Cir. 1982), where we held the Tax Court not to be clearly erroneous in finding a nonprofit theatre group to be operated exclusively for charitable purposes under these circumstances: outside investors put up some of the capital needed by the group to put on “First Monday in October” but the investors were not shareholders nor officers nor directors of the theatre group. Factually the case is distinct from this one where two of the partners in Grant Square were also directors of Pioneers.

**Holding**

The Tax Court was not clearly erroneous in its findings as to the non-exempt purpose of Pioneers. Accordingly, the judgment of the Tax Court must be affirmed.