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IRS Ruling Changes Generally Understood Requirements for Extended Use Agreements

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The Internal Revenue Service (IRS) recently published a clarification of its position on the requirements for extended use agreements for low-income housing tax credit (LIHTC) properties. Revenue Ruling 2004-82 contradicts the universally understood requirements that have long been used by state housing finance agencies and LIHTC professionals. Some industry experts say this change could result in innumerable hours of paperwork and increased fees for state housing finance agency officials, LIHTC partnerships, lenders and other parties to existing extended use agreements, as well as the alarming possibility of total credit recapture for LIHTC investors. As the *LIHTC Monthly Report* went to press, the National Council of State Housing Agencies (NSCHA) had not yet finished analyzing the ruling, but did confirm it has raised concerns.

Background

At the end of the tax credit period, LIHTC property owners are given two options by the IRS: to enter into an extended use agreement that prolongs the period of low-income use to as much as 30 or 50 years, or to opt-out of the program. For the latter, Internal Revenue Code (IRC) §42(h)(6)(E)(ii) describes a three-year period in the opt-out process during which two things are expressly prohibited: the eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit; or any increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42. IRC §42(h)(6)(E)(ii) is the only passage in IRC §42 that gives these protections to tenants and, up until recently, LIHTC professionals took this to mean they were applicable only to the three-year period it described.

Revenue Ruling 2004-82

IRS Revenue Ruling 2004-82, issued July 29, 2004, addressed 12 points under IRC §42 (for a complete summary of the ruling's 12 points, please see the related article on page eight). Ten of the 12 points were compliance related and answered several long-standing questions. However, one point - the IRS position on the requirements of extended use agreements - raised red flags for state housing agency officials and LIHTC investors. In Rev. Rul. 2004-82, the IRS says an extended low-income housing commitment must prohibit evictions and increases in gross rent described in IRC §42(h)(6)(E)(ii)(I) and (II) throughout the initial compliance period and the entire extended use period — not just for the three-year period described in IRC §42(h)(6)(E)(ii) – as previously had been commonl practice by LIHTC professionals.

Question and Answer 5 reads:

"**Q-5.**

Must the extended low-income housing commitment prohibit the actions described in subclauses (I) and (II) of §42(h)(6)(E)(ii) only for the 3-year period described in §42(h)(6)(E)(ii)?

A-5.

No. Section 42(h)(6)(B)(i) requires that an extended low-income housing 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 §42. When Congress amended §42(h)(6)(B)(i) to add the language emphasized above, §42(h)(6)(E)(ii) was already part of §42. As a result, Congress must have intended the amendment to § 42(h)(6)(B)(i) to add an additional requirement

(continued on page two)

IRS Ruling Changes

(continued from page one)

> beyond what was contained in § 42(h)(6)(E)(ii), which already prohibited the actions described in that section for the 3 years following the termination of the extended use period. Because the requirements of §42(h)(6)(B)(i) otherwise apply for the extended use period, Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii) to apply throughout the extended use period. If it is determined by the end of a taxable year that a taxpayer's extended low-income housing commitment for a building does not meet the requirements for an extended low-income housing commitment under §42(h)(6)(B) (for example, it does not provide no-cause eviction protection for the tenants of low-income units throughout the extended use period), the low-income housing credit is not allowable with respect to the building for the taxable year, or any prior taxable year. However, if the failure to have a valid extended low-income housing commitment in effect is corrected within 1 year from the date of the determination, the determination will not apply to the current year of the credit period or any prior year."

The IRS suggests in its answer that its position follows Congressional intent: "Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii) to apply throughout the extended use period." This contention, however, has been disputed by the LIHTC industry.

Anthony Freedman, an attorney with Hawkins Delafield & Wood LLP, who specializes in affordable housing finance, says the ruling is not only contrary to the wording of the law and the legislative history, it is contrary to the LIHTC program's entire procedural history. "Could Congress really have changed the law so substantially without anyone in this industry noticing for 14 years?" asks Freedman. "It's silly; they are suggesting that Congress passed a stealth amendment."

State Agencies Instructed to Review Existing Agreements for Compliance

In Rev. Rul. 2004-82, the IRS orders state housing finance agencies to review by December 31, 2004 their extended low-income housing commitments for compliance with this interpretation of IRC § 42(h)(6)(B)(i). If during the review period the housing credit agency determines that an extended low-income housing commitment is not in compliance with the interpretation of IRC §42(h)(6)(B)(i) provided in Rev. Rul. 2004-82, the state agency has one year from the date of that determination to amend the agreement to bring it into compliance.

Given only four months to review all existing extended use agreements and a year after that to amend those that don't comply, many people are doubtful that state agencies will be able to complete the task in time. Freedman suggests the review of the existing agreements is of less concern

(continued on page three)

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IRS Ruling Changes

(continued from page two)

(each state has used relatively few standard agreement formats) than the fact that the results of some reviews may be inconclusive because some agreements are very specific while others are more vague. For example, some agreements simply require owners to comply with all the provisions of IRC §42. Moreover, he says, the real "administrative nightmare" would be for state agencies to make amendments to tens of thousands of agreements and get those amendments recorded under the laws of the states. If state agencies fail or fall short, and an agreement is found to be out of compliance after the IRS' deadline, investors face 100 percent recapture of their credits - at least for tax return years that are still open to adjustment.

Investors' Hands Tied

Though the onus of the review and correction called for in Rev. Rul. 2004-82 falls to state housing agencies, investors are perhaps the most worried over the implications. Because investors are not a direct party to extended use agreements and are not permitted to amend them, they are dependent on state housing agencies to meet the IRS' demands, which some professionals say is unfair.

"Having not had a hand in writing the extended use agreements, and not having a hand in correcting them, should we really be on the front line to be punished through complete recapture of credits?" asks David Kunhardt, senior vice president of community investments for AEGON USA Realty Advisors Inc. AEGON and its subsidiaries have invested more than $1.1 billion in LIHTC partnerships.

Initial consensus in the LIHTC industry is that the IRS' position is simply incorrect and the ruling should be withdrawn. "Frankly, I think the right thing is for this proposed ruling to just be withdrawn because it is just wrong," Kunhardt says.

It is expected that any remedy, rollback or otherwise, would likely have to be coordinated with the IRS through NCSHA and state housing agencies. As the *LIHTC Monthly Report* went to press, NCSHA's analysis of Rev. Rul. 2004-82 was still ongoing. "NCSHA has not completed its review of the revenue ruling, but the organization is extremely concerned about the burden this ruling could place on state agencies," said NCSHA Executive Director Barbara Thompson.

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