Low Income Housing Credit Newsletter

Internal Revenue Service

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

Interviewing LIHC Property Owners: What to Ask?

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

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

Starting the Interview

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

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

Background Information

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

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

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

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

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

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

Project Financing

There are really four areas that need to be explored.

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

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

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

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

Day-to-Day Operations

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

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

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

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

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

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

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

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

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

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

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

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

  See IRC §42(g)(2) for details.

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

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

- Why did the noncompliance occur?

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

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

<u>Due Diligence</u>

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

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

Audit Adjustments:

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

- Under Treas. Reg. 1.42-5(b)(2), the taxpayer must keep the records for the first year of the credit period until six years after the date for filing the tax return for the last year of the 15-year compliance period. Altogether, that's at least 21 years! If the taxpayer cannot produce the records for the first year of the credit period, then the *Applicable Fraction* cannot be determined and the taxpayer not entitled to any LIHC under IRC §42. *OUCH!*

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

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

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

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

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

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

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

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

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

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

Example:

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

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

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

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

Just an Administrative Reminder

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

Surveying LIHC Tax Returns

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

? Grace Notes ?

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

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

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

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

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

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

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

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

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

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