

Special Edition

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!!

Read All About Them!

Acquisition-Rehabilitation LIHC Projects

Take Center Stage

(Follow-Up & Clarification of Information Presented in the April 2005 Edition)

While we generally think of the LIHC supporting the construction of new residential rental housing, IRC §42 also provides a tax incentive for acquiring existing buildings and “rehabilitating” them for use as LIHC residential rental housing. New buildings are defined in IRC §42(i)(4) as buildings for which the original use begins with the taxpayer. Existing buildings, then, are defined in IRC §42(i)(5) as buildings that are not new buildings.

Credit for Acquisition of Existing Building

Under IRC § 42(b)(1)(B)(ii), the applicable percentage for acquiring existing buildings was 4% in 1987, the first year of the LIHC program. For years after 1987, as described in IRC §42(b)(2)(B)(ii), the applicable percentage is 30% of the qualified basis discounted using a present value computation outlined in IRC §42(b)(2)(C). So, the “acquisition” credit is sometime called the “4%” credit, and the “30%” credit other times; either way works.

Qualifying Acquisition Costs

Under IRC §42(d)(2), the eligible basis of an existing building is its adjusted basis at the end of the first year of the credit period, but only if it meets four requirements:

1. the building is acquired by purchase,

2. there is a period of at least 10 years between the acquisition date and the later of:
 - a. the date the building was last placed in service (see IRC §42(d)(2)(D)(ii) for rules for certain transfer and IRC §§ 42(d)(6) and 42(f)(5)(B) for an exception for federally-assisted buildings),
 - or
 - b. the date of the most recent nonqualifying substantial improvement of the building. Nonqualified substantial improvement is defined in IRC §42(d)(2)(D) as costs of 25% or more of the adjusted basis without the improvements, within any given 24 period.
3. the building was not previously placed in service by the taxpayer or by any person related to the taxpayer at the time it was previously placed in service, and
4. the building qualifies for the rehabilitation credit under IRC §42(e), which we will be discussing later in this article.

Generally, if the building does not meet all four requirements, then the eligible basis for the acquisition credit is zero....after consideration of the exceptions!

Credit Period for Existing Building

Under IRC §42(f)(5), the credit period for an acquisition credit cannot begin before the first year of the credit period for the rehabilitation expenditures.

Acquiring Building Within Compliance Period

Under IRC §42(d)(7), a taxpayer acquiring a LIHC building during the 15-year credit period steps into the shoes of the previous owner.

1. the building is not eligible for acquisition LIHC, and
2. the credit allowable to the new owner after the acquisition is equal to the amount allowable to the prior owner, and the new owner must maintain the property as LIHC property for the remainder of the compliance period.

Finally, under IRC §42(f)(4), if a building is disposed of during the 10-year credit period, the credit is allocated between the parties on the basis of the number of days during the year the building (or interest) therein was held by each. (*Note: In Revenue Ruling 91-38, Q&A #5, the parties can also allocate the credit according to the number of months each party held the property.*)

And, in such cases, proper adjustments are made in the application of IRC §42(j), which are the recapture rules.

Credit for Substantial Rehabilitation

IRC §42(b) doesn't identify the applicable percentage for rehabilitation costs, but IRC §42(b)(3)(A) provides a cross reference to IRC §42(e), which outlines the requirements for treating rehabilitation costs as a separate new building. This is important, because new buildings are eligible for the "9%" credit under IRC §42(b)(1)(A), also known as the "70%" credit under IRC §42(b)(2)(B)(i).

Qualifying Rehabilitation Costs

Under IRC §42(e)(2), the rehabilitation expenditures are amounts for property (additions and improvements) that is subject to depreciation of a building. In other words, the costs must meet the definition of Eligible Basis as outlined in IRC

§42(d) – basically, depreciable residential rental buildings, property used in common areas or provided as amenities, and (if the property is located in a qualified census tract) a portion of the costs associated with a community service buildings.

Substantial Rehabilitation

To qualify for the 9% credit, the owner must perform substantial rehabilitation to 1 or more rental units, or substantially benefit the rental units. Substantial rehabilitation is defined in IRC §42(e)(3) as the expenditures during any 24-month period that are the greater of either:

1. 10% (or more) of the adjusted basis of the acquired building as of the first day of the 24-month period,

or
2. the qualified basis (applicable fraction x eligible basis) attributable to the rehabilitation costs is \$3,000 or more. This is not a unit-by-unit determination; just divide the qualified basis by the number of LIHC units.

There is just one exception to the 10% test under IRC §42(e)(3)(B) for buildings acquired from a government unit. The taxpayer can elect not to apply the 10% test and use the 4% credit amount.

Also, be careful not to confuse the test for nonqualifying substantial improvements associated with the acquisition LIHC with the "substantial rehabilitation" test associated with the rehabilitation LIHC. Both use 24-month periods, but the percentages are different.

Placed in Service Date

As described in IRC §42(e)(4)(A), expenditure qualifying as "substantial rehabilitation" are treated as if placed in service at the close of the 24-month period. This is important because, under IRC §42(f), the credit period begins with the taxable year in which the building is placed in service, unless the owner elects to delay the beginning of the credit period until the subsequent taxable year.

Rehabilitation Costs Included in Eligible Basis

Once a determination has been made that the owner did substantial rehabilitation to an existing building, the owner can treat all the rehabilitation costs as if it is a separate new building. As noted in IRC §42(d)(1), the eligible basis for a new building is its adjusted basis as of the close of the first year of the credit period.

Applicable Fraction

The applicable fraction is the percentage of LIHC units or floor space occupied by income-qualified tenants. Under IRC §42(f)(2), there is a special rule for determining the applicable fraction for the first year of the credit period. Based on the month the unit is first occupied, the rule is an average of the applicable fractions on a monthly basis; i.e., the sum of the monthly applicable fractions divided by 12.

In the case of buildings that were acquired and then rehabilitated, there are two separate allocations of credit documented on two Forms 8609 – one at 4% for the acquisition and a separate allocation at 9% for the rehabilitation. However, the owner is not required to determine two applicable fractions. Under IRC §42(e)(4)(B), the applicable fraction for the 9% substantial rehabilitation credit will be the same as the applicable fraction for the 4% acquisition credit.

Qualifying Households

Because LIHC buildings can be acquired and rehabilitated, or constructed, over a two-year period, or the beginning of the credit period can be delayed to the year subsequent to the year the building is placed in service, it is reasonable to expect that LIHC units may be rented to income-qualified households *before* the beginning of the credit period. For this situation, the owner must demonstrate that the household was income-qualified *at the beginning* of the first year of the credit period to include the unit in the applicable fraction. The IRS has provided a safe harbor for this situation in Revenue Procedure 2003-82.

Under Rev. Proc. 2003-82, a unit occupied before the beginning of the credit period will be considered a low-income unit at the beginning of

the credit period, even if the household's income exceeds the income limit at the beginning of the first year of the credit period, if the unit is rent restricted and the following two conditions are met:

1. The household must be income-qualified at the time of acquisition or time of move-in, and
2. The household's income must be tested at the beginning of the first year of the credit period. If the household's income has increased to 140% or more of the income limit, the Available Unit Rule (IRC §42(g)(2)(D)) is applied.

Summary

If there's one thing that's clear, executing the development of an acquisition/rehabilitation LIHC property requires a thoughtful consideration of unique ownership and timing issues. Pass the aspirin!

Welcome to Barbara Dougherty, Acting Manager for the LIHC Compliance Unit

Barbara Dougherty has accepted a temporary assignment as manager of the LIHC Compliance Unit in the Philadelphia Service Center. We wish her a warm welcome as she learns all about the program....Forms 8823,.. 8693,8609,.... 8610, 8877

In the meantime, Angie Kaminski will be working as an analyst on the embedded quality program.

Monitoring LIHC Cases

Project Code 0670 and Tracking Code 9812 have been established for LIHC audits. If you expand an audit to include additional years or taxpayers, please remember to update the Project Code and the Tracking Code on the new returns.

Should you need to survey a LIHC return, please complete Form 1900 and submit to Program Analyst Grace Robertson for approval. The form can be faxed to (202) 283-2240 or transmitted by e-mail.

♪ Grace Notes ♪

I admit it; I'm a Star Trek fan...I remember the first time, a particularly meaningful episode of TOS, and I watched the original airing of every episode of TNG, DS9, Voyager, and Enterprise. Believe me, I came up with some really creative excuses for not being where the adults in my life thought I (a high school senior) ought to be on Saturday mornings, just so I could watch the animated series.

Wondering where I'm going with this confession of the soul? In an episode titled "Unnatural Selection", Dr. Pulaski, the passionately dedicated doctor aboard the Enterprise, convinces Captain Picard (much against his better judgment) to allow her to help a desperately ill colony of scientists even though doing so would risk exposing herself to a deadly pathogen (an unintended outcome of the scientists' research). Of course, the doctor contracts the deadly disease, but (as you might expect), the crew of the Enterprise figures out an elegant solution and the doctor is saved.

Here's the relevant part. The voice over during the last scene of the episode is a log entry by Dr. Pulaski. She writes, "Scientists believe no experiment is a failure. That even a mistake advances the evolution of understanding. But all achievement has a price..." The point is, even though there is always a risk of failure and sometimes the price of failure is high, our mistakes help us learn, perfect our skills, and expand our knowledge.

I would contend that we (the LIHC community) are like scientists in our attempts to unravel the mysteries of IRC §42. While tax administration isn't generally an issue of life or death, there is a risk of error that can affect the financial well being of America's taxpayers, and more specific to the LIHC program - those in need of affordable housing. We might not look at it as

overwhelming, but every time we distribute a LIHC newsletter, there is an inherent risk.

This edition of the newsletter is dedicated to discussing the law pertaining to "Acquisition-Rehabilitation" LIHC housing projects. We decided that this topic deserved the focused attention because of the responses to the last newsletter. Despite the fact that Kent and I double check each other's work, I started getting e-mails about a single sentence that wasn't...well, as precise as it might have been. Within an hour of distribution, I learned several things:

The newsletter is read soon after its distribution. I've never received such immediate feedback! And, the newsletter is read thoroughly. Our error pertained to an important point, but it was buried within a paragraph deeply embedded in the article.

Researching and writing this newsletter also expanded my knowledge, as I "put all the pieces" spread out over IRC 42 into one place and could see how it all fits together.

And, it's nice to know we are not alone in our trek through IRC §42. Your responses provided detailed explanations that helped us understand the problem and were so tactfully worded! We appreciate your graciousness. Thank you.

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Postscript: Just in case you aren't a Star Trek fan, TOS is the acronym for "The Original Series" with Captain Kirk, TNG is the acronym for "The Next Generation" with Captain Picard, and DS9 is the acronym for "Deep Space 9" with Captain Sisko.