

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!!

Frequently Asked Questions (The Revenue Agent's Side)

Question 1: I've been assigned a partnership return for audit. The taxpayer owns low-income housing and is claiming the LIHC. Where should I begin my pre-contact analysis?

Answer 1: A good place to start is an analysis of the Forms 8609 attached to the return, which are used by the state agency to document the completion of LIHC buildings and terms of the credit allocations. If you have multiple Forms 8609, using a spreadsheet to summarize the credit on a project basis is helpful.

Form 8609, Part I

Line C identifies the owner to whom the allocation was made. If the identified owner is not the taxpayer under audit, ask the taxpayer about the circumstances under which they acquired the building. This taxpayer under audit is liable only for the period for which they had ownership.

Line 1a is the date of allocation. The building must be placed in service within two years as identified on line 5, and the credit period may be postponed one year beyond that, as elected by the taxpayer on line 10a. Combining the three dates will give you a good estimate of key events for the development and implementation of the building as low-income housing.

Line 1b is the maximum allowable LIHC the taxpayer can claim each year. Line 15 on Form 8609, Schedule A should never exceed this amount. Schedule A should also be attached to the return; it is used to compute the credit each year.

Line 2 is the maximum applicable credit percentage. The applicable percentage is determined by the state agency and is seldom an audit issue. However, if LIHC units were first occupied by income-qualified tenants after the end of the first year of the credit period, then the unit qualified for an LIHC computed using 2/3 of the maximum credit percentage. The Schedule A computation accounts for this lesser credit by subtracting out the 1/3 portion of the credit that isn't allowable (see Schedule A, line 9).

Line 6 includes seven descriptors for LIHC allocations that impose different requirements on the owner. Identifying the relevant descriptions and understanding the unique requirements imposed will help you quickly evaluate the taxpayer's compliance.

Form 8609, Part II

Line 7 is the Eligible Basis. Basically, eligible basis is depreciable residential rental property; i.e., buildings and amenities such as common areas and facilities (IRC §42(d)(4)). Under IRC §42(m)(2), most state agencies require taxpayers to provide a summary of the costs qualifying as Eligible Basis that was prepared and certified by a CPA. The taxpayer should be able to provide you with this document.

Line 8a is the original qualified basis of the building at the close of the first year of the credit period. IRC §42(c)(1)(A) provides that:

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

Line 8b: Multiple Building Project – Under IRC §42(g)(3)(A), the dates for meeting certain requirements changes if a building is part of a project consisting of multiple buildings. The

requirements are outlined in the Form 8609 instructions for line 8b.

Line 9 includes elections the taxpayer must make before claiming the credit.

1. Line 9a, Election to Reduce Eligible Basis – If there are federal subsidies, then a new building does not qualify for the full 9% credit unless the basis supported by the subsidy is excluded from Eligible Basis (IRC §42(b)(1)(A) and IRC §42(i)(2)). If box 6a or 6d is checked, then the state has identified sources of federal subsidies.
2. Line 9b, Disproportionate Standards – If the cost of the non-LIHC units is greater than the LIHC units, then the cost of the more expensive non-LIHC units cannot be included in the Eligible Basis. Alternatively, the taxpayer can elect to reduce eligible basis by the excess cost of the non-LIHC units over the LIHC units if the difference in cost is not greater than 15% (IRC §42(d)(3)).

Line 10 also identifies elections the taxpayer must make, but these elections are identified in the Code as irrevocable.

1. Line 10a: Postpone first year of the credit period (IRC §42(f)(1)(B)). The taxpayer must demonstrate that they have acted in a manner consistent with such an election. This is an important decision because it will effect the computation of the Eligible Basis and Applicable Fraction – both determined as of the last day of the first year of the credit period.
2. Line 10b: Large Partnership Election under IRC §42(j)(5)(B) – Streamlines recapture of the credit for large partnership with 35 or more partners. Very few LIHC property owners that are partnerships have 35 partners at the first tier level. Even if your taxpayer meets the requirements and makes the election, TEFRA still applies.
3. Line 10c: Minimum Set-Aside – Taxpayers must provide a minimum amount of LIHC housing to qualify for any credit. If the minimum set aside is not met for the first year of the credit period at the *project* level, the

project does not qualify as LIHC housing and does not generate any LIHC for the 10 year credit period. Failure to meet this requirement in years after the first year will result in the disallowance of the credit for that year, but the property can generate credit in subsequent years if the minimum set-aside is restored (IRC §42(g)(1)).

4. Line 10d: Deep-Rent-Skewed-Project – Under IRC 142(d)(4)(B) a taxpayer may elect to serve population at low income levels. See instructions for Form 8609 for additional explanation.

Analyzing the Form 8609 will help you understand the parameters under which the LIHC project is operating. You will also be able to anticipate what you should see in the books, records and tenant files. Finally, Form 8609 will help you identify potentially large, unusual or questionable items that should be raised as audit issues.

Question 2: I've factually developed an LIHC issue, but there isn't any guidance on how this unusual issue should be treated. The taxpayer and I agree that a request for technical advice from Chief Counsel is appropriate. How do I do that?

Answer 2: Requesting assistance will result in the issuance of a Technical Advice Memorandum (TAM) to establish how the Internal Revenue Code should be applied to a specific set of facts. It is the Service's position and an examiner must following the position presented in the TAM.

Formal procedures are outlined in the second revenue procedure issued each year; e.g., Rev. Proc. 2005-2.

Key Points

Taxpayers can initiate a request for technical advice during an audit. If this is the case, a taxpayer must provide a statement of the facts, issues, and their position.

If an examiner initiates the request, the taxpayer is notified that the request is being made. The taxpayer is given time to

indicate whether there is any factual disagreement. Taxpayers are encouraged to submit a statement of their position.

There are opportunities for both Service representatives and the taxpayer to meet with Chief Counsel before the TAM is issued.

The Technical Expedited Advice Memorandum is a program intended to streamline the issuance of Technical Advice Memoranda and eliminates requirements for a TAM that can frustrate the process, such as the requirement that the taxpayer and examiner agree on facts.

References

1. IRM 4.2.3.4, Technical Advice Memorandum
2. IRM 4.8.8.12.4, Requests for Technical Advice

Frequently Asked Questions (The Owner's Side)

Question 1: I'm in the eleventh year of the compliance period and I need to compute the credit under IRC §42(f)(2)(B). I know the total amount of credit claimed the first year, but I don't have the tax returns or tenant files, and the general partner has changed several times. How do I prepare the tax return for the eleventh year if I can't compute the credit on a BIN by BIN basis?

Answer 1: Not to be painfully obvious, but....

IRC §6001 requires every taxpayer to maintain records sufficiently detailed to prepare a proper tax return, including 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.

Treas. Reg. §1.42-5(b)(2) requires LIHC property owners to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for

the 15th year of the compliance period of the building.

Owners may use electronic storage systems instead of hardcopy (paper) books and records to retain the required records. Rev. Rul. 2004-82, I.R.B. 2004-35, Q&A #11 is specific to the LIHC program. However, the electronic storage system must satisfy the requirements of Rev. Proc. 97-22.

The lesson learned is that the first year tenant records should be added to the list of documents transferred to a new owner upon purchase of the property. Not that this is particularly helpful to a taxpayer preparing a tax return for year 11. Here are some suggestions:

The state agency may have records noting which units actually qualified as low-income units at the end of the first year of the credit period.

If the tax return was prepared by a paid preparer, they may be able to provide a copy.

The IRS may be able to provide a copy, particularly if the return was late filed. The IRS maintains individual returns (Form 1040 series) for 7 years, and other returns may be available for a longer period of time. A taxpayer would need to file a Form 4506, Request for Copy of Tax Return. For a partnership return, any person who was a member of the partnership during any part of the tax period being requested can sign the request.

Question 2: The state agency reviewed my property and filed a Form 8823 notice of noncompliance with the IRS before I could correct the problem. I subsequently corrected the noncompliance and another Form 8823 was filed indicating that I was back in compliance. I've just been notified that I'm going to be audited. Why am I being audited when the noncompliance has been corrected?

Answer 2: The filing of a Form 8823 with the IRS is not a good thing, if for no other reason that it draws attention to the taxpayer. And it is reasonable to conclude that if the noncompliance

has not been corrected, the attention may be a little more focused.

However, LIHC tax returns may be selected for audit *even if the noncompliance is corrected*. Perhaps the notice of corrected noncompliance had not been filed at the time the return was selected or, even though corrected, the noncompliance results in a loss of credit. When reviewing the tax return, tax issues unrelated to the reported noncompliance could have been identified.

And then...tax returns are selected for audit through a variety of methods. An LIHC return could be audited for an entirely different reason, and the report of noncompliance is just a coinciding series of unfortunate events.

Frequently Asked Questions *(The Management Company's Side)*

Question 1: A woman moved into our property. The woman provided us with a divorce decree indicating that she had joint custody of her little girl with her former spouse, and said the child would be living with her. Based on the income limits for a two person household, the household qualified. However, the woman alone would have been over the income limit for a one person household.

Her former spouse applied for housing at another LIHC property in the area. He included his child as a member of the household and was income qualified based on a two person household. Alone, he would not have qualified based on the income limit for a one person household.

When we found out the child was included in both households, we questioned the mother. She admitted that the child didn't actually live her, but sometimes visited on weekends. Her former spouse has physical custody of the child. Can the parents "split" the child for LIHC purposes?

Answer 1: Children are not "split" between households. According to HUD manual 4250.3, section 3-8, when determining family size for income limits, children in joint custody arrangements are included in a household when the child is physically present 50% or more of

the time. In this case, the child cannot be included when determining the family size of the mother's household.

Question 2: Where in the Code does it say that a student cannot be a low-income tenant?

Answer 2: This is a unique situation where a rule is referred to, but is not actually included in, the Internal Revenue Code. Instead, the general rule is found in the legislative history, and reads:

"In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under sec. 151(c)(4)), no one of whom is entitled to file a joint income tax return."

Under IRC §151(c)(4), we're basically talking about full-time students.

The Code does include four exceptions to the student rule in IRC §42(h)(3)(D).

1. An individual who is a student and receiving assistance under title IV of the Social Security Act.
2. An individual is enrolled in a job training program receiving assistance under the Job Training Partnership Act or under similar Federal, State or local law.
3. Units can be occupied entirely by full-time students if the students are single parents and their children, and such parents and children are not dependents (under IRC §152) of another individual.
4. Units can be occupied entirely by students that are married and file a joint return.

Frequently Asked Questions *(The Accountant's Side)*

Question 1: Is there a difference between the Minimum Set-Aside and the Applicable Fraction, or is the computation the same?

Answer 1: Yes, there is a difference and no, the computations are not the same.

The Minimum Set-Aside is strictly a count of the number of low-income *units* in the *project* as of the last day of the taxable year.

The Applicable Fraction is the percentage of a *building* dedicated to low-income residential rental units. Under IRC 42(c)(1)(B), the Applicable Fraction is the smaller of the unit fraction or the floor space fraction.

Example

A mixed-use LIHC project consists of one building with a hundred units. The Eligible Basis is \$1,000,000 and the Applicable Percentage is 8.93%. The taxpayer elected the 40/60 minimum set-aside and maintains only the minimum 40 units to qualify for the credit. The other 60 units are rented at fair market value. At the end of the taxable year, the taxpayer computes the Applicable Fraction.

Using the Unit Fraction, the taxpayer meets the minimum set-aside as anticipated; i.e., the fraction is 40% (40/100).

However, when the taxpayer uses the floor-space method, the Applicable Fraction is only 37.3%. The fraction is lower than the fraction computed using the Unit Fraction method because smaller units were occupied by income-qualified households and larger units were rented to households paying fair market rent.

Therefore, the taxpayer met the minimum set-aside requirement and will claim IRC §42 credit in the amount of \$33,309 each year. The computation is:

| | |
|------------------------|-----------------|
| Eligible Basis: | \$1,000,000 |
| Applicable Fraction: | <u>x 0.373</u> |
| Qualified Basis: | \$373,000 |
| Applicable Percentage: | <u>x 0.0893</u> |
| Annual LIHC: | \$33,309 |

Explanation: So, it is possible to claim credit based on an Applicable Fraction that is less than the minimum set-aside – as counter intuitive as that may seem.

Question 2: My client wants to sell her LIHC building, which is a single family home with a 1989 credit allocation. And since the allocation was made before 1990, there isn't a restrictive covenant. The first year of the credit period was 1991, and was first occupied by a qualifying tenant in September of that year. 2005 is the 15th year of the compliance period. When can my client sell the home without triggering a recapture event - January 1st or October of 2006?

Answer 2: Under IRC 42(i)(1) the compliance period is defined as the period of 15 taxable years beginning with the 1st taxable year of the credit period. Under IRC 42(f)(1) the credit period is a ten-year period beginning with the year in which the building is placed in service, or if elected, the succeeding taxable year.

Assuming that your client is a calendar year taxpayer, both the credit and compliance periods began on January 1, 1991 and the compliance period will end on December 31, 2005.

The confusion arises because the credit for the first year is based on the number of months within the first year that the LIHC units were occupied by qualified tenants, and the credit that isn't claimed in the first year is allowable in the 11th year under IRC §42(f)(2)(B). It really is logical to think the credit period begins when the units are first occupied, but logic does not always prevail in the world of taxes. The credit periods follow the taxpayer's taxable year, which is almost always the calendar year.

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 an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-2240, for signature approval.

♪ Grace Notes ♪

This newsletter was easier than most to write. Every time someone asked a really good question, I'd not only find the answer and respond, but I'd copy it from my e-mail response right into my draft of the newsletter. Isn't Microsoft Word grand!?!

So, as I was editing and making sure I've included all those little words in the right places -really slows down the typing when you've got to quote correctly and check your references- I realized that these questions really focus on the little quirky twists and turns of IRC §42.

Let's face it - IRC §42 isn't your normal in-the-box debit-and-credit accounting type of issue, and it takes a while to figure out the vocabulary! Applicable Fraction is not the same as the Applicable Percentage, and well - "eligible basis" and "qualified basis" still get twisted on my tongue. I'm still wondering what to do if parents with joint child custody actually document an exact 50%-50% split, and I, too, once searched IRC § 42 looking for the student "rule". The question about the minimum set-aside and applicable fraction really twisted my brain as I'd never thought about it before and one little word escaped me on ALL my previous readings! The answer to the question about finding a really old tax return actually came from a consultant (thank you very much) helping a client.

As much as I like my life stable, or at least predictable, and I'd really like to make a CORRECT intuitive guess just once in awhile, IRC §42 just doesn't allow for such ease of mind.

When I was in junior high school, with a major headache over quadratic equations, I asked my mother (sincerely) when I might possibly be asked to solve such an equation in the real world. After explaining to my mother what a quadratic equation was, and her thoughtful pause, this is what she told me.

First of all, she said, I should seize (yes, that was her word) the opportunity to learn whenever the occasion presents itself - you never know when whatever you are learning might just come in handy.

Second, I might actually need to solve one of these equations someday, and without learning how now, I might not even recognize that the problem involves a quadratic equation.

And finally, at her pragmatic best, my mother pointed out that school - the forced learning of a whole bunch of stuff, most of which doesn't have an apparent immediate use and isn't remembered - is really about learning how to learn. She refers to learning as "brain gymnastics".

Thanks for the exercise!!!

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P.S. My mother is a wise woman and practices what she preaches. "Learn to learn, and never stop learning", she says. She's 82 and now writing her memoirs. English is a second language for her, so she sends me drafts to check for spelling and grammar mistakes. We're both learning.