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!!

Hurricane Katrina

Hurricanes Katrina is one of the most devastating storms in American history, resulting in a major loss of life and massive destruction in Louisiana, Mississippi, and Alabama. The flooding of New Orleans required an extraordinary evacuation effort and more than a million people have been displaced.

In response, the IRS issued Notice 2005-69, which provides that owners of LIHC properties throughout the United States, in coordination with their state agencies, may offer temporary housing to individuals who were displaced by Hurricane Katrina, without regard for whether the displaced person qualifies as low-income. To qualify, the displaced persons must have (1) resided in jurisdictions designated for Individual Assistance in Alabama, Louisiana, and Mississippi, and (2) their residences were destroyed or damaged as a result of devastation caused by Hurricane Katrina.

Relief measures are also available to owners of LIHC property in areas identified in major disaster declarations issued by the President of the United States under the Stafford Act on or after January 1, 1995. See Revenue Procedure 1995-28.

Rent Limits & Providing Services: Regulation §1.42-11

A unit qualifies as an LIHC unit when the gross rent does not exceed 30% of the income limit for the unit. The income limit for a low-income housing unit is based on the minimum set-aside election made by the owner under IRC §42(g)(1). This election is documented on Form 8609, Part II, line 10c. Under Treas. Reg. 1.42-11(b)(3), the cost of services that are required as a condition of occupancy must be included in gross rent even if federal or state law required that the services be offered to tenants by building owners.

<u>Optional Services</u>

Units may be residential rental property qualifying for the LIHC even though services other than housing are provided. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent. A service is optional when the service is not a condition of occupancy and there is a reasonable alternative. For example, for a qualified low-income building with a common dining facility, the cost of meals is not included in gross rent if payment for the meals is not required as a condition of occupancy and a practical alternative exists for tenants to obtain meals other than from the dining facility. See Treas. Reg. 1.42-11(b)(1) and Rev. Rul. 91-38, Q&A #12. There is one exception under Treas. Reg. 1.42-11(b)(3)(B) for mandatory meals in any federally-assisted project for the elderly or handicapped in existence on or before January 9, 1989 that is authorized by 24 CFR 278 to provide a mandatory meals program

<u>Continual or Frequent Services</u>

If continual or frequent nursing, medical, or psychiatric services are provided, it is presumed that the services are not optional and the building is ineligible for the credit. For example, a hospital, nursing home, sanitarium, life care facility or intermediate care facility for the mentally and physically handicapped, would not be considered residential rental property qualifying for the IRC §42 credit. Treas. Reg. 1.42-11(b)(2) cross references Treas. Reg. section 1.42-9(b), which explains the general public use rule.

Tenant Facilities

No separate fees should be charged for tenant facilities (i.e., pools, parking, recreational facilities) if the costs of the facilities are included in eligible basis.

Supporting Services

There is an exception for fees paid for supportive service. A fee, in addition to rent, may be charged for services provided under a planned program that enables tenants to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. If the building is transitional housing for the homeless or single-room occupancy housing, supportive services includes helping tenants locate and retain permanent housing.

Prohibition Against Evictions Without Good Cause

Under IRC §42(h)(6)(B)(i), an extended low-income housing agreement must 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. See Rev. Rul. 2004-82, Q&A #5 and Rev. Proc. 2005-27.

Noncompliance must be reported to the IRS if:

extended use agreement does not include appropriate language;

the owner fails to certify annually that for the preceding 12-month period no tenants in LIHC units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42;

If a tenant is evicted or tenancy is terminated for other than good cause; or

the gross rent increases in a manner not permitted by IRC §42.

Rent Limits & Utility Allowances: Regulation §1.42-10

An allowance for the cost of any utilities, other than telephone, is paid directly by the tenant(s) is included in the computation of gross rent. The utility allowance is computed on a building-by-building basis. Under Treas. Reg. §1.42-10, there are specific rules based on the type of assistance provided to the building or the tenants within the building, specifically:

1. buildings receiving assistance from Farmer's Home Administration (FmHA)
2. tenants in the building receive FmHA housing payments,
3. buildings regulated by HUD
4. tenants receiving HUD rental assistance
5. If none of the rules in 1 through 4 apply, then the appropriate utility allowance for the rent restricted units in the building is the public housing authority estimate unless an interested party has obtained a utility company estimated cost of that utility for a unit of similar size and construction in the geographic area in which the building containing the unit is located.

If, at any time during the building's extend use period, the applicable utility allowance for a unit changes, the new utility allowance must be used to compute gross rent of the rent-restricted units due 90 days after the change.

Available Unit Rule: IRC §42(g)(2)(D) and Reg §1.42-15

The determination of whether a tenant qualifies for LIHC housing is made on a continuing basis, considering both the tenant's income and the qualifying area median gross income (AMGI), rather than on just the date the tenant first occupied the unit. However, Congress did not intend that tenants be evicted to bring the unit back into compliance with the program requirements for housing income-qualified tenants.

IRC §42(g)(2)(D) says that, "notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation…such unit shall continue to be treated as a low-income unit if the income of such occupants initially met the income limitation and such unit continues to be rent-restricted."

However, if the income of the occupants of the unit increases above 140 percent of the income limitation, the unit will cease to be a low-income 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 the income limitation.

In summary, the next "available unit" must be rented to a qualified low-income tenant if the income of occupants of an LIHC unit increases above 140% of the applicable income limit.

The rule for deep rent skewed projects described in IRC §142(d)(4)(B) is slightly different. If the income of the occupants of the unit increases above *170* percent of the income limitation, the unit will cease to be a low-income unit if *any low-income unit in the build is occupied by a new resident whose income exceeds 40 percent of area median gross income.*

For example, a resident qualifies at move-in and continues to be income-qualified at the time of the first annual income recertification. At the time of the second annual recertification, the resident's income exceeds the income limit by less than 2%. The resident can continue to live in the LIHC unit and the owner can continue to claim the credit. At the time of the third annual recertification, the resident now has income of more than 140% of the income limit. The resident can continue to live in the LIHC unit and the owner can continue to claim the credit, *as long as the next available unit of comparable size is rent to an income-qualified tenant.*

Suitability for Occupancy: IRC §42(i)(3)(B)

In order to be treated as an LIHC unit, the unit must be suitable for occupancy. The Code provided authority for the IRS to determine whether the housing is suitable, considering local health, safety and building codes.

The instructions for the October 2003 revision of Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, provides an in-depth discussion of IRS expectations for LIHC housing, and is the basis for our discussion here.

State agencies must use the local health, safety and building codes or the Uniform Physical Condition Standards (UPCS) when conducting physical inspections of LIHC properties, but not a combination. If a state agency chooses to use the UPCS, then HUD's Dictionary of Deficiency Definitions to determine the severity of the violation.

The IRS adopted the Dictionary of Deficiency Definitions to provide objective standards that can be applied consistently by all the state agencies. The UPCS include five major categories:

> the site, including components such as fencing and retaining walls, the grounds, parking lots and play areas;
>
> building exteriors, including fire escapes, foundations, and roofs;
>
> building systems such as domestic water, electrical system and elevators, fire protection and sanitary systems;
>
> dwelling units, including electrical systems and outlets, hot water heaters, functional bathrooms and kitchens, lighting, smoke detectors, stairs, walls and windows;
>
> common areas, such as garages, utility rooms, laundry rooms and trash collection areas.

HUD's Dictionary of Deficiency Definitions also includes descriptions to gage the extent of the noncompliance with the UPCS: (1) minor, (2) major, and (3) severe. The descriptions often include threshold measurements that must be met before noncompliance is reportable. For example, it may be found that the shower, tub, components, or hardware such as grab bars and shower doors, are damaged or missing

> Level 1, Minor – a stopper is missing. However, this is not a violation if the

stopper is visibly observable near the tub or shower.

Level 2, Major – the shower or tub can be used, but there are cracks or extensive discoloration in more the 50% of the basin.

Level 3, Severe – the shower or tub cannot be used for any reason. The shower , tub, faucets, drains, or associated hardware is missing or has failed.

The state agencies must report all noncompliance to the IRS on Form 8823:

regardless of whether the noncompliance is corrected at the time of the physical inspection.

regardless of the extent of the noncompliance (minor, major, or severe).

IRS Releases Revised Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

The IRS has revised Form 8823 to improve the filing processing and enhance internal analyses. State agencies started using the new form on October 1, 2005.

The most visible change is the use of bar coding. State agencies use a PDF fillable form which creates a bar code in the upper right hand corner as entries are made for each line item. The IRS will scan the document to extract data for a database. This improvement will increase the accuracy of the data collected and significantly reduce the time to input the data. Other changes include:

identification of amended Forms 8823, which are filed to correct previously reported information, and

reporting of the total allowable credit allocated to the building (BIN).

The categories of noncompliance (lines 11a-q) have also been updated.

Separate lines for reporting noncompliance associated with the initial tenant income certification (line 11a) and the subsequent annual tenant income recertification (line 11b). Failure to maintain tenant files and documentation of the tenant's initial eligibility and subsequent recertification are also reported using these categories.

All violations of the Uniform Physical Condition Standards or local inspection standards are reported on line 11c, regardless of the severity (minor, major, or severe).

Violations of the Available Unit Rule and the Vacant Unit Rule are reported on separate lines (11i and 11j respectively).

How a Form 8823 Turns Into an IRS Audit

By Kent Rinehart, Program Analyst

For many taxpayers, the first indicator that they get about an IRS audit comes on the day they open their mail, or on the day they receive a phone call, from the Department of Treasury that starts out something like: "Your return has been assigned to me for examination…".

For owners of Low-Income Housing Credit (LIHC) properties, their senses may be prompted a little earlier should the state housing agency issue the owner a Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition.

Although a return can be selected independently for a number of reasons and audited by the IRS for any large, unusual or questionable issue, one Form 8823 puts any return much closer to an IRS audit simply because it has identified an LIHC owner (taxpayer) that is not in compliance with section 42 of the Internal Revenue Code. Any Form 8823 puts a taxpayer four steps closer to an IRS audit. Let's take a look at how:

Step #1: When the state agency sends a Form 8823 to the IRS, the LIHC owner receives a copy.

When a Form 8823 is issued by the state agency, it is generally <u>not</u> an instant decision on the part of any agency unless the form is issued because of one defining event, such as a building disposition. The overall process of monitoring project compliance is ongoing between each state agency and building owner. The state agency may make numerous contacts with the building owner and property managers to resolve noncompliance issues identified through their reviews of the tenant files and inspections of the property.

Regardless of whether the noncompliance is subsequently corrected, the state agency will send a Form 8823 to the IRS Philadelphia Campus, with a copy sent to the owner. Receiving a Form 8823 may just be the motivating factor that finally gets the noncompliance corrected. And for the agency—that's a good thing! But whatever happened to that initial Form 8823 that went to the IRS?

Forms 8823 are initially screened, and may be immediately selected for further audit consideration. The state agency's "property owner" is now the IRS' "taxpayer" and the first step is to match the Form 8823 with the taxpayer's tax return for the year of noncompliance.   The IRS then determines whether the owner's tax return should be audited.

Step #2: Even if the LIHC owner corrects the noncompliance after the Form 8823 was issued, the IRS will review the tax return because of the initial Form 8823 issued by the agency.

One Form 8823 gives the IRS a reason to look at a tax return. It is a notice that something is wrong with respect to IRC § 42, the Low-Income Housing Credit. At this point, the IRS not only analyzes the return for IRC § 42 issues, but will also consider any other item that appears large, unusual or questionable.

A corrected Form 8823 may be a good thing for the state agency, but it may arrive at the IRS a couple of days, weeks, months, or even years after the original Form 8823 was received, and perhaps long after the original Form 8823 and corresponding tax return have been reviewed for audit consideration.

A corrected Form 8823 will not reverse the IRS' process for identifying tax returns for audit. Even though the noncompliance may have been corrected, the potential still exists for a portion of the current year credit to be disallowed and recapture of prior year credit.   This is especially true when a portion of the building was found not to qualify for IRC § 42 credits and the noncompliance was not corrected until after the close of the tax year.

Step #3: The number of Forms 8823 issued by the agency on a LIHC project, <u>or</u> the type of noncompliance item checked on the form, <u>or</u> the number of noncompliance items checked on the form are considered to determine if an IRS examination is warranted.

Taxpayers are always trying to figure out how the IRS picks returns for audit, and LIHC property owners are no different. For example, taxpayers may believe that the number of Forms 8823 issued on a LIHC project are an indication of either how isolated, or how widespread, the noncompliance may be. For example, if a project consists of ten different buildings, and a noncompliance issue for each building is reported to the IRS, it indicates a high level of widespread noncompliance.

On the other hand, a taxpayer may worry when a Form 8823 is filed for noncompliance with a single requirement, which could result in some type of credit adjustment or recapture; e.g., the household's income is above the income limit upon initial occupancy; the project failed to meet minimum set-aside requirement, or the project is no longer in compliance or participating in the IRC §42 program. Noncompliance issues are not only tough to correct, but they can be widespread and significantly reduce the amount of credit the taxpayer can claim.

Of course, a taxpayer might also be concerned about repetitive noncompliance. Even if a tax return is not selected for audit, all Forms 8823 issued by the agency are retained by the IRS and can be associated with any future Forms 8823 they receive from the agency.

The three factors we've discussed here are logical and make sense. Surely, these indicators of noncompliance are somewhere in the mix. The problem with speculation, however, is that there's just no way of knowing for sure how much weight these factors are given when the IRS reviews a specific tax return for audit.

Step #4: The tax return is reviewed for all other items that are large, unusual or questionable.

Once the IRS has the tax return, it is not good business sense to simply analyze the return for IRC §42 issues. There are hundreds of other Code sections that potentially could impact the taxpayer. So, in addition to IRC§ 42 issues that originated with Form 8823, the IRS will take the time to see if any other large, unusual or questionable issues warrant examination. The issue may not be part of the Low-Income Housing Credit program—but the issue may warrant an audit just the same.

Overall, an analogy can be made between a Form 8823 and a spark. It's hard to start any fire without a spark, and one spark generally does not start a fire—but it could. More sparks means a greater chance for a fire and hotter issues for any IRS examiner.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

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♫

The Monday before Thanksgiving I found myself meandering around the beltway during a torrential rainstorm for several hours, with more than sufficient time to muse upon the trivial happenings of my day and the great mysteries of life. Do we make a difference? Have we done any good? You might consider these are odd questions to ask an IRS employee, and particularly a revenue agent auditing the owner of an LIHC property, so maybe rephrasing the question will help.

a. *Are we helping taxpayers understand and comply with the requirements of IRC §42?*

b. *When evaluating a taxpayer's compliance with IRC §42, do we apply the Internal Revenue Code with integrity, which results in impartial conclusions after consideration of all the facts?*

c. *When determining the consequences of noncompliance, do we apply the Internal Revenue Code fairly so that all taxpayers are treated equitably?*

Actually, we ask these questions when auditing any tax return, and in fact, I derived these questions from our mission statement. But there's something else we need to keep in mind. IRC §42 is more than tax Code. Congress created the Low-Income Housing Credit to meet specific housing needs of particularly vulnerable members of our community. To ensure we meet this objective, we also need to ask whether we are administering the Low-Income Housing Program so that clean and safe affordable housing is available for those who need it. Has anyone's burdened been lightened? Have we helped anyone in need?

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