Examination Specialization and Technical Guidance's

# Low Income Housing Credit Newsletter

Internal Revenue Service Issue #26, September 2007

*The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.*

## Documenting Household Income

The accurate determination of a household's income is a fundamental requirement of the IRC §42 Low-Income Housing Credit program. Not only is it necessary for identifying households most in need of the housing, but the determination must be adequately documented in order for the owner to claim the credit.

Under Treas. Reg. §1.42-5(b)(1)(vii), owners of LIHC properties must keep "documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation)." Taxpayers must retain these records for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year ($15^{th}$) of the compliance period of the building.

Further, under section 6001 of the Code, *all taxpayers* are required to maintain records sufficiently detailed to prepare a proper tax return. This requires the maintenance of such 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. This requirement also applies to the preparation and maintenance of tenant files sufficiently documented to support household eligibility for purposes of claiming the low-income housing credit under IRC §42.

In some cases, a potential tenant may have self-employment income. Income from a sole proprietorship can be estimated by reviewing the individual's prior year tax return and Schedule C. But what if the potential tenant doesn't file a tax return? Now what should you do?

All income defined under IRC §61 is subject to taxation, and a tax return must be filed for all self-employed individuals who operate sole-proprietorship businesses or otherwise report income on Schedule C. It doesn't matter whether the taxpayer is reporting a profit or a loss.

If the person is not eligible to get an SSN, which is needed to file a tax return, an individual taxpayer identification number (ITIN) can be obtained using Form W-7.

Publications 501 and 519 may be helpful if more detailed information is needed.

## Defining "Married" Students

Residential rental units comprised of full-time students (no one of whom is entitled to file a joint return) do not qualify as low-income units. However, there are exceptions. Under IRC §42(i)(3)(D)(ii)(II), a unit is still treated as a low-income unit when it is occupied entirely by full-time students if such students are married and file a joint return. As explained in the Guide for Completing Form 8823, a married couple that is entitled to file a joint return, but has not filed one, still satisfies the requirement.

So, who is entitled to file a "joint" tax return? A taxpayer can choose "married filed jointly" if married and both spouses agree to file a joint return.

For purposes of filing a married joint return, a couple is considered married for the whole taxable year if, on the last day of the tax year, the couple meets any one of the following tests.

1. The couple is married and living together as husband and wife,
2. The couple is living together in a common law marriage that is recognized in the state where they now live or in the state where the common law marriage began,
3. The couple is married and living apart, but not legally separated under a decree of divorce or separate maintenance, or
4. The couple is separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint tax return, the couple is not considered divorced.

For more information, refer to Publication 501.

## Treating Buildings as Part of a Multiple Building Project

As part of the First-Year Certification required under IRC §42(l)(1) and documented on Form 8609, Low-income Housing Credit Allocation and Certification, a taxpayer can elect to treat the buildings as part of a multiple building project. To qualify for the election, the buildings must be:

1. located on the same tract of land (unless all the units in all the buildings are low-income units),
2. owned by the same person for tax purposes,
3. financed under a common plan, and
4. have similarly constructed residential units.

The taxpayer's election will effect how the property operates in at least four ways.

<u>Minimum Set-Aside Requirement</u>

Under IRC §42(g)(1), an LIHC property owner elects to provide housing to low-income households with income at specific levels when compared to the area's median gross income, as adjusted for family size. The taxpayer also agrees to provide housing to a minimum number of low-income households. The determination of whether the owner has met the minimum set-aside requirement is made at the *project* level.

Suppose an owner has two LIHC buildings with 100 units in each building, and elects the 40-60 minimum set-aside; i.e., 40% of the units in the project will be rented to households with income not exceeding 60% of the AMGI.

If the owner decided to treat the buildings as separate projects, then 40 units in each building must be rented to income-qualifying households, or 80 units in total.

If the owner decides to treat the buildings as a multiple building project, the owner will still need to provide 80 low-income units (40% x 200 = 80) but the units do not need to be distributed equally between the two buildings.

<u>Transferring Tenants Between Buildings</u>

Under Rev. Rul. 2004-82, Q&A #8, a low-income household can transfer to a low-income unit in a different building within the *project*. A cautionary note is needed here. Only households whose income is no greater than 140% of the income limit (or 170% for deep rent skewed projects) can move between buildings in a project because the Available Unit Rule under IRC §42(g)(2)(D)(ii) is applied at the *building* level.

<u>Vacant Unit Rule</u>

Under Treas. Reg. §1.42-5(c)(1)(ix), if a low-income unit *in the project* became vacant during the year, reasonable attempts must be made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the *project* were or will be rented to tenants not having a qualifying income.

<u>Physical Inspections and Tenant File Reviews</u>

State agencies are required to physically inspect at least 20% of an LIHC *project's* low-income units and review the low-income certifications (and documentation) for the households in those units at least once every three years.

Suppose an owner has two buildings with a hundred low-income units in each building. If each building is treated as a separate project, the state agency will review 20 units in each building, for a total of 40 units. If the taxpayer elects to treat the buildings as a multiple building project, 20% of the 200 units is also 40 units.

The answer is quite different if the owner's low-income property consists of 100 single family houses. If each house is treated as a separate project, the state agency will need to review all 100 homes and all the tenant files. If the owner elects to treat all the homes as a multiple building project, only 20 of the homes will need to be inspected along with the review of the tenant files for those units.

## Impact of Noncompliance Reported to the IRS on Forms 8823

State agencies use Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, to notify the IRS of noncompliance with IRC §42 requirements.

The form may indicate that the owner was noncompliant, but the noncompliance was corrected before the Form 8823 was sent to the IRS. In cases where the noncompliance was not corrected before the end of the correct period, the Form 8823 will indicate that noncompliance previously reported on a different Form 8823 has now been corrected. In either case, these "back in compliance" Forms 8823 are processed without contacting the taxpayer.

Owners are notified, however, when the IRS receives Forms 8823 disclosing noncompliance which has not been corrected within the correction period. The notification letter identifies the noncompliance issues and explains that nonqualifying units should not be included when calculating the credit. The owner may be subject to the recapture provisions under IRC §42(j).

LIHC property owners are taxpayers who are expected to file accurate tax returns just like everyone else. So, if noncompliance occurs, taxpayers should account for the noncompliance regardless of whether the state agency identifies it, reports it to the IRS, or which letter (if any) is sent to the taxpayer by the IRS.

For example, a state agency reviews a project and finds that the owner is out of compliance. The owner is notified of the noncompliance and immediately corrects the problem. As a result, the owner is reported as "out and back in compliance" when the state agency files the Form 8823 with the IRS. Will the owner receive the notification letter? Are they expected to forego credits?

<u>Example 1</u>

The state reviewed a project and found that a unit was not suitable for occupancy on February 1, 2007. The owner was notified and immediately fixed the problem on March 30, 2007. Therefore this unit was "out and back in compliance" and an 8823 will be filed, but the taxpayer will not receive a notification letter.

Assuming the taxpayer's tax year ends December 31$^{st}$, there is no tax impact. At the end of the tax year, when the Applicable Fraction is computed based on a "snapshot" measurement, the unit is in compliance.

<u>Example 2</u>

A state agency reviewed a project in December of 2006 and noted that water pipes had frozen and burst. The pipes could not be repaired until spring when the ground thawed. The state agency extended the correction period to the maximum six months and reported the owner out of compliance on December 15th, 2006 and back in compliance on April 15th, 2007 when the Form 8823 was filed.

Even though the taxpayer won't get a letter, and assuming the broken pipes affected all the units, the Applicable Fraction is zero on December 31, 2006, the last day of the taxable year. No credit would be allowable for the building in 2006 and the noncompliance would trigger a credit recapture event.

<u>Credit Recapture Events</u>

A taxpayer is required to recapture a portion of the credit allowed prior years if, for any year in the 15 year compliance period, the qualified basis at the end of the taxable year is less than the qualified basis at the end of the preceding taxable year. Since the qualified basis is equal to the eligible basis multiplied by the applicable fraction, any decrease in either the eligible basis or applicable fraction will trigger a recapture event.

Decreases in qualified basis can be caused by:

1. noncompliance at the low-income unit, building or project level,
2. disposition of the low-income building, or
3. disposition of an interest in a low-income building.

The "credit recapture amount" is defined in IRC §42(j)(2) and has two parts:

1. The amount of credit recaptured is based on the year in which the recapture event occurs. For years 2 through 11, the amount of credit to be recaptured is 33.3% of the credit allowed in previous years. The percentage recaptured decreased every year thereafter.
   - 26.7%. in year 12,
   - 20% in year 13,
   - 13.3% in year 14, and
   - 6.7% in year 15.

2. The amount of interest is determined for the recaptured credit at the overpayment rate for all prior taxable years involved starting on the due date for the filing of the tax return for the prior taxable years involved.

Refer to IRC §42(j)(4) for "special rules"; i.e., (1) the application of the tax benefit rule, (2) no recapture of credit claimed under IRC §42(f)(3), (4) decreases in qualified basis caused by casualty events, and (5) di minimis changes in floor space.

## LIHC Administrative Reminders

**Expanding Exam, Project/Tracking Code:** All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

**Form 5344, Revenue Protection:** The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 44 through 47 identify the type of credit and the extent of any adjustment made. See IRM 104.3.12.4.55 through 58 for details.

**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.

**TEFRA Requirements:** As LIHC property owners are almost always partnerships, and are likely to be subject to TEFRA procedural requirements, please remember document actions taken and decisions made by completing:

- Form 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with TEFRA Coordinators that can help walk you through the procedures.

**http://tefra.web.irs.gov/m1/1a_home.asp**

## 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**.

## ♫ Grace Notes ♫

*You're right. An LIHC newsletter was issued just a month ago, and while the newsletters are normally issued quarterly (more or less), I write the articles as I think of relevant topics or someone asks a question. In this case, four people asked really good questions. Voila! – a newsletter goes to print!*

*On the other hand, you might notice that the questions are totally unrelated and not entirely based on IRC §42 law. Just think of this newsletter as the far right category on the Jeopardy answer board titled "Odds and Ends."*

*Which, quite logically, reminds me that it's the end of summer. I hope your summer included some fun vacation time…or at least wasn't all work….and you are ready to begin the new year because……………..*

*…to be continued….*

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*P.S. Don't you just love cliffhangers?*