Examination Specialization and Technical Guidance's

Low Income Housing Credit Newsletter

Internal Revenue Service Issue #30, June 2008

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.

Chief Counsel Advisory 200812023

On March 21, 2008, the IRS released a Chief Counsel Advisory (CCA) providing guidance regarding IRC §42, the low-income housing credit. The issue involved the allocation of tax credits when special allocations in the partnership agreement result in the actual allocation of depreciation being different from the allocations provided for in the partnership agreement.

Chief Counsel Advisories are issued as requested by IRS' Examination functions. The following article, written by Kristina Thompson, provides an analysis of the legal issues presented in the CCA.

LIHC Partnerships and Credit Allocations under IRC §704 (b)

By Kristina Thompson, SBSE Revenue Agent

Generally when auditing LIHC issues, we are evaluating the taxpayer's compliance with the requirements of IRC §42. However, most owners of LIHC projects are partnership entities, so agents also need to review the taxpayer's compliance with partnership tax law.

Background

If you are new to LIHC issues, it may be helpful to understand why partnerships are generally set up as the ownership entity. The LIHC was set up under section 42 of the Internal Revenue Code to provide an incentive for taxpayers to invest in affordable housing by providing a tax credit. The credit is a dollar for dollar reduction of the investor's income tax liability. The taxpayer will generally invest in the affordable housing in exchange for a 10-year stream of tax credits and a 15-year stream of tax losses. The amount that any taxpayer is willing to invest in the project usually depends upon the rate of return generated by the future benefit of the tax credits and losses. Basically, investors are buying tax credits.

The entity of choice for these investors is the Limited Partnership or Limited Liability Company. Both entities offer limited liability for the investor, along with the flexible provisions of subchapter K which allow the taxpayer to allocate substantially all of the tax benefits associated with the project to the limited partners. The partnership agreements are often structured so that all of the gain, loss, and credits are allocated 99.9% to the limited partner and .01% to the general partner.

Under IRC §704 (a) the partnership is allowed to provide for the partners' distributive share of gain, loss or credits to be allocated based upon the partnership agreement. However IRC §704(b) provides that the partners distributive share of gain, loss, or credit shall be allocated in accordance with the partners interest in the partnership. If the allocation in the partnership agreement does not have substantial economic effect the allocation will not be allowed.

Overview of IRC §704(b)

Under IRC §704(b), an allocation of the partnership items will be respected if either of the following is satisfied: (i) the allocation has (or is deemed to have) substantial economic effect; or (ii) the allocation is (or is deemed to be) in accordance with the partners' respective interests in the partnership. In meeting these requirements, special rules apply in allocating deductions attributable to nonrecourse debt.

Substantial Economic Effect Test - Under the IRC §704(b) regulations, a two-part analysis is used to determine whether an allocation has ''substantial economic effect.'' First, the allocation must have economic effect, based on a mechanical analysis, and second, such economic effect must be substantial. This determination is made at the end of the partnership taxable year to which such allocation relates.

Economic Effect – The IRC §704(b) regulations provide, as a general rule, that allocations under a partnership agreement will be considered to have economic effect if the partnership agreement requires (i) the partners' capital accounts to be maintained in accordance with the IRC §704(b) regulations, (ii) liquidation proceeds to be distributed in accordance with positive capital accounts, taking into account all necessary adjustments to the partners' capital accounts for the taxable year of such liquidation, and (iii) ***partners to be unconditionally obligated to restore negative capital accounts upon the dissolution of the partnership by contributing cash or other property to the partnership.*** I recommend that you read your taxpayer's partnership agreement carefully. Many times, the limited partner is ***not*** required to restore any negative capital account balance upon the dissolution of the partnership.

The capital account requirements set forth in the IRC §704(b) regulations provide the fundamental rules for measuring each partner's equity investment and determining the economic relationships among the partners. A partner's capital account generally is increased by (i) the amount of money that the partner contributes to the partnership, (ii) the fair market value of property that the partner contributes (net of liabilities secured by the property and assumed by the partnership), and (iii) any allocations of partnership income or gain allocated to the partner. A partner's capital account is decreased by (i) the amount of money distributed to the partner by the partnership, (ii) the fair market value of property distributed to the partner (net of liabilities secured by the property and assumed by the partnership), and (iii) the amount of loss and deduction allocated to the partner. Thus, a partner's capital account reflects its economic interest in the transaction, based on the assumption that the value of the partnership property equals its IRC §704(b) book basis.

In the above discussion, note that tax credits do not have any effect on a partner's capital account. The provisions in the regulations under IRC §704 state that since the credit does not effect the capital account, any allocation of the credit must be in relation to the item that is effecting the capital account. In the case of the Low-Income Housing Credit, this would be depreciation since the basis in the building is what the dollar amount of the credit is based upon. Many partnership agreements will state that depreciation is allocated 99.9% to the limited partner, and as such, that partner would also be entitled to 99.9% of the credit. An issue arises if the limited partner ***does not have an unconditional obligation to restore the negative capital account upon the dissolution of the partnership <u>and</u> the partner is not allocated the overall total loss at the stated rate of 99.9% because the partner has a negative capital account.***

The regulations for IRC §704 are over 72 pages long and would require a great deal of discussion to thoroughly understand all the implications. However, for our purposes here, the result is that ***the LIHC should be reallocated based upon the amount of <u>minimum gain</u> that is required to be allocated to the limited partner.***

The minimum gain is actually the allocation of depreciation that is giving rise to the credit. Under the economic substance tests of IRC §704(b), the partnership is required to allocate at least a minimum gain to the limited partner based upon its share of the nonrecourse debt. This is required once the limited partners' original contribution is completely offset by the operating losses the property is generating.

To calculate the minimum gain, you are required to determine what the basis of the property is and the amount of debt associated with it. Since we are dealing with real estate, the debt is usually nonrecourse. If the nonrecourse debt is greater than the adjusted basis of the building, then the partnership will have minimum gain based upon a hypothetical sale of the asset for the amount of the associated nonrecourse debt.

For example, if the partnerships adjusted basis (purchase price less depreciation) in the building is $450,000 and the nonrecourse debt is $500,000, then the partnership would have $50,000 of minimum gain. Since the limited partner is allocated 99.9 % of the debt, 99.9% of that gain is also allocated to the limited partner.

Let's say that limited partner has a negative capital account and has no obligation to restore any negative capital account deficit. If the depreciation on the housing project is $50,000 for the year and the minimum gain allocation is only $5,000, the limited partner is not entitled to a credit allocation of 99.9% even though the partnership agreement calls for such. In this scenario the limited partner would only be allocated 10% of the credit and the general partner would be allocated the other 90%. Most of the time the general partner (e.g., a nonprofit entity) cannot use the credit to offset a tax liability and the credit is lost.

Summary: How to Identify the Issue

Generally, a LIHC project is owned by a partnership, with a limited partner (LP) and a general partner (GP). If you are auditing an LLC the member is usually a (LP) and the managing member is the (GP).

When a project is initially started the GP might contribute a small portion of capital and the LP will contribute a significantly larger portion of the total capital. In exchange for the contribution, the LP is allocated tax losses generally limited to the LP's initial contribution as well as the LIHC.

As the partnership operates and generates losses (due to depreciation of the building) the losses are allocated per the partnership agreement. At some point, the LP will offset all of its capital contribution by claiming the tax losses. The LP's do not want to have a negative capital account deficit for which additional contributions must be made, so the partnership agreement will limit the LP's obligation. Be sure that you read the partnership agreement and understand the LP's obligations.

Basically, when the LP has a negative capital account, the partnership computes the minimum gain and the LP must be allocated at least its percentage of the minimum gain amount. If any allocation of loss is in excess of this minimum gain, a reallocation of the losses and corresponding credit must occur. Issues have been identified where no reallocation of the credit is being done by the taxpayer.

If you are auditing a partnership claiming LIHC, check the K-1's for profit and loss percentages. Most of the time the LP is 99.9 % and the GP is 0.1%. Compare the total loss on the return to the allocated amount on the K-1 and then compare this to how the credit was allocated among the partners. If the losses and credit are not allocated in the same percentage, you may have the issue.
The key to identifying and developing this issue is reviewing the partnership agreement and understanding the limited partners' obligations.

Subscribing to the LIHC Newsletter

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

♫Grace Notes♫

According to the dictionary, the word "thankful" mean to be conscious of benefits received, and "thank you" is an expression of gratitude. So, I'd like to express my gratitude to all the examiners who are so enthusiastically and diligently working LIHC issues. I know that IRC §42 is complex, with its own tongue-twisting terminology and requirements.

And I'd also like to thank all the managers for their patience and supplying the aspirin – and my manager, too. I'd also like to thank the Philadelphia LHC Compliance Unit for keeping all the paperwork straight…and Chief Counsel, who must translate all the tongue-twisting terminology into (relatively) plain English. I would be remiss if I didn't thank the state housing agencies, who are so diligently administer the program with a heart, the developers who have a vision and investors who provide the resources.. and I simply cannot forget the property managers who are the face of this affordable housing program for persons most in need of assistance.

I'd really like to thank everyone, but I don't want to overlook anyone, but the list is getting rather long. But, let's face it, it takes a village! So here goes:

I'm thankful that there is a village,
I'm thankful to be a part of the village, and
I thank you for your citizenship.
We serve together.

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