

August 2, 2010

Mr. Michael F. Mundaca  
Assistant Secretary of the Treasury for Tax Policy  
Department of the Treasury  
1500 Pennsylvania Ave., NW  
Room 3120  
Washington, DC 20220

RE: Recapture Rules Surrounding Section 1602 of the American Recovery and Reinvestment Act of 2009

Dear Mr. Mundaca:

The LIHTC Working Group works to resolve technical and administrative LIHTC program issues. The Group consists of low-income housing tax credit (“LIHTC”) industry participants including developers, syndicators, investors, owners, and managers. We are writing you this letter to bring back to your attention questions we previously raised on July 30, 2009 surrounding the recapture rules of Section 1602 subawards from the American Recovery and Reinvestment Act of 2009 (“Section 1602”). In addition, we hope to bring to your attention another issue regarding the timing of when a building should test for recapture, especially during the lease up phase of a building. We request that you add these issues to the list of IRS regulation projects and issue an IRS Notice outlining the guidance that the regulations will provide.

### **Partial Recapture**

Section 1602 states:

The State housing credit agency shall impose conditions or restrictions, including a requirement providing for recapture, on any subaward... so as to assure that the building with respect to which such subaward is made remains a qualified low-income building during the compliance period.

Furthermore, Section 1602 states:

Any such subaward with respect to any qualified low-income building shall be made in the same manner and shall be subject to the same limitations (including rent, income, and use restrictions on such building) as an allocation of housing credit dollar amount allocated by such State housing credit agency under section 42 of the Internal Revenue Code of 1986.

Within Internal Revenue Code (“IRC”) Section 42, subsection (j) provides for recapture of LIHTCs. Treasury has expressed its intentions to issue separate recapture procedures for Section 1602 funds.

As it pertains to the amount of recapture, Treasury stated in its Frequently Asked Questions and Answers Document released July 9, 2009 and updated on September 14, 2009 (“FAQs”), the amount of funds to be recaptured would be equal to “the full amount of the Section 1602 subaward... minus 6.67 percent (1/15th) for each full year of the building’s 15-year compliance where a Section 1602 recapture event has not occurred.” We believe that Treasury should allow for partial recapture, similar to what occurs under IRC Section 42, since Section 1602 states that subawards be “made in the same manner and shall be subject to the same limitations as an allocation of housing credit dollar amount allocated by such State housing credit agency under section 42 of the Internal Revenue Code of 1986.” For example, under IRC Section 42, if a building has an applicable percentage of 100% (and 100 units of equal square footage), a decrease in 1% (or 1 unit) only causes the recapture of 1% under IRC Section 42(j). However, Treasury has stated that under Section 1602, if the Section 1602 percentage (defined as the percentage of Section 1602 funds that comprise the eligible basis of the building) is 100% and the applicable fraction expressed as a percentage is 100%, then a loss of 1 unit would cause 100% recapture of the remaining subaward. Thus, Treasury should allow for partial recapture when a building’s applicable fraction expressed as a percentage falls below the building’s Section 1602 percentage, but is greater than its minimum set-aside percentage. We propose that the amount of recapture be equal to  $1/15^{\text{th}}$  of the subaward times the percentage of the building that is out of compliance for each of the years remaining in the compliance period. This percentage would be equal to the new applicable fraction divided by the Section 1602 percentage and then subtracted from 1. We have attached Exhibit A to illustrate our calculation.

In the FAQs, question and answer #9(b), Treasury implies that recapture is on a building by building basis, but does not specifically address the issue of whether the recapture calculation is building by building or property based. We believe it should be building by building to keep in line with IRC Section 42. In addition, if the calculation is done on a building by building basis, the Section 1602 funds will have to be allocated among the buildings in a reasonable manner. We believe it makes sense to allocate the Section 1602 funds among the buildings pursuant to the Section 1602 subawardee document or other regulatory agreement. If the subawardee document or other regulatory agreement does not provide for an allocation among the buildings, then the project owner should be allowed to allocate the Section 1602 funds among the buildings using any reasonable method adopted by the taxpayer, such as affordable square footage or number of affordable units. This methodology would be more in line with IRC Section 42 and therefore the spirit of Section 1602.

### **Casualty Loss**

Since Treasury plans to replace IRC Section 42(j) with new rules as it pertains to subawards from Section 1602, we believe Treasury should also address other issues in IRC Section 42(j). One issue surrounds IRC Section 42(j)(4)(E) or recapture when a building has a casualty loss.

Treasury has implied full recapture when a building's applicable fraction expressed as a percentage is less than its Section 1602 percentage or minimum set-aside percentage. If a building were to suffer a casualty loss, without exclusion for this type of situation, a building could be subject to full recapture. IRC Section 42(j)(4)(E) provides a cushion of a reasonable period of time to restore a building due to a casualty loss. We believe that a project owner should be able to cure the problem in a reasonable period of time without facing a loss of any of its subaward or recapture. We believe that this exception would be in line with IRC Section 42 and request Treasury's guidance on this issue.

### **Building Disposition during the Compliance Period**

Another provision in IRC Section 42(j) that needs to be addressed is the disposition of a building. Pursuant to IRC Section 42(j)(6), there is no recapture on the disposition of a building "if it is reasonably expected that such building will continue to be operated as a qualified low-income building for the remaining compliance period with respect to such building." Since this section is in IRC Section 42(j), which is being replaced by Treasury as it pertains to subawards, we believe that a building should still be able to rely on IRC Section 42(j)(6) when it disposes of a building during the compliance period and it is reasonable to expect that the new owners will continue to operate the building as a qualified low-income building for the remaining compliance period. Similar to the previous issue, we believe that this carve out should be included in Treasury's guidance on recapture, as it captures the intent of IRC Section 42.

### **Timing of Recapture Event**

Question 9b from the FAQs states:

A Section 1602 recapture event occurs *any time* within the 15-year compliance period (as defined in Section 42(i)(1) of the Internal Revenue Code) the applicable fraction of a building under Section 42(c)(1)(B) falls below the percentage of Section 1602 funds that comprise the eligible basis of the building (the Section 1602 percentage), or below the minimum set-aside elected for the building under Section 42(g)(1), whichever is greater.

IRC Section 42(i) states that "the term 'compliance period' means, with respect to any building, the period of 15 taxable years beginning with the 1<sup>st</sup> taxable year of the credit period with respect thereto." This definition means that even though a building is placed in service in September of Year 1, the compliance period begins January of Year 1 unless an election is made to postpone the credit period under IRC Section 42 (f)(1)(B). For any building that is placed in service during the first year of its credit period, its applicable fraction from the beginning of the year until it starts to lease up is zero percent. Therefore, any building that does not postpone its credit period will face recapture since its applicable fraction will be less than the greater of its Section 1602 percentage or minimum set aside unless its applicable fraction was greater than its Section 1602 percentage and minimum set-aside on January 1 of Year 1.

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Furthermore, even if a building's compliance period were postponed to the year after it was placed-in-service, a building could still be out of compliance during the first few months of its compliance period. For example, if the greater of the Section 1602 percentage and minimum set-aside is 85% and a 10-unit building was placed in service in September of Year 1 leasing up one unit every month starting in October, at the end of Year 1, the applicable fraction of the building would be 30%. In this situation, the building owners would need to elect to begin the credit period in the year after the building is placed in service, and thus, the compliance period would begin January 1 Year 2. Unfortunately, since a recapture event occurs at any time during the compliance period and the building is only leasing up 1 unit per month, it would be out of compliance until June when its applicable fraction is finally greater than the 85% threshold. In order to illustrate the problem, we have attached Exhibit B.

We believe that the test for recapture should happen at the end of the first year of the compliance period (12/31 for a calendar year taxpayer). Under the above scenario, as long as the building owner postponed the compliance period to Year 2, he would not face recapture since the building's applicable fraction was over the 85% threshold by the end of the first year of the compliance period.

Overall, we are requesting that Treasury issue detailed written guidance on these subject matters. We appreciate your time and are available if there is any way we can be of assistance. Please feel free to contact Michael Novogradac (415) 356-8000 or Michael Morrison (415) 356-8025.

#### THE LIHTC WORKING GROUP

Very truly yours,  
NOVOGRADAC & COMPANY LLP

by



Michael J. Novogradac

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Michael G. Morrison

cc: Paul F. Handleman  
Jean Whaley

Attachments

Exhibit A

	<u>Treasury Proposed Recapture Amount</u>	<u>LIHTC Working Group Proposed Recapture Amount</u>
Applicable Fraction	100%	100%
Minimum Set-Aside	40%	40%
Total Credit Exchange Dollars	\$ 4,250,000	\$ 4,250,000
Total Eligible Basis	\$ 5,000,000	\$ 5,000,000
Section 1602 Percentage	85.00%	85.00%
Year of recapture	Year 4	Year 4
New Applicable Fraction	75.00%	75.00%
Percentage of Building Out of Compliance	11.76%	11.76%
Subaward	\$ 4,250,000	\$ 4,250,000
	1/15	1/15
	283,333	283,333
Remaining Years	12	12
Recapture	\$ 3,400,000	3,400,000
Percentage of Building Out of Compliance with Section 1602 Percentage		11.76%
Recapture		\$ 400,000

**Exhibit B**

<b>Year</b>	<b>Month</b>	<b>Applicable Fraction</b>	<b>Threshold</b>	<b>Compliance Status</b>
Year 1	January	0%	85%	<b>Recapture</b>
	February	0%	85%	<b>Recapture</b>
	March	0%	85%	<b>Recapture</b>
	April	0%	85%	<b>Recapture</b>
	May	0%	85%	<b>Recapture</b>
	June	0%	85%	<b>Recapture</b>
	July	0%	85%	<b>Recapture</b>
	August	0%	85%	<b>Recapture</b>
	September	0%	85%	<b>Recapture</b>
	October	10%	85%	<b>Recapture</b>
	November	20%	85%	<b>Recapture</b>
	December	30%	85%	<b>Recapture</b>
Year 2	January	40%	85%	<b>Recapture</b>
	February	50%	85%	<b>Recapture</b>
	March	60%	85%	<b>Recapture</b>
	April	70%	85%	<b>Recapture</b>
	May	80%	85%	<b>Recapture</b>
	June	90%	85%	In compliance
	July	100%	85%	In compliance
	August	100%	85%	In compliance
	September	100%	85%	In compliance
	October	100%	85%	In compliance
	November	100%	85%	In compliance
	December	100%	85%	In compliance