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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Washington, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

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MEMORANDUM FOR EXAMINERS ASSIGNED LOW-INCOME HOUSING CREDIT CASES

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SUBJECT: Low-Income Housing Credit (LIHC) – Noncompliance Resulting from Conflicting Program Requirements

This memorandum is written to provide guidance regarding the treatment of taxpayers who fail to comply with the requirements of IRC §42 at all times during the 15-year compliance period.

Continuous Compliance with Program Requirements

Under IRC §42(c)(2), the term "qualified low-income building" means any building that is part of a qualified low-income project *at all times* during the 15-year compliance period.

Under IRC §42(g)(1), a "qualified low-income housing project" means any *project* for residential rental property if the project meets the minimum set-aside, as elected by the owner on Form 8609, line 10c.

Identified Fact Pattern

An owner of LIHC property uses additional financing sources in combination with the investment generated by the IRC §42 credit to construct low-income housing. The funding may be from any source; i.e., commercial, a state-level housing development program, or a private charitable source such as a foundation. The funding may not actually be money, but the use of an asset such as a long-term land lease. The funding or use of property, however, is available only if the owner complies with specific requirements. We are identifying instances where the requirements for the use of these additional funds are in conflict with the requirements of IRC §42.

Issue Identification

1. Review the balance sheet included with the tax return. Documentation for all loans and other long-term payables should be reviewed to ensure the terms are not in conflict with IRC §42 requirements.

2. Review the land records to identify any land use restrictions recorded against the property other than the extended use agreement required under IRC §42(h)(6).

3. Interview the taxpayer regarding the policies, procedures and controls in place to ensure compliance with the IRC §42 requirements. See IRM 4.10.3.4.3.3, Control Procedures. Many taxpayers use professional management companies to operate LIHC projects; if necessary, interview a management company representative.

4. Review tenant leases to identify conditions of occupancy that are in conflict with the requirements of IRC §42. Also review the taxpayer's website and other forms of advertisement.

Issue Development & Audit Techniques

Once it is determined that conflicting requirements exist, document the taxpayer's policies and procedures regarding the conflicting requirements. Two examples are provided here.

1. A property is located in a state-level jurisdiction offering an abatement of property taxes to owners of residential rental housing if the owner rents to low-income households. Using HUD's definition of "low-income," no household can have income above 80% of the area's median gross income (AMGI). The owner elected the 40/60 minimum set-aside and all tenants initially qualify for both the property tax abatement and the IRC §42 credit. However, if a tenant's income is determined to be in excess of 80% of AMGI at the time of the annual income recertification, the tenant is evicted.

   The examiner reviewed the tenant roles, noticing that a significant number of tenants were evicted. The taxpayer was interviewed and confirmed that the tenants were evicted because their income exceeded 80% of AMGI.

   Because tenants are evicted, the taxpayer violated IRC §42(g)(2)(D)(i), which protects initially qualifying households from being displaced as their incomes rise. Under this rule, a unit continues to be a low-income unit for the credit even if the tenant's income exceeds the income limit, as long as the tenant initially met the income requirements and the unit continues to be rent restricted. Under IRC §42(g)(2)(D)(ii), the Available Unit Rule, in the event the tenant's income increase above 140% of the income limit, the unit will continue to qualify as a low-income unit as long as the next available comparable unit in the building is rented to an income-qualified household.

As the taxpayer has given precedence to the requirement for the property tax abatement, which is in conflict with IRC §42(g)(2)(D), the project is no longer in compliance at all time during the 15-year compliance period and no credit under IRC §42 is allowable.

2. A property is located on land leased for 99 years from a private foundation. The only stipulation, as recorded in the land records, is that the property be used to assist the poor. Using HUD's definitions, the foundation defined "poor" as having income no more than 80% of AMGI. The taxpayer elected the 40/60 set-aside and all households initially qualified for both the land use stipulation and the §42 requirements. If a household's income was determined to be in excess of 80%, the household was required to leave within one year (the lease would not be renewed) or within three years provided the household participated in a savings plan.

   The examiner found the land use restriction while researching the land records and confirmed by interview that the taxpayer' had established a policy of not renewing a household's lease when its income exceeded 80% of AGMI.

   Similar to the scenario described in (1) above, this taxpayer is violating IRC §42(g)(2)(D). Because the taxpayer has given precedence to the foundation's land use restriction, which is in conflict with the requirements of IRC §42, the project is no longer in compliance at all time during the 15-year compliance period and no credit under IRC §42 is allowable.

<u>Conclusion</u>

If it is established that the taxpayer has implemented policies and/or procedures that are in conflict with the requirements of IRC §42, the building's qualified basis is reduced to zero; i.e., the building is not part of a qualified low-income project *at all times* during the 15-year compliance period under IRC §42(c)(2). It is not necessary to determine exactly how many or which units were affected by the conflicting policy. No credit is allowable in the year under audit and the taxpayer is also subject to the credit recapture provisions under IRC §42(j).

IRC §42(c)(2) should be cited as authority for disallowing the credit and applying the recapture provisions only in those cases where the taxpayer has (1) established policies and/or procedures that are in conflict with IRC §42 or (2) subordinated the requirements of IRC §42 in favor of conflicting requirements for other programs.

If you have any questions, please contact Grace Robertson, LIHC Program Analyst, at (202) 283-2516.

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