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CERTIFIED PUBLIC ACCOUNTANTS

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Internal Revenue Service
CC:PA:LPD:PR (Notice 2016-23)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2016-23 and Internal Revenue Code §1101 of the Bipartisan Budget Act of 2015

As a leading national certified public accounting and consulting firm since 1989, Novogradac & Company LLP has assumed a leadership position in the affordable housing, community development and renewable energy industries. As part of its leadership role, the firm established the Low-Income Housing Tax Credit (LIHTC), the New Markets Tax Credit (NMTC) and the Renewable Energy Tax Credit (RETC) Working Groups, coalitions established to provide a platform for LIHTC, NMTC and RETC industry participants to work together to resolve technical and administrative LIHTC, NMTC and RETC program issues to make the LIHTC, NMTC and RETC Programs ever more efficient in delivering the maximum benefit to end users. Our groups include nonprofit and for-profit developers, LIHTC syndicators, NMTC allocatees, independent power producing project sponsors, utilities, nonprofit and for-profit community development entities (CDEs), investors, accountants, lawyers, and other related professionals.

We are providing comments as requested by Notice 2016-23 in connection with the new partnership audit rules of Internal Revenue Code (IRC) §6221 through 6241 which were added pursuant to IRC §1101 of the Bipartisan Budget Act of 2015 (Act), generally effective for taxable years beginning after December 31, 2017. The regulatory project related to implementation of the new partnership audit rules is particularly relevant to the LIHTC, NMTC and RETC industries due to the fact that partnerships are a fundamental component of LIHTC, NMTC and RETC investment structures.

Background on the LIHTC

Since its creation in the Tax Reform Act of 1986, the LIHTC has been used to raise equity capital to finance a wide variety of affordable rental housing developments, from low-income family housing to housing for the elderly, people with disabilities, the homeless, veterans, farmworkers, rural populations, and many others. Each state is provided with $2.35 per capita in annual LIHTC authority, which is competitively awarded to affordable housing developments.

Developers in turn use LIHTC allocation awards to raise equity capital from investors and syndicators to finance the development of affordable rental housing, which is subject to land-use restrictions designed to maintain the property as low-income housing for a minimum of 30 years. The LIHTC serves low-income households earning at or below 60 percent of the area gross median income (AMGI) at rents no more than 30 percent of 60 percent AMGI.

The LIHTC has been found to have a substantial economic impact on the communities in which the properties are located. The National Association of Home Builders found in a 2014 study that in a typical year, the LIHTC supports 95,700 jobs; $3.5 billion in federal, state, and local tax revenue; and $9.1 billion in economic income (wages and business income).

Background on the NMTC

Authorized in the Community Renewal Tax Relief Act of 2000, the NMTC was created to address a persistent problem in economically distressed areas: despite the presence of attractive business opportunities and untapped demand, the cost and scarcity of patient, flexible capital is a substantial impediment to local economic growth. Underserved communities face challenges in securing conventional commercial loans, including: lack of investor familiarity; perceived risk; lingering effects of past discrimination; and difficulty in obtaining formal market data. Whatever the reason, many of the cities, neighborhoods, and rural communities targeted by the NMTC have experienced decades of stagnation and disinvestment that stubbornly persisted even during the 1990s, a period of extraordinary economic growth.

The NMTC attracts capital to low-income communities by providing private investors with a 39 percent federal tax credit for investments made in businesses or economic development projects located in some of the most distressed communities in the nation – census tracts where the individual poverty rate is at least 20 percent or where median family income does not exceed 80 percent of the area median.

Since its creation in 2000, the NMTC has been considered one of the most effective economic and community development programs in the nation, and its effectiveness results in large part from its structure as a tax incentive, instead of an appropriated, government spending program.

A recent NMTC economic impact report using the most robust and comprehensive data collection system of all federal economic development programs found that its investments led to 744,267 jobs in low-income urban and rural communities, including 457,487 construction jobs and 286,781 full-time equivalent jobs in nearly every industry sector of the economy. This impact also was found to produce more federal tax revenue than it costs; for example, in 2012, the NMTC generated $15.2 billion in economic activity, resulting in $984 million in federal tax revenue, more than enough to cover the estimated $800 million annual federal cost of the program in 2012. Similarly, the NMTC was found to produce about $542 million in state and local tax revenue.

Background on the RETC

The Federal government has a wide variety of legislative and regulatory incentives designed to promote all major sources of energy, and renewable energy has been a key component of the nation's energy policy for many years. Well-crafted and efficient federal tax incentives can provide powerful policy mechanisms to promote the nation's energy objectives and leverage private sector investment for the deployment and utilization of new energy resources. Today, federal renewable energy policies are largely carried out through the tax code, and tax incentives have played a vital role in developing new domestic energy resources to power America's long-term economic prosperity and growth.

Since the creation of the 30% energy tax credit for commercial solar energy systems (Solar ITC) in 2005 as part of the *Energy Policy Act of 2005* (P.L. 109-58), solar has become a more competitive energy resource as the average price for installed solar has dropped by more than 70 percent. The solar industry has added more than 150,000 new jobs—a twelve-fold increase since the ITC was implemented in 2006—and now employs more Americans than the coal industry. Most importantly the tax policy certainty given to the industry with the recent multi-year extension of the ITC is helping to drive down consumer costs to the point where every tax dollar devoted to the ITC has received a higher return to the U.S. Treasury on its investment than the year before.

LIHTC, NMTC and RETC transaction structures

The LIHTC investment community has created transaction structures that are commonly used for affordable housing investments. These structures generally include a property partnership that owns the affordable apartment complex. In turn, an upper-tier partnership owns a significant percentage of the property partnership. Corporate investors own a majority of the upper-tier partnership. The credits are allocated from the property partnership to the upper-tier partnership and then ultimately to the investor based on the allocation of depreciation expense at each level over a period of 10 to 15 years.

The NMTC industry commonly uses a structure in which a CDE forms a subsidiary CDE partnership that makes loans to and/or investments in qualified businesses. An investment fund makes a qualified equity investment (QEI) in the subsidiary CDE and in return owns a significant percentage of the partnership. Since the investment fund is the holder of the QEI, it is entitled to NMTCs in an amount equal to 39% of the amount of its QEI, taken over the 7-year compliance period. The credits are allocated from the investment fund partnership to the investor based on its ownership percentage.

The RETC industry commonly uses partnerships to own and operate qualified renewable energy facilities. The most common of these partnership structures is referred to as the partnership flip (Flip). The Flip structure often uses a two partner partnership where one partner is the general partner or managing member ("Sponsor Member") and the other partner is a limited partner or investor member ("Investor Member"). The Sponsor Member is usually an affiliate of the developer. The Sponsor Member and Investor Member often structure the Flip whereby they initially contribute capital to the partnership in exchange for a 1% and 99% pre Flip interest, respectively, in the partnership's profits, losses tax credits and cash flow followed by a 95% and 5% post Flip interest, respectively. The Flip is typically triggered upon the Investor Member achieving a minimum internal rate of return following the end of the tax credit compliance recapture period of five years.

There are variations from these structures that are also used, but the partnership form of business is integral to almost all LIHTC, NMTC and RETC transactions.

<u>Recommendations Regarding Regulatory Guidance</u>

Tax Credit Recapture and Loss of Tax Credits

In order to assure that the activities generating tax credits under the LIHTC, NMTC, and RETC programs maintain their effect during each program's compliance period, Congress implemented a recapture regime that requires investors to recapture previously taken tax credits and lose tax credits reported in the year under audit under specified circumstances[1]. The LIHTC is generally claimed over a 10-year period but is earned over a 15-year period. If a project is out of compliance with the LIHTC program, a recapture event is generally triggered during the 15-year period; investors who took credits will generally lose the ability to take credits in the current year and must recapture a portion of all credits taken from the start of the 10-year tax credit period based on applicable recapture percentages established by law. The NMTC is claimed on the day a QEI is made and the following six anniversary dates but the compliance period is the seven year period beginning on the date the QEI is made. The Solar ITC is generally claimed in the year in which the energy property is first placed in service however is effectively earned 20% per year on the energy property's placed in service anniversary. If the energy property triggers a recapture event prior to the end of the five year ITC recapture compliance period then some or all of the Solar ITC is recaptured. For example if a recapture event occurs prior to the energy property's first placed in service anniversary then 100% of the Solar ITC is recaptured; 80% if a recapture event occurs prior to the second anniversary, and so on. Under the current recapture regimes of these three tax credit programs, the partner who was originally allocated credits is generally the partner who reports additional tax and interest on recapture and loss of credits. There are provisions in IRC §42(j), §45D(g) and §50(a)(1) that attribute tax credit recapture and loss of tax credits to the partner who claimed the credits which appear to contradict the general provision of the new partnership audit rules, as provided in IRC §6221. Treasury should provide guidance on how the new audit rules interact with these recapture rules and under what circumstances one will take priority over the other in the following circumstances:

a. If tax credit recapture and loss of credits is triggered by an IRS audit, the regulations should clarify who is responsible for the additional tax and interest. Is it the partner who claimed the credit as described in IRC §42(j), §45D(g), and §50(a)(1) or is it the partnership under audit under the new audit regime? Under the new audit regime, it comes to reason that since the partnership is assessed the tax for adjustments to the

[1] Details regarding recapture for the LIHTC program can be found in IRC §42(j), in IRC §45D(g) for the NMTC program, and IRC §50(a)(1) for the RETC program.

amount of tax credits available and taxable income at the partnership level, recapture and related interest would be assessed at the partnership level that owns the LIHTC property, qualified energy property, or the holder of the QEI.

b. Guidance is needed regarding whether reporting tax credit recapture and loss of credits by a partnership on its originally filed return is governed by the new partnership audit rules, thus assessing tax and interest at the partnership level, or whether IRC §42(j), §45D(g) or §50(a)(1) should apply which assesses tax and interest at the partner level. Since reporting recapture and loss of credits on the original return isn't a result of an IRS audit, we believe those items should be passed-through to the partners on their respective Schedules K-1s to be reported by its partners in their tax returns.

c. Under current rules, the liability for recapture, loss of tax credits and related interest is paid by partners who receive an amended Schedule K-1 from a partnership that filed an amended return for a request for administrative adjustment. In this situation, the partner reports the changes on the Schedule K-1 and related tax and interest when they file their own amended return. Under the rules in IRC §6227 that go in effect under the new audit regime, a partnership may file a request for administrative adjustment for any partnership tax year open under the statute of limitations, however rules similar to the rules in IRC §6225 apply which assesses any tax related to the administrative adjustment at the partnership level except to the extent amended returns are filed by partners under §6225(c)(2) or an election is made under IRC §6226. Please clarify that new rules generally effective for tax years after December 31, 2017 apply to administrative adjustments requested in all amended returns even if the partnership is not under audit by the IRS.

Tiered partnerships

LIHTC, NMTC and RETC investments often consist of two or more tiers of partnerships in the chain of ownership. The regulations should clarify to what extent a partnership is liable for an administrative adjustment when you have tiered partnerships. We strongly suggest that each tier should be looked at independently and only be assessed adjustments for activity occurring at the partnership level being audited. A partnership should not be assessed tax for any adjustments related to any pass through entities flowing into the partnership being audited since the partnership audit is now separate and distinct from the partners. If not, there could double taxation of the same adjustment if both tiers get audited.

Tax Attributes of Partners

Subchapter K incorporates a pass-through regime that results in only a single level of tax, as opposed to the double-tax regime of Subchapter C. The new partnership audit rules have the potential to negate the pass-through regime of Subchapter K unless partnerships are allowed to take specific taxpayer's tax attributes into account in determining partnership-level tax. The regulations should allow partnerships to demonstrate that particular partners have tax attributes to reduce income resulting from partnership-level adjustments. Here are some examples:

a. There are situations where a tax credit has been allocated to a partner who has never utilized the credit because of limitations (such as at-risk limits) or lack of tax liability at the partner level. There is a risk that the new partnership audit rules could impose an adjustment to the total amount of tax credits allowed and impose tax on the partnership when a partner had never utilized the tax credit. The regulations should allow partnerships to avoid additional tax by demonstrating that the original credit was never used by a partner to offset tax liability.

b. There are several limitations that can apply to the deduction of losses that flow from a partnership to a partner, including basis limits per IRC §704(d), at-risk limits per IRC § 465 and passive activity limits per IRC §469. If these limitations apply, deduction of losses by the partner from a partnership can be delayed or denied until the limits no longer apply, if ever. The regulations should allow partnerships to avoid paying tax at the partnership level to the extent that the income relates to recapture of losses that were not deducted under one of these, or any other, limitations. At a minimum, the regulations should provide guidance for partnerships regarding how to account for such disallowed losses on the partnership return to the extent that tax is paid at the partnership level from reversal of such deductions where the adjustment (and related tax) is not passed through by the partnership to the partners.

c. Taxes are only due from corporations and individuals when there is income (and not losses) for a specific year. An IRS audit may determine that a partnership has income for a particular year with tax due at the partnership level under IRC §6225. However, there might be situations where one of more of the partners has an overall net operating loss for that year that even when factoring in their share of partnership adjustments which would have otherwise flowed through to them absent the new partnership audit rules. In such a situation, the new partnership audit rules have the potential to cause the partnership to pay tax when the partners would not pay tax under the current partnership audit provisions. The regulations should take into account these situations and allow the partnership to avoid payment of taxes to the extent that the partnership establishes that the partners have tax attributes that would otherwise offset the partnership adjustments.

Effect on IRC §704(b) capital accounts

The new partnership audit rules contemplate that additional tax could be paid by the partnership and not the partners who actually took the benefits of the credits and/or taxable losses. In that situation, partnerships will need guidance from the IRS as to the mechanism for allocating the payment of the tax liability among the partners for IRC ***§***704(b) purposes and how it affects the partners' IRC ***§***704(b) capital accounts. Please clarify that the partnership-level payments should be reflected as a nondeductible expense reducing capital under IRC §705.

IRC §6226 elections

LIHTC and NMTC investments often consist of two or more tiers of partnerships in the chain of ownership. IRC §6226 provides that a partnership can elect to avoid adjustments under IRC §6225 at the partnership level by furnishing each partner and the Secretary with a statement as to each partner's share of any partnership level adjustments. Guidance will be needed in implementing these rules in tiered partnership structures. For example, the partnerships will need guidance regarding how the 45-day period applies at each partnership level; whether the 45-day period applies to each partnership or whether the same 45-day period applies to all partnerships in the ownership structure.

Judicial Review

IRC §6234 provides for judicial review of a final partnership adjustment provided the request is made within 90 days after the date on which notice of final partnership adjustment is mailed under IRC §6231 with respect to any partnership taxable year. If a partnership elects under IRC §6226 to provide statements to partners, the regulations should clarify that such election does not prohibit a partnership from also seeking judicial review under IRC §6234. In addition, an election under IRC §6226 should not prohibit a partnership from seeking relief in Tax Court under IRC §6234 if some partners pay the tax under IRC §6226 prior to the time the Tax Court petition is filed. At a minimum, the regulations should address how IRC §6226 and IRC §6234 interact and under what circumstances, if any, a IRC §6226 election precludes a partnership from seeking relief under IRC §6234. The regulations should include guidance on how refunds are obtained if a court grants a partnership's request for relief under IRC §6234 in situations where the partnership does and does not elect under IRC §6226.

Amended tax returns

IRC §6225(c)(2) provides that partnership level adjustments can be avoided to the extent that one or more partners agree to report their share of such adjustments on amended returns. IRC §6225(c)(6) provides that amended returns filed pursuant to IRC §6225(c)(2) must be submitted not later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed under IRC §6231. If not all partners agree to file amended returns, the regulations should clarify when the partnership has to pay its portion of tax on any adjustments made under IRC §6225

Many tax credit investors are large C corporations that are audited every year by the IRS. As a result, some of these corporations might be unable to file amended returns under IRC §6225(c)(2) and pay their share of partnership-level adjustments. In these situations, the C corporation investor (typically owning 99% or more of the partnership) will likely encourage the partnership to pay the tax at the partnership level since the adjustments are often immaterial to the C corporation's overall tax liability. Under these circumstances, the payment of tax at the partnership level is likely to put more economic pressure on LIHTC project partnerships, NMTC investment partnerships and RETC investment partnerships, which typically operate at or below break-even level. The regulations should consider options for tiered partnerships with under a certain number of partners in the chain of ownership to elect out of these provisions completely to avoid impacting the financial feasibility of these projects which undermines the intent of Congress for establishing these programs.

Conclusion

We appreciate the opportunity to provide comments as requested by Notice 2016-23 in connection with the new partnership audit rules of IRC §6221 through 6241 of the Act. Thank you in advance for your time and careful consideration of these recommendations. Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,

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