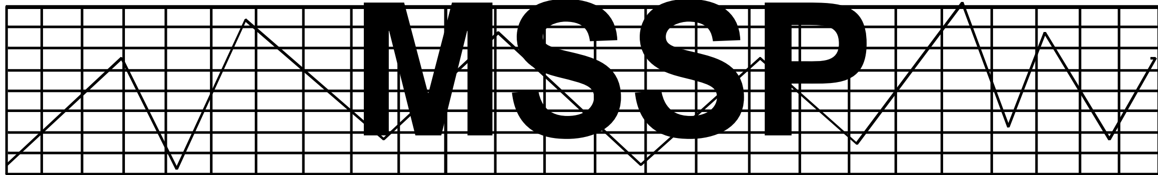


**Market Segment Specialization Program**

# Low-Income Housing Credit

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual.*

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

Department of the Treasury
**Internal Revenue Service**

**Training 3123-006 (6-99)**
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## HOW THIS GUIDE IS SET UP

This audit techniques guide has been developed to offer the examiner technical support for identifying and developing issues related to IRC section 42 in this area of tax law. The guide consists of chapters covering specific LIHC topics and issues. The chapters are arranged topically, with the various elements of the LIHC being introduced and discussed in the order in which they are generally encountered during the development of a project -- a building block format of terms and mechanics.

Exhibits, as applicable, are also included at the end of each chapter. In an effort to provide the examiner with valuable examination tools, several "Pro Forma" documents have been drafted for use specifically in IRC section 42 cases. These include an Information Document Request, Initial Interview Questionnaire, and Revenue Agent Report. These documents appear at the end of the guide.

Once the components and mechanics are provided, additional topics and issues are introduced to allow the examiner a complete understanding of the issues and transactions found in this industry. "Audit Techniques" relevant to that topic are included at the end of each chapter. These techniques are based on field experience and are intended to offer assistance in the application of the chapter information to audit activity. They are not all-inclusive and, given the difference in facts and circumstances found from project to project, are meant to provide general information.

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# Chapter 1

# INTRODUCTION

## BACKGROUND

The low-income housing tax credit was enacted by Congress to encourage new construction and rehabilitation of existing rental housing for low-income households and to increase the amount of affordable rental housing for households whose income is at or below specified income levels. In establishing the tax credit incentive, Congress recognized that a private sector developer may not receive enough rental income from a low-income housing project to: 1) cover the costs of developing and operating the project, and 2) provide a return to investors sufficient to attract the equity investment needed for development. To spur investment, Congress authorized the states, within specified limits, to allocate tax credits to qualifying housing projects. The credits may be shared among the owners of a project (equity investors), much as income and losses are shared among business partners for tax purposes. Generally, the investors are recruited by syndicators, and ownership rights are controlled by limited partnership agreements.

The program is jointly administered by the Service and state tax credit allocation agencies. Currently, each state is annually allocated tax credits in an amount equal to a statutory dollar amount per state resident (for example, in 1999 the dollar amount was $1.25 per state resident). Under section 42 of the Internal Revenue Code, the state agencies are responsible for determining which housing projects should receive tax credits and the dollar amount of tax credits each should receive.

In making these determinations, the states are to consider housing needs and costs. The Internal Revenue Code provides the states with general guidance on how to consider needs and costs. The state tax credit agencies are required to have an allocation plan that identifies the states' priority housing needs and contains selection criteria for awarding credits to help meet those needs. Housing needs are intended to include consideration of such matters as the availability of low-income housing over extended periods of time. To ensure that no more tax credits are awarded than necessary to stimulate low-income housing development, the state agency is required to evaluate such factors as the reasonableness of development costs and the sources and uses of project funds.

After the state allocates tax credits to developers, the developers typically sell the credits to private investors. The private investors use the tax credits to offset taxes otherwise owed on their tax returns. The money private investors pay for the credits is paid into the projects as equity financing. This equity financing is used to fill the gap

between the development costs for a project and the nontax credit financing sources, such as mortgages, that could be expected to be repaid from rental income.

Generally, owners must place the projects in service within 2 years of carryover allocation or return the credits to the state for reallocation to other projects. Investors can claim the credits for each year of a 10-year period called the "credit period" as long as a minimum percentage of the projects' units are rented to low-income tenants at restricted rents for a 15-year compliance period. Individual and corporate investors attach Form 8609, Low-Income Housing Credit Allocation Certification, to their income tax returns when they claim the credits.

Once projects have been placed in service, state agencies are also responsible for monitoring the projects for compliance with federal requirements concerning household income, rents, and project habitability. If noncompliance is not corrected, the Service may recapture or deny credit for previously used or issued tax credits. The Service is responsible for issuing regulations on state monitoring requirements.

## OVERVIEW OF THE CREDIT PROCESS: THE PARTICIPANTS AND THEIR ROLES

### IRS Apportions Tax Credits to the Allocation Agencies

IRC section 42 directs the Service to provide the tax credit allocating agencies with information each year for computing the tax credits available to them for allocation. The allocation is limited annually to: 1) $1.25 per state resident for 1987-1999, 2) unused credits from the prior year, 3) credits initially allocated in previous years and returned in the current year, and 4) a portion of the unused tax credit returned to the Service by other states. The allocating agencies have up to 2 years to award the credits to housing projects; after that time, they must return any unused credits to the Service for reassignment to other states. When the credits have been awarded, they are usually available to the owners/investors annually for a 10-year period as long as the project continues to meet the statutory and regulatory requirements.

### Developers Apply to the Allocating Agencies for Tax Credits

To apply for tax credits, a developer must submit a detailed proposal to an allocating agency. This proposal must describe the housing project, indicate how much it will cost, and identify the sources and uses of the funds available to finance the project's development and operations. In describing the project, the developer must identify the total number of units and the number of units expected to qualify for tax credits. To qualify for consideration, a project must:

1. be residential rental property;

2. maintain at least 20 percent of the available units for households earning up to 50 percent of the area's median gross income adjusted for family size or at least 40 percent of the units for households earning up to 60 percent of the area's median gross income adjusted for family size;

3. restrict the rents (including the utility charges) for tenants in low-income units to 30 percent of either the 20/50 or 40/60 income limitations;

4. maintain habitability standards; and

5. operate under the program's rent and income restrictions for 15 years for projects placed in service before 1990 and for 30 or more years for later projects pursuant to extended use agreements.

## State Housing Agencies

### Allocation Division: Awards Tax Credits to Selected Housing Projects

The allocating agencies are responsible for: 1) awarding their tax credits to qualifying projects that meet their state's qualified allocation plans and 2) controlling the value of the tax credits awarded to projects.

When selecting developers' proposals for tax credit awards, an allocating agency is required to evaluate the proposed projects against a qualified allocation plan developed in accordance with the Code's requirements. The qualified allocation plan must establish a procedure for ranking the projects on the basis of how well they meet the state's identified housing priorities and meet selection criteria that are appropriate to local conditions. In addition, the plan must give preference to projects that serve the lowest income tenants and serve qualifying tenants for the longest period of time.

In awarding tax credits to a project, an allocating agency is to provide no more credits than it deems necessary to ensure the project's financial feasibility throughout the 15-year tax credit compliance period. An allocating agency must consider any proceeds or receipts expected to be generated through tax benefits, the percentage of housing credit dollar amounts used for project costs other than the cost of intermediaries, and the reasonableness of developmental and operational costs. In general, the agency is to compare the proposed project's developmental costs with the nontax credit financing, both private and governmental. The difference between the development costs and the nontax credit financing is the financing gap. Tax credits are used to attract the equity investment needed to fill the gap, but are limited to a ceiling.

Under IRC section 42, the ceiling on tax credits limits the present value of the 10-year stream of tax benefits to: 1) 70 percent of the qualified basis for new construction or

substantial rehabilitation of each qualified low-income building or 2) 30 percent of the qualified basis of acquired buildings that are substantially rehabilitated. To qualify as "substantial rehabilitation," the rehabilitation expenditures must equal at least 10 percent of the building's cost or at least $3,000 per low-income unit, whichever is greater.

For buildings placed in service in 1987, the credit was taken at annual rates of 9 percent (for the 70 percent value credit) and 4 percent (for the 30 percent value credit). Three types of credit are available for low-income buildings placed in service after 1987. The first type of credit is a 9 percent annual credit for the cost of a new building or qualifying rehabilitation costs, without a "federal subsidy." The second type of credit is a 4-percent annual credit for the cost of a new building or substantial rehabilitation built with a "federal subsidy." The third type of credit is a 4-percent annual credit for the cost of buying an existing building for which substantial rehabilitation expenditures are also incurred. Although the three types of credits are called 9-percent and 4-percent credits, the 9-percent and 4-percent figures are approximate. These figures are set each month by the Service based upon fluctuating interest rates. A project can qualify for one of the three credits or a combination of the credits. For example, the same project can be eligible for the 4-percent credit, based on the cost of purchasing an existing building, and the 9-percent credit, based on the amount spent to substantially rehabilitate that building.

Low-income housing tax credit amounts are based on the cost of a building and the portion of the project that low-income households occupy. The cost of acquiring, rehabilitating, and constructing a building constitutes the building's eligible basis. The portion of the eligible basis attributable to low-income units is the building's qualified basis. In general, the qualified basis excludes the costs of land, obtaining permanent financing, rent reserves, syndication, and marketing. The applicable percentage (described in the previous paragraph) of the qualified basis may be claimed annually for 10 years as the low-income housing tax credit.

Low-income housing tax credit projects that use federal subsidies generally receive a smaller credit. If federally subsidized loans are used to finance substantial rehabilitation or new construction, either the eligible basis of the building must be reduced or the 30 percent credit must be used. Federally subsidized loans include below-market federal loans and tax-exempt financing. Projects funded by the Affordable Housing Program established under section 721 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), as well as Community Development Block Grants, are not treated as federally subsidized and, therefore, are eligible for the 90-percent credit. Below market loans made after August 10, 1993, with Homes Investment Partnership Act Funds may also qualify for the 9-percent credit if 40 percent of more of the residential rental units in the building are occupied by individuals with income of 50 percent or less of the area median gross

income.

**Compliance Division: Monitors Compliance with IRC Section 42 After a Tax Credit Has Been Allocated**

A state agency cannot allocate IRC section 42 credits unless the state allocation plan contains a procedure that the agency (or an agent of, or private contractor hired by, the agency) will follow in monitoring compliance with the requirements of IRC section 42. The agency is required to notify the IRS of any noncompliance of which the agency becomes aware.

The requirement that a state agency monitor for compliance with IRC section 42 was made effective on January 1, 1992, and applies to all buildings for which the low-income housing credit determined under IRC section 42 is, or has been, allowable at any time. Section 1.42-5 of the Treasury Regulations provide the minimum standards for how a state agency must conduct its compliance monitoring activities. An agency must have complied with the requirements of Treas. Reg. section 1.42-5 by June 30, 1993. Treas. Reg. section 1.42-5 does not require monitoring for whether a low-income housing project was in compliance with the requirements of IRC section 42 prior to January 1, 1992. However, if an agency becomes aware of noncompliance that occurred prior to January 1, 1992, the agency is required to notify the IRS of that noncompliance.

The compliance monitoring regulations require the owner of a project, at a minimum, to certify annually to the state agency that for the preceding 12-month period the project was in compliance with the requirements of IRC section 42. The certification covers a variety of requirements including that the owner has received an annual income certification from each low-income tenant and documentation supporting that certification, and that each building in the project was suitable for occupancy, taking into account local health, safety, and building codes. Treas. Reg. section 1.42-5(c)(1) lists the annual certification requirements.

The compliance monitoring regulations also require an agency, at a minimum, to review tenant income certifications and rent charges of projects using one of the following three monitoring options: 1) review the annual income certifications, including the documentation supporting the certifications for at least 50 percent of the agency's low-income projects, and tenant rent records in at least 20 percent of the low-income units in these projects; (2) make annual on-site inspections of at least 20 percent of the projects, and review the low-income certification, the documentation supporting the certification, and rent record for each tenant in at least 20 percent of the low-income units in those projects; or (3) obtain from all project owners tenant income and records for each low-income unit and, for at least 20 percent of the projects, review the annual tenant income certification, backup income certification,

and rent record for each low-income tenant in at least 20 percent of the low-income units in those projects.

The compliance monitoring regulations require agencies to report noncompliance or failure to certify and whether the noncompliance or failure to certify was corrected, to the IRS on Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance.

Proposed regulations (Reg-114664-97) have been issued that would amend an agency's compliance monitoring requirements. The proposed regulations will require on-site inspections of all low-income housing projects. The regulations were published in the Federal Register on January 8, 1999, and are generally proposed to be effective on the date the final regulations are published in the Federal Register.

## Tax Benefits Provide a Return on Equity Investments

Syndicators (investment partnerships) are a primary source of equity financing for tax credit projects. They recruit investors who are willing to become partners (generally, limited partners) in housing projects that, because of rent restrictions, are generally not expected to return rental profits to investors. Rather, the investors expect, for 10 years, to receive tax credits and other tax benefits, such as business loan deductions, that they can use to offset taxes. These tax benefits (plus the possibility of cash proceeds from the sale of the project) represent the return on investment. The value of the tax benefits may vary from year to year, since the value of the tax credit depends on the number of habitable, rent-restricted units occupied by qualifying low-income households.

# Chapter 2

# QUALIFIED LOW-INCOME HOUSING PROJECT

## INTRODUCTION

A project must meet two fundamental requirements to be considered a qualified low-income housing project. First, it must be **residential rental property**. For purposes of IRC section 42, the definition attributed to the term residential rental property generally is the same as applied to qualified tax-exempt rental housing bonds under IRC section 142. This definition focuses on the following issues.

## RESIDENTIAL RENTAL REQUIREMENTS

### Functionally Related Facilities

In addition to the actual residential units, **functionally related and subordinate facilities** may be included in eligible basis if they are available to all tenants and with no additional fees attached to them.

#### Example 1

A qualified low-income project has a children's playground as well as parking facilities available to tenants. No additional fees are charged for use of these facilities, which are available to the low-income and market-rate tenants. As such, the playground and parking lot are functionally related and subordinate, and are considered part of this qualifying project.

### Scattered Site Project

A **scattered site project** will be treated as a single project if all units in the buildings are rent-restricted. A scattered site is a project where multiple buildings with similar units are not located in proximity to one another, but are owned by the same party and financed under the same agreement.

### Mixed Used Building

If a building consists of **both residential and nonresidential** areas, the nonresidential portion will not preclude the residential portion from qualifying for the credit. Allocations must be made on a reasonable basis to ensure that the costs for the

commercial use portion of such a **mixed-use building** are not included in the credit computation.

**Example 2**

A five story building consists of a convenience store on the first floor, with apartments occupying the upper floors. The nonresidential use of the first floor does not disqualify the building from use as a low-income project, but care must be taken to ensure that costs related to the commercial portion of the building are excluded from the eligible basis.

## General Public Use

The residential rental units must be held out for **use to the general public** in a nondiscriminatory manner. Definitions and authority regarding public use and discrimination are provided by the Department of Housing and Urban Development, with HUD Handbook 4350.3 serving as the appropriate resource for such issues. Per Treas. Reg. section 1.42-9(c), it should be noted that units not held out for use to the general public may be included in the eligible basis of the building with regard to the credit computation. However, in calculating the applicable fraction, the unit is treated as a residential rental unit that is not a low-income unit. This concept will be discussed further in subsequent chapters on basis and computation issues.

## MINIMUM LOW-INCOME SET-ASIDE REQUIREMENT

The second criteria to be met for a project to qualify for credit is the **"minimum low-income set-aside requirement."** The minimum set-aside requirement must be met no later than the close of the first year of the credit period for such building. The taxpayer elects the minimum set-aside test on Part II of Form 8609. See Exhibits 2-1 and 2-2.

A building owner must elect and fulfill one of the following minimum set-aside tests:

1. **The "20/50" Test** - at least **20 percent** of the units must be both rent restricted and occupied by tenants with incomes at or below **50 percent** of the Area Median Gross Income;

**OR**

2. **The "40/60" Test** - at least **40 percent** of the units must be both rent restricted and occupied by tenants with incomes at or below **60 percent** of the Area Median Gross Income.

These first two tests are the general tests to which we commonly refer when discussing set-aside elections. It should be noted, however, that two additional special options exist as follows:

3. **The "New York City" Test** - available only to projects located in New York City, this test requires buildings to maintain **25 percent** occupancy at rent restricted levels and with income at or below **60 percent** of the Area Median Gross Income. This test is in lieu of the 40/60 test.

4. **The "Deep Rent Skewed" Test** - this test applies to projects which consist of both low-income and market-rate tenants, where the rent charged to the low-income units is significantly less. Under this test, in addition to the general set-aside test elected by the project owner, at least **15 percent** of all low-income units in the project must be occupied by individuals having **40 percent** (rather than 50 percent or 60 percent) or less of Area Median Gross Income adjusted for family size. Rent restrictions are much more strict in this situation. Gross rent with respect to each low-income unit in the project cannot exceed half of the average gross rent with respect to units of comparable size which are not occupied by individuals who meet the applicable income limit.

As detailed above, the minimum set-aside tests consist of both household income limitations and rent restrictions, both of which are affected by the Area Median Gross Income figure. The area median gross income figures are determined by the Department of Housing and Urban Development and are published on an annual basis. The HUD released income limits may be relied upon by the building owner until 45 days after the IRS publishes notice of such change in the Internal Revenue Bulletin, or a new effective date published by HUD in connection with revised income limits.

## HOUSEHOLD INCOME LIMITATIONS

In determining the **household income limitations**, all applicable income standards are adjusted for family size according to HUD standards. See Example 5 for an illustration. For purposes of the low-income housing credit, all occupants of a unit are considered in the determination of family size -- no relationship need exist. To determine the appropriate household income figure for purposes of IRC section 42, refer to the HUD published table relating to "very low income," which is defined by HUD as being an income level at or below 50 percent of the area median gross income. HUD prepares tables at this income level and provides corresponding income figures for family sizes ranging from one to eight persons. As stated earlier, the area median gross income figures must always be adjusted to reflect the size of the household. The four-person family is considered to be a guideline and is used by HUD to compute the 50 percent figures.
A smaller family size would be computed by HUD using a smaller relative percent of

AMGI, while a larger family would have a greater amount. It is important to use the specific tables published by HUD in determining these relative income percentages, as they take into account additional issues and do not simply reflect a straight-forward mathematical calculation based on the family size.

**Example 3**

During an initial lease-up, a building owner has applicants for which allowable household income limitations must be determined. The building owner has elected the 20/50 set-aside test. The first tenant will occupy the low-income unit with his spouse and two children. In this example the four- person household published by HUD also corresponds exactly to 50 percent of Area Median Gross income for that statistical area. Recall that HUD considers other issues and at times the table listings for the 20/50 test do not exactly equal 50 percent of AMGI. In this instance the 50-percent figure would be the household income limitation for this unit. The second tenant is a single mother with one child. This two-family household is stated on the HUD table as being comparable to 40 percent (for this example) of what the four-member household would earn. Note here that we use the HUD table figure rather than assuming a household one-half in size should be limited to earning one-half of the income.

Although HUD does not publish a table which specifically corresponds to the 60-percent AMGI level, if the building owner chooses that minimum set-aside election, he or she would refer to the figures published for the 50-percent table and multiply by 1.2. There should be no rounding of these figures, as HUD has already rounded up the figures in its 50-percent table.

**Example 4**

The 1996 Area Median Gross Income published by HUD for Philadelphia County, Pennsylvania, is $40,000. The AMGI for a "very low-income" (that is, 50 per- cent AMGI) family is listed as $25,000. Note that the figure provided by the table would be used, rather than simply multiplying the AMGI by the appropriate percentage (which would have yielded $20,000). The $25,000 published figure corresponds to the 20/50 minimum set-aside. If the building owner had instead elected the 40/60 set-aside, he would multiply the published figure by 1.2 to equal $30,000. Both of these figures correspond to a family of four, and would have to be adjusted to reflect any differences in family size.

**Example 5**

Apply the same facts as provided by Example 4, except that the AMGI for a family of four does exactly equal 50 percent of the AMGI amount (no special changes computed by HUD). The following tables indicate the impact made by the differences in family size and indicate what the corresponding household income levels would be:

| MINIMUM SET-ASIDE ELECTED | | | | | |
|---|---|---|---|---|---|
| **HOUSEHOLD SIZE:** | **20/50** | | | | **40/60** |
| 1 | 35% | x | 1.2 | = | 42% |
| 2 | 40% | x | 1.2 | = | 48% |
| 3 | 45% | x | 1.2 | = | 54% |
| 4 | 50% | x | 1.2 | = | 60% |
| 5 | 55% | x | 1.2 | = | 66% |
| 6 | 60% | x | 1.2 | = | 72% |
| 7 | 65% | x | 1.2 | = | 78% |
| 8 | 70% | x | 1.2 | = | 84% |

| HOUSEHOLD SIZE: | 20/50 | 40/60 |
|---|---|---|
| 1 | 14,000 | 168,000 |
| 2 | 16,000 | 19,200 |
| 3 | 18,000 | 21,600 |
| 4 | 20,000 | 24,000 |
| 5 | 22,000 | 26,400 |
| 6 | 24,000 | 28,800 |
| 7 | 26,000 | 31,200 |
| 8 | 28,000 | 33,600 |

| HOUSEHOLD INCOME LIMITATIONS | | | | |
|---|---|---|---|---|
| **APPLICABLE SET-ASIDE PERCENTAGE** | **X** | **AREA MEDIAN GROSS INCOME** | = | **ALLOWABLE HOUSEHOLD INCOME** |
| (GENERALLY 50% OR 60%) | | (BASED ON # OF PERSONS) | | |

With respect to the minimum set-aside election, the AMGI tables are only referred to once when determining the household income limitations. This occurs during the initial lease-up of a tenant. The allowable household income is determined at the beginning of a landlord/lessee relationship and becomes the "ceiling" against which we compare tenant income (discussed in greater detail in Chapter 4) during the entire compliance period. Additionally, it should be noted that the definition of income provided by the HUD handbook is not the same as the Service's determination of gross income per IRC section 61. The responsibility of the examiner, with regard to the

HUD income figures, is simply to determine whether or not the appropriate choice has been selected and adhered to. Inspection of the supporting documentation may lead to the development of an unrelated income issue and should be pursued accordingly. For purposes of determining whether or not the minimum set-aside has been met, the HUD definition can be relied on. Refer to Exhibit 2-4 for the definition of "Annual Income" provided by the HUD handbook.

A tenant's income must be reviewed and documented at least annually throughout the compliance period. Increases to a tenant's income will not disqualify the tenant if the changes are "de minimis." The general rule is that an initially qualifying tenant will be treated as continuing to satisfy the income test as long as the tenant's income does not rise above 140 percent of the applicable income limit (that is, increases up to 140 percent are considered de minimis). If a tenant's income increases above 140 percent, the unit will continue to be treated as a qualified unit if another unit in the building of comparable or smaller size which subsequently becomes vacant is rented to tenants who satisfy the applicable income test. This is referred to as the **"Available Unit Rule".** Note that for projects electing a Deep-Rent Skewed set aside, the threshold is raised to 170 percent. The "Available Unit Rule" is discussed in much greater detail in Chapter Four. An additional comment with regard to the minimum set-aside election is that this test commits the building owner to a specific income level which will serve to define "low-income" for that building.

**Example 6**

A building owner applies for and is granted an allocation to maintain 75 percent of the units in a building for low-income tenants. The building owner has also elected the 40/60 minimum set-aside test to apply to this building. In this instance, the minimum percentage of the building which must be rented to low-income tenants (with income at or below 60 percent of the AMGI) in order for the project to remain qualified is 40 percent.

For the building owner to claim the additional allowable credit related to the state allocation for 75 percent of the units, 35 percent of the remaining units must be rented to tenants whose incomes are at or below 60 percent of the AMGI.

In determining the **restriction limitation**, however, no reference is made to the initial lease-up tables. Instead we refer to the current AMGI tables, which factor in inflation during the compliance period.

The basic rule regarding the restriction of rent under IRC section 42 is that the gross rent paid by the tenant cannot exceed 30 percent of the 50 percent or 60 percent of area median gross income elected for the project (adjusted for family size). As such, an increase in the area median income level will increase the allowable rent charged to

a tenant. Conversely, a decrease to such figure would reduce the rent allowed to be charged. However, a floor exists to protect the building owner's income. Thus, the law allows for fluctuations to occur, but does not allow these adjustments to fall below the established rent floor.

The adjustment for family size made during the computation of the gross rent restriction is not based on the actual number of persons in the household. Instead, a designated number of persons is deemed to occupy a household based on the number of bedrooms in the unit. This is referred to as the "**imputed income limitation**." It should be noted that this general rule does not focus on the specific income of the household, but instead relates to the rent ceiling to the AMGI. The imputed income step further removes the calculation from the specifics of the tenant makeup by disregarding the actual number of persons occupying the unit, and instead focuses on the bedroom number.

Specifically, for purposes of determining the maximum gross rent that may be charged for a unit, a studio apartment is considered to be occupied by one individual. Apartments with one or more separate bedrooms are deemed occupied by 1.5 individuals per bedroom. It should be noted, however, that actual family size is still used for purposes of the minimum set-aside test as well as the computation of low-income occupancy percentage. The imputed income rule based on bedroom number does not apply to projects receiving credit allocations prior to 1990, but owners of low-income projects placed in service before 1990 may have made an irrevocable election to use this rule to determine maximum allowable rent.

**Example 7**

A building owner follows the IRS and HUD guidelines regarding allowable rent. The minimum set-aside of 20/50 is elected and the related rent limitation represents 15 percent of area median gross income. (This represents the selected set-aside of 50 percent times the 30-percent rent limitation). Assume that this calculation, at the beginning of the project, equals $350 of rent per month.

As the area median gross income figures are published, they increase for the second and third years of the compliance period. In such instances, the building owner would be permitted to increase the allowable rents accordingly. Now assume the AMGI decreases in the fourth year to the point that the calculated rent would be $325. In this instance, the building owner would adjust the rent back down, but would be permitted to charge the original floor of $350, rather than having to decrease rents down to the $325.

**Example 8**

If a taxpayer elects the 40-60 minimum set aside test, consider a situation where 60 percent of the area median gross income for a family of three persons is $18,630. For purposes of calculating the maximum chargeable rent, a

two-bedroom unit will be considered to be occupied by a family of three persons (1.5 x 2), even if the actual family size is not three. The rent for this unit may not exceed 30 percent of $18,630 or $5,589 per year regardless of the number of people living in the unit.

Nevertheless, in determining whether the family occupying the unit is eligible, it is essential to consider the family size and its combined income. If the family has three persons, the family's income may not exceed $18,630. However, if the family size is only two, a lower income figure must be used to determine if the family is eligible.

| RESTRICTED RENT COMPUTATION | | | | |
|---|---|---|---|---|
| STEP (1) | | | | |
| # OF BEDROOMS | X | 1.5* | = | "IMPUTED HOUSEHOLD" |
| STEP (2) | | | | |
| "IMPUTED HOUSEHOLD" | X | APPLICABLE SET-ASIDE PERCENTAGE | = | "IMPUTED INCOME" |
| STEP (3) | | | | |
| "IMPUTED INCOME" | X | .30 | = | MAXIMUM GROSS RENT |

* IF STUDIO APT. WITH NO SEPARATE BEDROOM, IMPUTED HOUSEHOLD = 1

The rent restrictions are not limited to a simple fixed percentage of the income of the low-income household. Other factors must also be taken into consideration, such as **utility allowances** and whether or not any **services are provided**. These are common issues that tenants and building owners must address and resolve to ensure that they do not jeopardize the unit's qualification under IRC section 42. If consideration is not given to the effect that these situations have on the gross rent limitations, the building owner may inadvertently or erroneously overcharge for the units and disqualify them as low-income units.

The **utility allowances** used by the Service are taken directly from the HUD Section 8 utility allowance procedures. These definitions are necessary since the general rule is that gross rent restrictions include utilities (except telephone) or the Treasury "utility allowance" in their calculations. This rule applies to a situation where a tenant is paying the utilities. The Code provides that in order to determine how much this "utility allowance" should be, we first check to see if HUD has made such a determination for the building. If HUD has, we would rely on such figures.

It should be noted, however, that after May 2, 1994, any reliance on HUD figures only applies to HUD specific units and will not commit the entire low- income portion of the building to those amounts. The next option would be to use a Public Housing Authority (PHA) figure, if available. Special rules similarly apply to Farmers Home

Administration properties (FMHA). If no such programs apply, the local utility company can be referred to for providing estimates. In a situation where the tenant pays for utilities, therefore, we must then reduce the gross rent by the utility allowance.

The concept being addressed here is that part of the gross allowable rent under IRC section 42 pays for the actual housing of a tenant, and part pays for related utilities. Overall, this is the restriction to which building owners are held with regard to what they can charge for a low-income unit. As such, if tenants were required to pay for their utilities directly, they would actually be paying for them twice -- once to the utility company and again to the building owner as part of the designated rental payment. The intent of the law was neither to add this burden to the tenant, nor to subsidize the building owner's income for an expense that has not been incurred. Rather than using the actual expense amounts incurred by the tenant, the Code instead provides that this utility allowance be used to reduce the gross amount the tenant must pay.

| | | Building Owner Pays Utilities | Tenant Pays Utilities |
|---|---|---|---|
| | Maximum Rent | Gross Rent | Gross Rent |
| - | Utilities | -0- | Utility Allowance |
| = | Allowable Rent Paid by Tenant | Gross Rent | Net Rent Charged |

The **provision of services** is a similar issue with regard to whether or not related charges should be included into the restricted rent figure. The basic rule in this instance is that the provision of services to low-income tenants that are related to the occupancy of a unit and required as a condition of occupancy should generally be included in gross rent, and thereby the rent that can be collected from the tenants. In other words, it would be like providing a "service allowance," which would also serve to reduce the gross amount of rent charged for that unit.

Subsequent to 1991, the Service added a **"practical alternative"** position with regard to these issues. This position stated that if a practical alternative to receiving the service exists (and acceptance of such services is still not required as a condition of occupancy), then the related charges for such services will not be included in the gross rent limitation.

**Example 9**

A qualified low-income tenant seeks occupancy in a qualified low-income building. Per the AMGI level and imputed income rate, the IRC section 42 maximum gross rent would be $350 a month. As a condition of occupancy, a fee of $25 a month is charged for use of a laundry facility. The building is located in a rural area with no laundry facilities available. This fee would be included in the gross rent charged to the tenant, reducing the rent to $325.

**Example 10**

A qualified low-income tenant seeks occupancy in a qualified low-income building. Per the AMGI level and imputed income rate, the IRC section 42 maximum gross rent would be $350 a month. A dining facility is maintained at the building, but is not required as a condition of occupancy. Tenants pay $100 a month for the privilege of using the facility. The building is located in an urban area with numerous alternatives available. The cost of meals in such a facility is not includable in gross rent charged to the tenant, which would remain $350 regardless of whether or not the tenant ate in the dining facility.

There are, of course, exceptions to the rules. The regulations provide that certain **"supportive services"** fees that allow tenants to reside independently from a formal care facility defined as a nursing home, hospital, or intermediate care facility for the mentally or physically handicapped would be allowable fees to be added to the gross rental figure. The fee must be paid to the owner of the unit (on the basis of the low-income status of the tenant) by any governmental unit or tax-exempt 501(c)(3) program if such program provides assistance for rent and the amount of assistance provided for rent is not separable from the amount of assistance provided for supportive services. Transitional housing services, which are designed to assist and prepare individuals to locate and maintain a permanent residence, are also excluded from the gross rent restrictions. The last exception to the general provision of services rule is that gross rent related to any federally-assisted project required to provide meals to its elderly or handicapped residents does not include the cost of the meals.

An additional exception under IRC section 42(g)(2)(B) with regard to the gross rent computation is that it would not include any HUD Section 8 payments (or any comparable Federal or state low-income housing assistance) made on behalf of a tenant. It should be noted that the Service has not defined what programs are included as such assistance. Additionally, after 1990, assistance provided by the Farmers Home Administration (Section 515 rental assistance) to the owner of the unit will not be included in gross rent provided the owner pays an equivalent amount to the FHA under Section 515.

**Example 11**

Per IRC section 42 rent restriction computations, the gross rent charged for a particular low-income unit is found to be $350 per month. A qualified HUD Section 8 tenant receives a voucher designated for housing in the amount of $100 per month. The building owner can receive a total of $450 per month for that unit, consisting of $350 rent and the $100 HUD Section 8 voucher.

## MINIMUM SET-ASIDE ELECTION

The minimum set-asides that have been discussed here are an irrevocable election, made by the building owner on part two of Form 8609, "Low-Income Housing Credit Allocation Certification." This election is made on the tax return for the first taxable year of the credit period. The credit period generally begins in the year the property is placed in service, but may, at the election of the taxpayer, begin in the subsequent year instead. These timing issues and other mechanical computations are discussed in greater detail in subsequent chapters.

The requirements of the elected set-aside test must be met no later than the close of the first year of the credit period and must continue throughout the compliance period (which is 15 years from the beginning of the first year in which the low-income housing credit is claimed). An item to note with regard to the minimum set-aside test is that only the percentage of low-income units should be used to calculate this figure. This contrasts with other low-income computations, which often compare occupancy and floor space figures, as will be discussed in subsequent chapters.

In a situation where a project consists of multiple buildings, placed in service on different dates, special consideration must be given to determine whether or not the minimum set-asides have been met.

The general rule is that a building in such a project is a qualified low-income building only if the project as a whole meets the minimum set-aside requirements of IRC section 42(g)(1) not later than the close of the first year of the credit period for such building. Under a phased exception of IRC section 42(g)(3)(B), a building can be a qualified low-income building based on later buildings in the project. The taxpayer can elect to take subsequent buildings into account under two conditions. See Exhibit 2-3.

First, the subsequent buildings must be placed in service not later than the end of the 12-month period beginning on the date the prior building was placed in service. Second, the taxpayer must elect to use the placed-in-service date of the prior building as the beginning of the 12-month period during which the prior building and subsequent buildings, taken together, must meet the minimum set-aside requirement. If the taxpayer makes this election, the prior building is considered to be placed in service in determining the credit period and compliance period.

It should be noted that a multiple building project is a formal designation which would be made on part two of Form 8609, "Low-Income Housing Credit Allocation Certification" by the close of the first calendar year relating to the first or initial building. Additionally, the project should have disclosed its status as a multiple building when it applied to the state for an allocation.

## AUDIT TECHNIQUES

The development of issues regarding a building's qualification as a low-income project should begin with the inspection of tenant files. These files should provide enough information about the occupants and their income levels to determine whether or not the units qualify. Overall unit information should then be compared to the selected minimum set-asides to determine whether or not these requirements have been maintained. Failure to meet the elected set-asides reduces the building's eligible basis to zero. No credit would be allowed in such instance and recapture of the accelerated portion of earlier years' credits would be necessary.

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These tenant files should include the following documents:

1. Rental Application
2. "Plain English" Lease
3. Third Party Verification (including tenant income verification
4. Income Certification
5. HUD Section 8 Agreement (where applicable)

**NOTE:** An example of a tenant file is provided as Exhibit 2-5. This example shows the type of information and documentation an examiner would encounter during the audit process.

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Additionally, consider the state housing agency to be a valuable resource for information regarding the qualification of the project. This is especially true if there has been a filing of a Form 8823 (Report of Non-Compliance) by the state housing agency for the building owner.

The state files should contain the original application package whereby the owner requested the credit allocation. The requirements for these applicants can be quite stringent and may provide helpful information. In addition, the state may have specific information if a state compliance audit was conducted on a particular property. Other summarized information may also be available.

These issues are addressed on the initial interview IDR as items 2 c, d, e, f, g, and 8.

NOTE:  State requirements for tenant leases and rental applications vary dramatically from state to state.

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**EXHIBIT 2-1**

| QUALIFIED LOW-INCOME HOUSING PROJECT | |
|---|---|
| | MINIMUM SET-ASIDE REQUIREMENTS |
| 20/40 Test | 20 percent or more of the residential units are both:<br><br>(1) rent restricted &<br>(2) occupied by tenants whose income is 50% or less of the Area Median Gross Income |
| 40/60 Test | 40 percent or more of the residential units are both:<br><br>(1) rent restricted &<br>(2) occupied by tenants whose income is 60% or less of the Area Median Gross Income |
| | ALL ELECTIONS ARE IRREVOCABLE |

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**EXHIBIT 2-2**

| QUALIFIED LOW-INCOME PROJECT | | |
|---|---|---|
| MINIMUM SET-ASIDE TEST | | |
| CRITERIA | 20/50 | 40/60 |
| Maximum Tenant Income (as percentage of AMGI) | 50% | 60% |
| Minimum Occupancy Rate | 20% | 40% |
| Maximum Rent for Low-Income Units (= 30% of Maximum Tenant Income) | 15% | 18% |

Note: A special test, in lieu of the 40\60 test is available for New York City. This test is the 25\60 test and operates the same as the above tests mechanically.

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**EXHIBIT 2-3**

| QUALIFIED LOW-INCOME HOUSING PROJECT |
|---|
| DEFINITION OF A QUALIFIED LOW-INCOME HOUSING PROJECT:<br><br>1. MUST BE RESIDENTIAL RENTAL PROPERTY<br><br>2. MINIMUM LOW-INCOME SET-ASIDE REQUIREMENTS MUST BE MET<br><br>DEFINITION OF A QUALIFIED LOW-INCOME BUILDING:<br><br>1. MUST BE PART OF A QUALIFIED LOW-INCOME PROJECT DURING THE ENTIRE 15 YEAR COMPLIANCE PERIOD.<br><br>2. SUBJECT TO MACRS |

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DEFINITION OF ANNUAL INCOME (HUD HANDBOOK 4350.3)

Note: When a particular type of income appears in both Part A and Part B of this exhibit, it is discussed under the same number in both Parts (for example, military pay is discussed under Number 7 in both Part A and Part B).

PART A ANNUAL INCOME INCLUDES:

1. a) The gross amount (before any payroll deductions) of wages and salaries, overtime pay, commissions, fees, tips, bonuses, and other compensation for personal services of all adults of the household. Included are all salaries received from a family-owned business.

   b) Net income, salaries and other amounts distributed from a business.

   c) Any earned income tax credit to the extent it exceeds income tax liability. Includes credits received in a lump sum or as part of recurring payments.

2. a) The gross amount (before deductions for Medicare, etc.) of periodic social security payments. Includes payments received by adults on behalf of minors or by minors for their own support.

   Note: If Social Security is reducing a family's benefits to adjust for a prior overpayment, use the amount remaining after the adjustment for the overpayment. This is usually the "gross amount reported on Social Security's verification form.

   b) Annuities, insurance policies, retirement funds, pensions, disability or death benefits and other similar types of periodic receipts.

   c) Lump-sum payments received because of delays in processing unemployment, Social Security, welfare or other benefits (but only as otherwise provided in HUD Handbook 4350.3 paragraph 3-4C).

3. Welfare Assistance

   * If the payment includes an amount specifically designated for shelter and utilities and the welfare agency adjusts that amount based upon what the family is currently paying for shelter and utilities, special calculations are required.
   * If the welfare agency is reducing a family's benefits to adjust for a prior overpayment, use the amount remaining after the adjustment for the overpayment. This is usually the "gross" amount reported on the welfare agency's verification form.

4. Alimony and child support, unless the exclusion of these amounts is justified by other HUD sections.

5. Interest, dividends and other income from net family assets (including income distributed from trust funds). On deeds of trust or mortgages, only the interest portion of the monthly payments received by the applicant is included.

6. Amount by which education grants, scholarships or Veterans Administration benefits are intended as a subsistence allowance to cover rent, utility costs, and board of a student living away from home. (No part of a student loan can be included in Annual Income)

7. Lottery winnings paid in periodic payments. (Winnings paid in a lump sum are included in net family assets - not in annual income.)

8. Recurring monetary contributions or gifts regularly received from persons not living in the unit. (Includes rent or utility payments regularly paid on behalf of the family)

9. Note: For Intermediate Care Facilities for the Mentally Retarded (ICF/MR)

   * where Medicaid pays the ICF/MR directly for services and rent and pays the tenant only a small personal allowance (e.g. $25), annual income must include:

     a) the SSI payment the tenant would receive if he/she were not living in a group home AND

     b) all income the tenant receives from sources other than SSI (e.g. wages, training workshops, interest income, etc.).

   Note: The personal allowance (e.g. $25) must not be included i.e. owners must not add the allowance above the SSI amount.

Part B ANNUAL INCOME EXCLUDES:

1. Employment income of children (including foster children younger than 18)

2. Meals on Wheels or other programs that provide food for the needy; groceries provided by persons not living in the house hold.

3. Grants or other amounts received specifically for:

   a) auxiliary apparatus for a handicapped person;
   b) expenses for attendant care provided by other than a family member living in the household;
   c) medical expenses;
   d) out-of-pocket expenses for participation in publicly- assisted programs and only to allow participation in these programs. These expenses include special equipment, clothing, transportation, child care, etc.

4. Income associated with persons that live in the unit but are not regular household members. Includes:

   a) Payments received for care of foster children;
   b) Income of live-in attendants.

5. The principal portion of the payments received on mortgages or deeds of trust.

6. Hazardous duty pay to a family member in the military.

7. Lump-sum additions to family assets - such as inheritances; cash from the sale of assets; one-time lottery winnings; insurance settlements under health and accident insurance and workmen's compensation; settlement for personal and property losses.

8. Temporary, nonrecurring or sporadic income (including gifts).

9. Annual rent credits or rebates paid to senior citizens by government agencies.

10. Income excluded by Federal statute:

    a) Relocation payments made under Title II of the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970.

    b) Allotment value of coupons made under the Food Stamp Act of 1977.

    c) Payments received under Domestic Volunteer Services Act of 1973 (employment through VISTA, Retired Senior Volunteer Program, Foster Grandparents Program, youthful offender incarceration alternatives, senior companions.)

    d) Payments received under Alaskan Native Claims Settlement Act.

    e) Payments from certain submarginal U.S. land held in trust for certain Indian tribes.

    f) Payments, rebates or credits received under Federal Low-Income Home Energy Assistance Programs. Include any winter differentials given to the elderly.

    g) Payments under the Job Training Partnership Act (employment and training programs for Native Americans and migrant and seasonal farm workers, Job Corps, veterans employment programs, State job training programs, career intern programs).

SAMPLE TENANT FILE

***********************************

RENTAL APPLICATION (Example One)

***********************************

1. Tenant: ______________________ ______________ ___________ ______
   name SS # birth date age
2. Co-Tenant: __________________ ______________ ___________ ______
   name SS # birth date age
3. Phone # ________________ ___________________ _________________
   home work co-tenants work
4. Address: ________________________________________________________
   ________________________________________________________
5. Time at Current Address: ___________(Years) ____________(Months)
6. Landlord: ___________________________ _______________________
   name phone
7. Previous Address:_______________________________________________
   ________________________________________________
8. Marital Status: (please check)
   ____ married couple ____ legally separated
   ____ unmarried couple ____ separated
   ____ single ____ widowed
   ____ divorced
9. Race: (please check) ____White ____Asian ____Black
   ____Hispanic ____Other
10. Pets: _______dogs ______cats
11. Medical History: (comment) _____________________________________
    ________________________________________________________________
12. Physical or Mental Handicap of ANY Resident in the unit:
    ________________________________________________________________
13. Dependents: ________total number

| Name | Age | Sex (M/F) |
|---|---|---|
| | | |
| | | |
| | | |
| | | |

14. Employment: Firm ______________________________________________

Address ____________________________________________

______________________________________________

Supervisor________________________ ______________
name phone number

Position____________________________________________

Time with firm___________ Income___________________

15. Previous Employment: Firm_______________________________________

Address ____________________________________________

Supervisor________________________ ______________
name phone number

Position____________________________________________

Time with firm____________ Income__________________

16. Co-Tenant Employment: Firm_______________________________________

Address ____________________________________________

Supervisor________________________ ______________
name phone number

Position____________________________________________

Time with firm____________ Income__________________

17. Savings: _________________

18. Rent: _________________

19. Utilities: _______________

20. Debts: Creditors Balance Monthly Payment

| Creditors | Balance | Monthly Payment |
|---|---|---|
| __________________________________ | ____________ | _____________ |
| __________________________________ | ____________ | _____________ |
| __________________________________ | ____________ | _____________ |
| __________________________________ | ____________ | _____________ |
| __________________________________ | ____________ | _____________ |

21. Number of Bedrooms Required:
    ______ One ______Two ______Three ______Four

22. Personal References:

| Name | Address | Relationship | Phone |
|---|---|---|---|
| ________________ | __________________ | __________ | _________ |
| ________________ | __________________ | __________ | _________ |
| ________________ | __________________ | __________ | _________ |

23. Comments regarding special situations/housing needs:

_________________________________________________________________

_________________________________________________________________

Tenant Signature________________________________________ __________
Date

Co-Tenant Signature_____________________________________ __________
Date

Interviewer Signature__________________________________ __________
Date

******************************************************************

FOR OFFICIAL USE ONLY

1. Interviewer Comments:____________________________________________

_________________________________________________________________

_________________________________________________________________

_________________________________________________________________

_________________________________________________________________

2. Approval: __________________________________ ______________
Date

Denial:____________________________________ ______________
Date

3. Unit Assignment:____________________________

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******************************************
Rental Application (Example Two)
******************************************

HOUSEHOLD INCOME INFORMATION
(All information will be verified by a third party)

For each household member age 18 or older (including family members temporarily absent), list current and anticipated income for the twelve-month period commencing on the anticipated date of occupancy or recertification. Include all full-time, part-time or seasonal information. If a household member has more than one source of income, use a separate line for each source.

DO YOU RECEIVE:

1. Wages, salaries (including overtime, tips, bonuses, commissions, self-employment income? Yes___ No___ Amount $______
2. Does any member work for someone who pays them in cash? Yes___ No___ Amount $______
3. Regular pay for a member of the armed forces? Yes___ No___ Amount $______
4. Welfare or disability benefits (AFDC, SSI, GA) Yes___ No___ Amount $______
5. Worker's compensation? Yes___ No___ Amount $______
6. Unemployment benefits, or severance pay? Yes___ No___ Amount $______
7. Child Support? Yes___ No___ Amount $______
8. Alimony? Yes___ No___ Amount $______
9. Education grants, scholarships, or VA student benefits? Yes___ No___ Amount $______
10. Social Security payments? Yes___ No___ Amount $______
11. Pensions (PERA, Railroad, etc)? Yes___ No___ Amount $______
12. Retirement benefits? Yes___ No___ Amount $______
13. Death Benefits? Yes___ No___ Amount $______
14. Annuities or life insurance dividends? Yes___ No___ Amount $______
15. Lump sum payments (includes inheritance, lottery winnings, insurance settlements, etc.) Yes___ No___ Amount $______
16. Net income from rental property? Yes___ No___ Amount $______
17. Income from persons not living in the rental unit? Yes___ No___ Amount $______
18. Other (List)______________________________ Yes___ No___ Amount $______

Provide the following information for all items marked "yes" above

| Number from above) | Name of company, financial institution or other source | Mailing address and Phone Number |
|---|---|---|
| ______ | ________________________________ | ____________________________ |
| ______ | ________________________________ | ____________________________ |
| ______ | ________________________________ | ____________________________ |

HOUSEHOLD ASSETS

Do You Have Money Held For:

1. Checking Accounts Yes____ No____ Current Balance $_______
2. Savings Accounts Yes____ No____ Current Balance $_______
3. Stocks Yes____ No____ Current Balance $_______
4. Capital Investments Yes____ No____ Current Balance $_______
5. Bonds Yes____ No____ Current Balance $_______
6. Trusts Yes____ No____ Current Balance $_______
7. Securities Yes____ No____ Current Balance $_______
8. Insurance Settlements Yes____ No____ Current Balance $_______
9. IRA/KEOUGH Accounts Yes____ No____ Current Balance $_______
10. Certificates of Deposit Yes____ No____ Current Balance $_______
11. Pension/Retirement Funds Yes____ No____ Current Balance $_______
12. Money Market Funds Yes____ No____ Current Balance $_______
13. Treasury Bills Yes____ No____ Current Balance $_______
14. Safe Deposit Box Yes____ No____ Current Balance $_______
15. Other Yes____ No____ Current Balance $_______
16. Do you now own Real Estate Yes____ No____ Value $____________

    If yes, list address(es), expenses paid and income received:
    ____________________________________________________________
    ____________________________________________________________

17. Do you hold a contract for a deed? Yes___ No___ Value $________

18. Do you have any coin collections antique cars, gems/jewelry, stamps or any other items held as an investment (does not include personal jewelry) Yes___ No___ Value $_________

What assets are held jointly with another person? List persons and assets:

_______________________________________________________________________
_______________________________________________________________________
_______________________________________________________________________

Provide the following information for all items marked "Yes" above:

| Number (from above) | Name of company, financial institution or other source | Mailing address and Phone Number |
|---|---|---|
| ______ | ____________________________________ | ________________________ |
| ______ | ____________________________________ | ________________________ |
| ______ | ____________________________________ | ________________________ |

I/we hereby certify that I/we have____ have not____ sold or disposed of any assets for less than Fair Market Value during the two year (24 month) period preceding the date of this application. Any assets sold or disposed of for less than Fair Market Value are identified below.

| Household Member | Asset & Estimated Amount | Date Sold/ Disposed | Amount Received |
|---|---|---|---|
| ________________ | _________________ | ___________ | _________ |
| ________________ | _________________ | ___________ | _________ |
| ________________ | _________________ | ___________ | _________ |

(Please attach documentation available to verify income (i.e., divorce/settlement papers, tax returns, etc.)

## MISCELLANEOUS

The following questions pertain to yourself and every member of your household who will occupy the unit. Write either YES or NO in response to each question. Add an explanation below if the answer is YES.

______ Do you anticipate any change in your household composition during the next 12 months?

______ Does your household have any needs that might be better served by an apartment which is accessible to persons with mobility, hearing or visual impairments?

_______________________________________________________________________

_______________________________________________________________________

_______________________________________________________________________

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PLAIN ENGLISH LEASE

*********************************************************************

1) PARTIES This agreement is made between:

Landlord ______________________________________________________

Address ____________________________________ Phone_______________

Tenant ______________________________________________________

The following Managing Agent can act for the Landlord and receive notices for the Landlord: ________________________________________

Address ____________________________________ Phone_______________

2) DWELLING UNIT Landlord rents to Tenant for the period of this agreement (a) the dwelling unit located at:

______________________________________________________________

(b) the following furniture and appliances in the dwelling unit:

______________________________________________________________

______________________________________________________________

3) TIME PERIOD The time period of this Agreement shall be for _____ months, beginning on _____________ and ending on ______________.

4) RENT The monthly rent for the dwelling unit shall be $___________ due and payable on the first day of each month to the Landlord at

______________________________________________________________

5) UTILITIES Utilities shall be paid as follows:

| | Electricity | Water/Sewage | Heat | Hot Water | Other |
|---|---|---|---|---|---|
| Landlord | _______ | _________ | ____ | _______ | _____ |
| Tenant | _______ | _________ | ____ | _______ | _____ |

6) SECURITY DEPOSIT:

a) Tenant shall pay Landlord, when this lease is signed, a security deposit of $___________.
b) If Landlord has held the security deposit for more than 13 months after tenant moves out, the Landlord shall credit Tenant with interest on the security deposit 1/2% below the current passbook savings rate. (Rate at signing of this lease is ____%).
c) Landlord shall notify the tenant in writing of any deductions to be made from the security deposit during the course of the tenancy, within 30 days of making such deduction. This notice shall not be necessary for deductions made less than 30 days prior to the termination of the Agreement.
d) When the Agreement ends, Tenant shall notify Landlord when he or she has moved out and provide a forwarding address for return of security deposit. Landlord shall make an inspection within 72 hours after Tenant has moved to determine whether deductions from the security deposit will be necessary. Landlord shall give Tenant reasonable notice of the time and date of the inspection, and Tenant may be present if desired.
e) After the Agreement ends, Landlord may take from the security deposit any rent owed at the time and any other charges caused by Tenant's destruction of or failure to maintain the dwelling unit (except reasonable wear and tear). Landlord shall send an itemized accounting for any deductions from the security deposit and balance of the deposit to Tenant with 30 days of the termination of the lease.

7) USE OF DWELLING UNIT
Tenant shall use the dwelling unit only for residential purposes, except for incidental use of his/her trade or business (such as telephone solicitation of sales orders or arts and crafts created for profit), so long as such use does not violate local zoning laws or affect Landlord's ability to obtain insurance.

8) LANDLORD'S DUTY TO MAINTAIN DWELLING UNIT
Landlord shall make all necessary repairs to put and keep the dwelling unit in a fit and habitable condition, and shall obey all state and local laws regarding Landlord maintenance. Landlord shall also keep all common areas in a clean and safe condition, and shall provide adequate garbage cans.

9) TENANT'S DUTY TO MAINTAIN DWELLING UNIT
Tenant shall keep the dwelling unit in a clean and safe condition and shall obey all state and local law requiring tenants to maintain rented property. If damage to the dwelling unit (other than normal wear and tear) is caused by acts or neglect of Tenant or others occupying the dwelling with his/her permission, Tenant may repair such at his/her own expense. Upon Tenant's failure to make such repair, after 14 days notice by Landlord, Landlord may have the repairs made and Tenant shall owe Landlord for the Landlord's reasonable expense.

10) NOISE
Tenant agrees not to allow in the dwelling unit any excessive noise or other activity which disturbs the peace and quiet of other Tenants in the building. Landlord agrees to prevent other Tenants and other persons in the building from similarly disturbing Tenant's peace and quiet.

11) ALTERATIONS
No substantial alteration, addition, or improvement shall be made by Tenant to dwelling unit without prior consent of Landlord in writing.

12) ENTRY BY LANDLORD
The Landlord shall enter the dwelling unit only to inspect it, make repairs or improvements, supply services, or show the dwelling unit to other possible tenants, buyers, or workmen. Landlord shall give tenant reasonable advance notice of his/her intent to enter, and will enter only at reasonable times and with the consent of Tenant. In case of emergency, or if it is impractical to give notice, Landlord may enter without consent of Tenant. Landlord shall not abuse the right of entry, and Tenant shall not unreasonably withhold consent for legitimate entry without proper notice.

13) SUBLEASING
Tenant shall not assign this Agreement or sublet the dwelling unit without the written consent of Landlord. Consent shall not be withheld without good reason relating to the prospective tenant's ability to comply with this Agreement. This paragraph shall not prevent Tenant from having guests for reasonable periods.

14) LATE PAYMENT FEE
If rent is unpaid by 5:00 p.m. of the ________business day of the month it is due, Landlord may charge a late payment fee of $_______

15) FAILURE TO PAY RENT
If Tenant fails to pay rent when due, Landlord may give written notice that rent must be paid within five days or the Agreement will be ended. If Tenant does not pay, Landlord may ask for a court order to have Tenant put out and pay rent due. In the Alternative, Landlord may seek court judgment for the rent alone if it is unpaid when due.

16) OTHER VIOLATIONS
(a) If Tenant violates this Agreement (other than the sections dealing with payment of rent) or the applicable law in an important way, Landlord may deliver a written notice to Tenant stating what Tenant has done wrong and warning that the Agreement will end 30 days or more later if Tenant does not correct the problem within 21 days. If Tenant does not correct the problem, then Landlord may end the Agreement and ask for a court order to have Tenant put out.
(b) If Landlord violates this agreement or the applicable law in an important way, then Tenant may deliver a written notice to Landlord stating what Landlord has done wrong and warning that the Agreement will end 30 days or more later if the Landlord does not correct the problem in 21 days. If Landlord does not correct, Tenant may end the Agreement and move out
© If Tenant provides Landlord with a written notice of an important violation, or if notice is given by a public inspection agency, and Landlord does not correct the condition in a reasonable time, then Tenant may place his/her rent in an escrow account with the General District Court and ask for relief under the appropriate local legislation.

17) IMITATION OF REMEDIES
Tenant agrees not to refuse to pay the last month's rent because a security deposit exists. Landlord agrees not to evict or threaten removal of Tenant from dwelling unit by interrupting or reducing utilities or other essential services to Tenant without obtaining a proper court judgement or eviction.

18) DESTRUCTION OF DWELLING UNIT
If the dwelling unit becomes partly or wholly destroyed during the time period of the Agreement, either Tenant or Landlord may then end this Agreement upon reasonable notice.

19) TERMINATION
This lease may be ended by either Tenant or Landlord at the end of the original time period by providing written notice of desire to end the Agreement not less than 30 days before the end of the time period. If neither side gives notice, then the Agreement shall continue to be binding upon Tenant and Landlord as a month to month Agreement.

20) DUTIES OF TENANT WHEN AGREEMENT ENDS
When this Agreement ends, Tenant shall promptly leave the dwelling unit, remove all personal property belonging to him/her and leave the dwelling as clean as it was found (excluding reasonable wear and tear).

21) FAIR HOUSING
In accordance with State and Federal Fair Housing Laws, Landlord will not discriminate against Tenant because of his/her race, color, religion, national origin or sex.

22) CONTROLLING LAW
This Agreement and occupancy shall be subject to the appropriate State Residential Landlord and Tenant Acts.

WE AGREE TO BE BOUND BY ALL TERMS OF THIS AGREEMENT

| TENANT(S) | | LANDLORDS(S) | |
|---|---|---|---|
| ______________________ | | ______________________ | |
| Name | Date | Name | Date |
| ______________________ | | ______________________ | |
| Name | Date | Name | Date |

*********************************************************************

LEASE ADDENDUM

*****************

Covenants of TENANT ___________________________________

In addition to such other requirements as may be imposed upon Tenant by law, Tenant, for himself and his successors in interest agrees to the following:

1. To pay the rent promptly when due without demand therefore and without deduction or offset of any nature.

2. To use in a reasonable manner all utilities, services, facilities, appliances and equipment provided by Landlord; to keep all appliances and equipment within the dwelling in good and clean condition (reasonable wear and tear expected), and not to place fixtures, signs or fences in or about the dwelling without prior written permission from Landlord.

3. To comply with any obligations primarily imposed upon Tenant by applicable provisions of building and housing codes materially affecting health and safety.

4. To remove from the dwelling all garbage, rubbish and other waste in a clean and safe manner and in the receptacles provided by the Landlord.

5. Not to use the dwelling or permit the use thereof by others for any illegal purpose or activity.

6. To keep all doors, walkways and windows clear during inclement weather.

7. Not to keep in or about the dwelling any inflammable fluids or materials.

8. Not to affix or suspend any advertisements or notices on any part of the dwelling without prior written consent from Landlord.

9. Not to place any heavy articles (including waterbeds) in or about the dwelling without prior written consent from Landlord, and to be liable to the Landlord for all damages resulting from the placement or moving of such articles.

10. Not to keep any animals (wild or domestic) in the dwelling without prior written consent from the Landlord.

11. To conduct himself, and require other persons in the dwelling per his consent, to conduct themselves in a manner that does not disturb the other Tenant's enjoyment of the dwelling. Such conduct would not be

considered offensive, dangerous or disruptive to the rights, privileges and welfare of the other Tenants.

12. Not to deliberately or negligently destroy, deface, damage, impair or remove any part of the dwelling, or have any person in the dwelling at the consent of the Tenant do such and to repair or replace any such part of the dwelling affected by such actions.

Assignment/Sublease________________________________

Tenant may not, without prior written consent from Landlord, assign the Agreement or sublet the dwelling or any part thereof or to give accommodation to any roomer, lodger or other person not herein set forth, nor permit the use of the dwelling solely for the use of Tenant and Tenant's family consisting of the following named persons:

________________________________ ________________________________

________________________________ ________________________________

________________________________ ________________________________

WE HAVE AGREED TO BE BOUND BY THE TERMS OF THIS AGREEMENT:

LANDLORD | TENANT
---|---
________________________________ | ________________________________
Name Date | Name Date
________________________________ | ________________________________
Name Date | Name Date

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## Chapter 3

## ELIGIBLE BASIS

### DEFINITION

The determination of a building's **eligible basis** provides the starting point for the computation of the low-income housing tax credit. The eligible basis for a building may simply be stated as its **adjusted basis** (plus the cost basis of certain personal property and site improvements, such as stoves, refrigerators, air conditioning units swimming pools and parking areas) at the close of the first taxable year of the credit period. Adjusted basis reflects the adjustments applicable under IRC section 1016, except no adjustment for depreciation is taken into account. A unique aspect of this computation is that the "placed-in-service" date does not determine which items are includable in eligible basis, but taxpayers are instead allowed to include costs incurred after the placed-in-service date, but before the end of the first year of the credit period. Under the original provisions of the 1986 Code, it had been the placed-in-service date that was used to determine eligible basis. OBRA of 1989 changed this rule, extending it to the end of the first year of the compliance period, and the provision was made retroactive to the 1986 Code. The eligible basis remains constant throughout the 15-year compliance period, unless it is reduced to reflect additional federal grants.

**ELIGIBLE BASIS = ADJUSTED BASIS AT THE END OF 1ST YEAR OF THE CREDIT PERIOD**

The adjusted basis of a building consists of expenditures relating to the acquisition, rehabilitation or construction of the building. Land costs are not included in eligible basis. Exhibit 3-1 provides a list of some items which may be included or excluded from eligible basis. This exhibit was prepared for use as a study guide and should not be considered all-inclusive.

**ADJUSTED BASIS - CONSISTS OF 1 OR MORE OF THE FOLLOWING:**

**(1) ACQUISITION EXPENDITURES**
**(2) NEW CONSTRUCTION EXPENDITURES**
**(3) REHABILITATION EXPENDITURES**

Having been introduced to the general definition of eligible basis, the next step is to examine the specific eligible basis rules for its three components -- acquisition costs, new construction costs and rehabilitation expenditures.

## ISSUES SPECIFIC TO ACQUISITION EXPENDITURES (PURCHASE OF EXISTING BUILDINGS)

The acquisition of an existing property (as opposed to new construction) must conform to additional restrictions in order to achieve qualification as a low-income building. It is important to note that IRC section 42(d)(2)(A) provides that eligible basis is reduced to zero when the following requirements are not met.

### The 10-Year Rule

A prior owner must not have placed the building in service including personal, business, production of income, etc., within the 10 years prior to acquisition by the owner who now seeks to claim the credit on acquisition costs.

No capital improvement costing 25 percent or more of the building's adjusted basis may have been placed in service within the previous 10 years and either depreciated under ACRS or amortized over 5 years under IRC section 167(k).

### Exceptions to the 10-Year Rule

In determining the 10-year period, certain transfers will not be taken into account. They are: Carryover Basis Transactions, Nonprofit Acquisitions, Owner Occupied, Foreclosure, and Inheritance.

#### Carryover Basis Transactions

In a carryover basis transaction the new owner's basis is determined, either in whole or part, by the adjusted basis held by the previous owner.

#### Nonprofit Acquisitions

Property placed in service by a government unit or qualified nonprofit organization is also exempt from the 10-year rule. This exception requires that the placement in service by the government unit or nonprofit must itself satisfy the 10-year requirement. Qualifying nonprofit organizations are defined in IRC section 42(h)(5).

### Owner Occupied

This exception only applies when a transfer is made from a homeowner who had been using the property as a personal residence.

### Foreclosure

Under this exception, a building that would otherwise meet the 10-year test will not be disqualified based on a transfer due to foreclosure of any purchase-money security interest, if the building is resold within 12 months after the placed-in-service date following the foreclosure.

### Inheritance

Inheritance transactions are exempt from the 10-year rule, as governed by IRC section 1014(a).

## Waiver of 10-Year Rule for Certain Federally Assisted Buildings

The Secretary of the Treasury may waive the requirement concerning placement-in-service within the previous 10 years for projects assisted, financed, or operated under HUD Section 8, IRC section 221(d)(3), or section 236 programs, or the Farmers Home Administration section 515 program, or buildings acquired from insured depository institutions in default. See section 1.42-2 of the Income Tax Regulations for waiver procedures.

## Related Party Ownership

This requirement states that the building cannot have been previously owned by the new owner, or a party related to the new owner. These rules are governed by IRC sections 267(b), 707(b), and 52(a) and (b). For purposes of IRC section 42, however, all references to 50 percent should be changed to 10 percent, thus increasing the restriction.

## Like-Kind Exchange Property

This acquisition rule provides that acquisitions consisting of a "like-kind" exchange cannot include any carryover basis from property given up in the eligible basis computation.

## ISSUES SPECIFIC TO NEW CONSTRUCTION EXPENDITURES

Expenditures relating to the construction of a new building should be analyzed carefully. The dollar amount of these projects is generally larger than acquisition or rehabilitation projects and the amount of credits claimed is generally greater. These projects may include multi-tiered organizational structures; many of which serve specific purposes and could be related parties. For example, the developer, contractor, and management company may be related to (and/or controlled by) the general partner.

### Expenditures Specifically Excluded From Eligible Basis

As previously mentioned, land costs are specifically excluded from eligible basis, see Committee Reports to P.L. 99-154. In addition to the actual purchase price of the land, expenditures related to acquiring the land must also be capitalized under IRC sections 1016 and 263. Exhibit 3-2 outlines the more common expenditures requiring capitalization to land and their related court cases.

1. The audit techniques used in determining whether the basis of land is correct are located in Exhibit 3-3.

2. Other ineligible costs disallowed from eligible basis are listed below:

   a. Bridge Loan Interest
   b. Bridge Loan Origination Fees
   c. Permanent Loan Credit Enhancement
   d. Permanent Loan Origination Fees
   e. Reserves Required by Lender
   f. Permanent Loan Closing Costs
   g. Marketing/Advertising
   h. State Housing Compliance Fees.

**Note:** 1 and 2 above may be capitalized during the construction period.

A detailed accounting of expenditures can be found in the Final Cost Certifications prepared by the taxpayer for the state agency prior to the issuance of Form 8609.

### Developer Fee

An area requiring evaluation is the payment of developer fees. These fees are generally over a million dollars on medium to large projects ($10 million and greater). Chapter 11 addresses development fees and soft costs in greater detail. However, due to its effect on eligible basis, it is covered here as well.

The allowance of developer fees in eligible basis is not specifically addressed by IRC section 42 and its regulations. However, Treas. Reg. section 1.48-12(c), which defines qualified rehabilitation expenditures, allows development fees for rehabilitation purposes. Unfortunately, development fees are not defined in the Code or any court case.

Taxpayers may have incorrectly included the entire developer fee amount in eligible basis; including the developer fees associated with duties performed for land acquisition and syndication activities.

Land acquisition services involve the purchase of unimproved land for the construction of the LIHTC apartment building. These activities are generally time intensive and critical to the project's success. Listed below are activities normally performed by the developer to acquire land, the cost of which should be capitalized to the land.

1. Analyze the Qualified Allocation Plan (QAP) for targeted areas within a state.

2. Identify potential land sites.

3. Analyze the demographics of potential sites.

4. Analyze a site's economy and forecast future growth potential.

5. Determine site's zoning status and possible rezoning actions.

6. Contact local government officials concerning access to utilities, public transportation, impact fees and local ordinances.

7. Perform environmental tests on selected sites.

8. Negotiate the purchase of the land and its related financing.

The prior list is not meant to be comprehensive. In addition, each duty listed above may have numerous subtasks. This list of activities is meant to underscore the importance of conducting interviews and securing written documentation related to work performed by the developer.

In addition to land acquisition services, the developer commonly performs syndication activities. Syndication activities in LIHTC projects occur on two levels. On the first level a prospectus or Offering Memorandum may be created to sell the project. The limited partner will generally contact Fortune 500 company's to ascertain their interest in buying tax credits.

On the second level the developer negotiates with the limited partner on the partnership terms. An arms--length bargaining determines the price per credit, the percentage of building sale proceeds going to the general and limited partners, and numerous other provisions related to financing and capital contributions. The developers provide the limited partners with detailed feasibility projections to show the projects viability. Negotiations with two or more limited partners may occur at the same time. It is important to determine how much of the developers fee is related to syndication activities. The developer should maintain records to substantiate the work performed. Syndication costs are not included in eligible basis. See Chapter 11 for cases related to syndication and a more detailed discussion.

The preceding three paragraphs establish the importance of land acquisition and syndication activities performed by the developer. One issue is what portion of the developer fee should be included in eligible basis, if any, where the taxpayer has little or no documentation to support an allocation of the fee between amounts includible in eligible basis and amounts that should be capitalized to land or disallowed as syndications costs. A taxpayer must provide reasonable and adequate documentation of the services for which the fee is paid to establish that any part of the fee is includible in eligible basis. All records and other evidence, including credible information provided by the developer, should be considered in making this determination. A reasonable allocation between amounts that do and do not qualify for eligible basis, where a taxpayer provides adequate documentation supporting such allocation should be made. In the absence of any adequate documentation, no such allocation can be made. This conclusion is supported by the Tax Court's decision in ***Carp v. Commissioner***, T.C. Memo 1991-436. In ***Carp***, the Tax Court refused to apply the rule of ***Cohan v. Commissioner***, 39 F.2d 540 (1930), to allocate a developer fee to the various services specified in a development agreement, where the taxpayer failed to introduce any objective evidence to establish that services were performed for qualifying activities.

## Developer Fee Notes

"Issues Specific to New Construction Expenditures" addressed specific issues concerning the allowance of developer fees in eligible basis. This determination is made whether the developer fees were paid currently or the developer accepts a note. Depending on the contributions made by the limited partners, there may be insufficient funds at project completion to pay the developer fee. In these instances, the developer is either given a promissory note or an account receivable. Additional audit procedures are required to ascertain whether the notes are allowed in eligible basis. NOTE: further discussion assumes we have a valid debt instrument.

A determination must be made concerning the treatment of the notes as recourse, nonrecourse or qualified nonrecourse.

1. Treas. Reg. section 1.752-1(a)(1) defines recourse liability as follows, "A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss set forth under T.R. 1.752-2."

2. Treas. Reg. section 1.752-1(a)(2) defines nonrecourse liability similarly, "A partnership liability is a nonrecourse liability to the extent that no partner or related person bears economic risk of loss for that liability under T.R. 1.752-2."

3. IRC section 49(a)(1)(D)(iv) defines qualified nonrecourse financing as a:

   * * * "qualified person" is any person which is actively and regularly engaged in the business of lending money and which is not--

   (I) a related person with respect to the taxpayer,

   (II) a person from which the taxpayer acquired the property (or a related person to such person), or

   (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

Partnership liabilities meeting the definition of recourse or qualified nonrecourse are eligible for inclusion in eligible basis. The **nonrecourse** liability involves additional audit steps.

1. As a general rule, the Code provides in section 1012 that the basis of property is its cost. ***Crane v. Commissioner***, 47-1 U.S.T.C. 9217, clarified that the basis includes not just the taxpayer's equity, but also liabilities assumed or encumbering the property acquired. However, the courts have further held that certain liabilities are too contingent or speculative to be considered fixed **or** were not secured by property of equal value to the acquired property. Notes with contingencies are discussed later in this chapter.

2. The collateralization of notes was addressed in ***Gibson Products v. United States***, 78-2 U.S.T.C. 9836. The court stated, "Even if a nonrecourse liability is not contingent, the taxpayer who seeks to invoke the principal of the ***Crane*** case must still show that the value of the property securing the nonrecourse debt is equal to or greater than the amount of the debt. The basic underlying rationale of ***Crane*** is that a liability should be included in basis, even if the taxpayer has no personal liability, because the taxpayer can be expected to satisfy the liability rather than lose the property. This assumption is true only if the property's value is equal to the amount of the debt. If the value of the property is less than the amount of the nonrecourse debt, it cannot be assumed that the taxpayer will necessarily make full payment, or treat the liability as if it were his own." Thus it is important for the auditor to determine whether the nonrecourse note is secured and the value of

property securing the note. If the amount of the nonrecourse debt unreasonably exceeds the fair market value of the securing property at the time of the purchase, basis may be disallowed.

The following key documents must be obtained to verify the recourse or nonrecourse nature of the notes.

1. The partnership agreement will provide details on the assumption of partnership debt. Look for provisions related to IRC section 752 or language that assumes debt.

2. The promissory note often contains language about the recourse nature of the debt and any related collateral.

3. Seek appraisals or other valuation instruments if some type of property is securing the note. Make a determination on the value of the property and compare to the debt.

The At-Risk provisions of IRC sections 42(k), 49(a)(1), and 465(a)(1) are closely related to IRC section 752. However, these rules only apply at the individual partner level and to closely held corporations. Thus, a limited partner composed of Fortune 500 company's would not fall within the realm of At-Risk.

Developer fee note transactions between related parties may warrant additional evaluation, depending on the terms of the transaction; for example, cases involves an accrual basis taxpayer paying for developer fees with a note given or assigned to a related cash basis development company. The accrual basis taxpayer claims eligible basis with respect to the note payable, while the cash basis taxpayer is not required to include the note in income until payments on the note are received. Many partnership agreements call for the sale of the LIHTC property at the end of the 15-year compliance period, with payment on the developer fee note to be made at that time. Consideration should be given to whether the related development company's use of the cash method materially distorts its income, such that an adjustment is required under IRC section 446(b) to clearly reflect income.

A material distortion of income generally does not occur where a deferral of income arises in the regular course of business and not from a manipulation of the cash method. ***Gold-Pak Meat C. v. Commissioner***, 552 F.2d 1055, 1057 (9th Cir. 1975). Courts have also considered whether a business purpose exists for a transaction in deciding whether a taxpayer's method of accounting for a transaction materially distorts income. ***Frysinger v. Commissioner***, 645 F.2d 253 (5th Cir. 1981). A material distortion of income is likely to be found where the amount of an item differs substantially from what might normally be expected in an arm's-length transaction

between unrelated parties. ***Lewis v. Commissioner***, 65 T.C. 625, 629 (1975). The interval of time between the reporting of the payment of expenses and the receipt of associated income may be so great that a taxpayer's use of the cash method of accounting may result in an impermissible distortion of income. ***Silberman v. Commissioner***, T.C. Memo. 1983-782, ***aff'd without published opinion sub nom, David Whin, Inc. V. Commissioner***, 770 F.2d 1068 (3d Cir. 1985). Each case must be analyzed based on the facts and circumstances presented in that case. (Note: In addition to considering any potential material distortion of income issue, also consider whether the liability created by the note is contingent and, therefore, not includible in eligible basis, and whether the proper taxable entity is being charged with the income associated with the note.)

## Contingent Liabilities

On occasion, a payable is recorded on the property's books for developer fees with no corresponding note signed. Much of the previous discussion concerning partnership liabilities is applicable here, as well. However, the additional legal problems of collection, the lack of collateral, and whether a true liability exists and its value should be addressed.

Developer fee notes may contain provisions which make a liability contingent. An obligation, the payment of which is so speculative as to create a contingent liability, cannot be included in the basis of property. There are several factual circumstances that may support the conclusion that a liability is contingent for this purpose. For example, a liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits. See ***Pierce Estates v. Commissioner***, 195 F.2d 475 (3d Cir. 1952). Rev. Rul. 80-235, 1980-2 C.B. 229 and Rev. Rul. 81-262, 1981-2 C.B. 164, held that a note, even though for a fixed amount, was contingent because it was not secured by property having a fair market value equal to the amount of the note. (Note: A liability must also meet the requirements of IRC section 461 to be includible in eligible basis.

## Developer Fees Exceeding Economic Feasibility Under IRC section 42(m)(2)

The state housing agencies have the authority to set limits on the reasonableness of developer fees. The allowed developer fee is stated as a percentage of the project costs minus land. These percentages vary from state to state. In addition, some states apply this percentage to the **aggregate** of entities related to the developer for all services. However, some states allow separate entities to perform various services and receive compensation aside from the developer fee. Thus, it is essential to obtain the Qualified Allocation Plan (QAP) from the state agency in which the project was awarded. The QAP will set forth the allowable developer fee percentage. However, the amount of the developer fee approved by the state agency is not automatically

included in eligible basis. The developer fee itself must be examined.

> **<u>Extract</u>**
>
> IRC 42(m)(2)
>
> **Credit allocated to building not to exceed amount necessary to assure project feasibility.**
>
> (A) In general. The housing credit dollar amount allocable to a project shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.
>
> (B) Agency Evaluation. In making the determination under subparagraph (A), the housing credit agency shall consider:
>
> > (i) the sources and use of funds and the total financing planned for the project,
> >
> > (ii) any proceeds or receipts expected to be generated by reason of tax benefits,
> >
> > (iii) the percentage of the housing credit dollar amount used for project costs other than the cost of intermediaries, and
> >
> > (iv) the **reasonableness** [bolding added for emphasis] of the developmental and operational costs of the project. [word bolded for emphasis]
>
> * * * * * * *

The state allowed developer fee may be exceeded. The taxpayer can unintentionally calculate the wrong amount. This may occur when the project's costs have not been finalized or the developer may characterize portions of the fees as other services. For example, an entity related to the developer may be paid for services within the scope of the developer. Thus, the developer would claim the maximum developer fee while the related entity would collect an additional fee. Finally, although rare, the developer may direct the general contractor to make payments out of the general contractor's profits for the project. The general contractor may submit inflated draw requests to the bank so cash can be received at the commencement of the project. The payments made to the developer may be recorded as an additional building cost.

Various audit techniques can be used to find unreasonable payments of developer fees. They are:

1. Recalculate the state allowed maximum fees using the QAP.

2. Create a complete organizational chart showing payments to all entities. Determine which entities are related and what payments they have received. Secure all written agreements and/or notes for payment of additional fees.

3. Review the cash receipts journal of the developer and related entities for general contractor payments.

4. Specifically ask if such payments have occurred.

**Allocation of Overhead and Soft Costs to Land**

In addition, to the reallocation of developer fees (a soft cost), there are other overhead and soft costs which require consideration. Soft costs refer to costs not directly related to actual building construction. A determination of how much of these expenditures are related to land acquisition and syndication activities should be made.

To properly manage a LIHTC project, the developer will employ assistants to perform various functions. These employees will likely become involved in acquiring the land or assisting with syndication negotiations. A portion of overhead expenses may need to be allocated to land or syndication.

Overhead expenditures include, but are not limited to the following:

1. Salaries and benefits
2. Utilities
3. Depreciation expense
4. Occupancy or lease costs
5. Supplies
6. Expenditures requiring capitalization.
   (Consult IRC section 263A for a complete list.)

Once it has been established that these types of expenditures were omitted from the land or syndication basis, the taxpayer should be asked to make an allocation. If the taxpayer refuses to advance a methodology, consider allocating overhead based on the relative values of the projects assets, including land. An example of this simple proration is shown below:

**Example 1**

Assume it has been determined that $300,000 of overhead requires allocation to land. In the absence of contemporaneous records the proration may be made as follows:

| Item | Value | Percentage |
|---|---|---|
| Buildings | 10,000,000 | 66% |
| Land Improvements | 3,000,000 | 20% |
| FF&E | 1,000,000 | 7% |
| Land | 1,000,000 | 7% |
| Total | 15,000,000 | 100% |
| | ========== | ==== |

Multiply the $ 300,000 x 7 percent (land percentage) to arrive at an adjustment of $21,000 to eligible basis.

Consideration should also be given to the remaining soft costs. A detailed listing of these costs should be requested from taxpayer and are normally found in the accountant's workpapers concerning asset basis. The following soft costs should be analyzed to determine if they are related to land:

1. Developer Fees (Addressed above)
2. Environmental contamination studies
3. Surveys
4. Rezoning expenditures
5. Impact fees
6. Real estate appraisals
7. Soil tests
8. Title insurance to land
9. Real estate commissions
10. Excess Profit
11. Any other large and unusual item

## New Construction Summary

A summary of major considerations in auditing LIHTC new construction projects can be found in Exhibit 3-4. This exhibit provides a quick snapshot of the issues previously discussed concerning computing eligible basis for new construction projects.

## ISSUES SPECIFIC TO REHABILITATION EXPENDITURES

The term "rehabilitation expenditures" means amounts chargeable to capital account and incurred for property subject to the allowance for depreciation in connection with the rehabilitation of a building. Such term does not include the cost of acquiring any building. (See IRC section 42(e)).

The eligible basis issues regarding rehabilitation expenditures focus on whether or not such expenditures qualify as a "substantial rehabilitation," which would enable the project to receive treatment as if it were a new building. The elements to be met in order for these expenditures to be considered a "substantial rehabilitation" are the criteria and the substantial rehabilitation test.

### Criteria

THE AVERAGE OF THE REHABILITATION EXPENDITURES MUST BE THE **GREATER** OF:

(1) $3,000 PER LOW-INCOME UNIT
(Must occur within any 24-month period selected by the building owner.)

OR

(2) 10 PERCENT OF THE ADJUSTED BASIS OF THE BUILDING
(Determined as of the 1st day of the selected 24 month period.)

AND

(3) The expenditures are allocable to one or more low-income units or substantially benefit such units.

### Substantial Rehabilitation Test

This definition can be reduced to the following steps:

**SUBSTANTIAL REHABILITATION TEST**

1. Calculate 10 percent of the adjusted basis.
2. Multiply the # L-I units by $3,000.
3. Select the greater of #1 or #2.
4. Determine the amount of rehabilitation expenses attributable to the low-income units.
5. Compare #4 to #3. If #4 $\geq$ #3, the expenditures qualify as a "substantial rehabilitation" subject to treatment as a new building at the higher applicable percentage rate.

For purposes of the substantial rehabilitation test, the units of a building would be viewed on an aggregate basis, rather than on a specific unit-by-unit basis to determine whether the criteria are met. In other words, you would allow the expenditures to be averaged over the number of low-income units, rather than looking at each low-income unit independently to see if the $3,000 or 10-percent requirements had been met.

**Example 2**

Residential rental property is purchased on March 1, 1994, for $125,000. The purchase price is allocated as $100,000 for the structure and $25,000 for the land. The building consists of market rate and low-income units. Of the 40 units in the building, 30 are designated low-income. The building owner incurs rehabilitation expenditures of $300,000 during the period of March 1, 1994, through March 1, 1996. Of this amount, $200,000 is properly allocable to the low-income units. How would these rehabilitation expenditures be treated for the purpose of determining the building's eligible basis ?

This example meets the criteria for qualification as a substantial rehabilitation (computed per the steps indicated above) as follows:

Step:
1. 10% AB = $10,000.
2. $3,000 x 30 low-income units = $90,000.
3. $90,000 > $10,000.
4. $200,000 of the rehabilitation is allocated to low-income units.
5. $200,000 ≥ $90,000, so the expenditures qualify.

**Example 3**

The taxpayer incurs rehabilitation expenditures on a five-unit building. All units are qualified low-income units. The building's adjusted basis is $100,000. The expenses were incurred as follow:

| | |
|---|---|
| Unit 1 | $2,500 |
| Unit 2 | $2,750 |
| Unit 3 | $2,500 |
| Unit 4 | $3,500 |
| Unit 5 | $3,850 |
| | $15,100 / 5 units = 3,020 |

Step:
1. 10% AB = $10,000.
2. $3,000 x 5 low-income units = $15,000.
3. $15,000 > $10,000.
4. $15,100 of the expenses are attributed to low-income units.
5. $15,100 ≥ $15,000 ; so the expenditures qualify.

Although units 1-3 did not incur expenses in excess of $3,000, the project expenditures still qualify because the overall project expenses averaged $3,020 per unit.

**Note:** An exception to the 10 percent requirement exists in the form of an election by a taxpayer who purchases the building from a government unit. If elected, the 10 percent portion of the rule is not applied to the rehabilitation expenditures, however, the taxpayer is required to use the lower 30 percent present value credit (the 4 percent credit).

The above substantial rehabilitation rules apply to years after 1989. Prior to this, the rules were generally the same but the minimum rehabilitation threshold was only $2,000 per unit and the determination as to whether or not the threshold was met occurred at the end of the first year of the credit period. The 10-percent criteria did not apply at all, as this came into existence for years after 1989.

The qualifying substantial rehabilitation expenditures would be considered placed in service at the end of the selected 24-month period. See IRC section 42(e)(4)(A). It is also important to note that no **"double counting"** of rehabilitation expenditures is allowable. The same rehabilitation work cannot qualify for both the 70 percent present value credit as substantial rehabilitation and for the 30-percent present value credit as acquisition-related rehabilitation.

The specific issues discussed above regarding the components of eligible basis focus on the effect that their proper categorization has on the determination of eligible basis, since each of these components is subject to a specific credit percentage. These percentages apply as follows:

**APPROPRIATE LIHC CREDIT PERCENTAGES**

| | |
|---|---|
| **4% CREDIT** | **- APPLIES TO ACQUISITION COSTS AND RELATED REHABILITATIONS INCURRED BY THE END OF THE FIRST TAXABLE YEAR.** |
| **9% CREDIT** | **- APPLIES TO CONSTRUCTION EXPENDITURES. APPLIES TO "SUBSTANTIAL REHABILITATIONS".** |

## ELIGIBLE BASIS COMPUTATIONS FOR MIXED USE BUILDINGS

### (Properties with low-income and market-rate units, or commercial and residential units)

In addition, buildings which contain low-income units as well as market-rate units have

rules which apply to ensure that **disproportionate standards** do not exist between these two types of units. Basically, if similar construction and acquisition costs are found, rehabilitation costs do not improve the quality of the market unit above the low-income counterparts, and similar amenities are available for both the low-income and market-rate tenants (with no additional fee being charged for such amenities), then the cost of the market rate units is includable in eligible basis.

If these standards are not found to be proportionate, the expenditures for the market-rate units are to be excluded from eligible basis. Under IRC section 42(d)(3), an exception to this rule exists in the case where the costs per square foot of the market-rate units are not, on average, found to be in excess of 15 percent of the costs related to the low-income units. When this is the case, the taxpayer is provided an election to exclude any costs in excess of the low-income unit costs from eligible basis, rather than excluding all of the market-rate costs. This election is made on Form 8609, Part II. Most taxpayers would elect to reduce their eligible basis by the excess amount, rather than the entire amount of the market-rate units.

**Example 4**

A building consists of both low-income and market-rate units. The average cost per square foot of the low-income units is $50,000 per unit. The average cost of the market-rate units is $58,000 per unit.

| | | |
|---|---|---|
| **Comparison:** | $58,000 | market unit cost |
| | $50,000 | low-income unit cost |
| * | $8,000 | excess market costs |
| | | |
| | 50,000 | low-income unit cost |
| | x .15 | statutory limit |
| * | $7,500 | statutory limit for market costs |

Since the "excess market costs" of $8,000 per unit exceed the statutory limit, no portion of these market unit costs are includible in eligible basis.

**Example 5**

Same fact scenario as above. Change the average cost of market units to $57,000 per unit.

| | | |
|---|---|---|
| **Comparison:** | $57,000 | market unit cost |
| | $50,000 | low-income unit cost |
| | $ 7,000 | excess market costs |
| | $50,000 | low-income unit cost |
| | x .15 | statutory limit |
| | $ 7,500 | statutory limit for market costs |

Since the "excess market costs" of $7,000 per unit do not exceed the statutory limitation, the taxpayer can elect to reduce eligible basis simply by the amount of

the excess market costs, or $7,000 per unit.

It should be noted that **"mixed use" buildings** (which contain commercial space as well as residential rental space) are not precluded from qualification as low- income buildings. The commercial portion is not, however, includible in eligible basis and must be completely removed from such computations.

**Example 6**

Taxpayer Adam purchases a seven-story apartment house in an urban area. The bottom floor consists of commercial space occupied by a convenience store and dry cleaner. Adam would like to know if he is able to develop the upper stories as a low-income housing project.

The commercial space does not preclude the building from being used for low-income housing per IRC section 42. The commercial space must be excluded from the basis of the low-income project. It does not, however, disqualify the building for use as a low-income property.

## ELIGIBLE BASIS AND THE COMPLIANCE PERIOD

Once the eligible basis for a project has been determined, it remains the same throughout the 15-year compliance period. The eligible basis of a building is reported on Form 8609, Part II. An exception to the rule regarding eligible basis remaining the same, however, would be the situation where a **federal grant** is made to the project subsequent to the end of the first year of the credit period. In such an instance it would be necessary for eligible basis to be reduced by the amount of the grant for such taxable year and succeeding taxable years just as it would have been reduced during the initial year calculation. In addition, eligible basis relevant to construction or rehabilitation costs (not acquisition expenses) may be reduced by the amount of any federally-subsidized loans, should the taxpayer choose to utilize the higher 70 percent present value credit (the 9 percent credit).

## ELIGIBLE BASIS IN "DIFFICULT DEVELOPMENT AREAS"

An additional eligible basis topic deals with a benefit available to taxpayers who initiate projects in **"difficult development areas."** The low-income housing credit is effectively increased for these projects as the eligible basis is deemed to be up to 130 percent of the regularly computed eligible basis. This increase is determined by the state housing credit agency. A key point is that the full 130-percent increase is not automatic. The state housing authority has the discretion to grant only those costs up to 130 percent, which will make the project economically feasible. Eligible basis costs

for new construction or rehabilitation only can qualify for this basis increase. Acquisition costs are specifically excluded. Additionally, the location of the project must qualify for such classification as of the placed-in-service date. This designation of a "difficult development area" or "qualified census tract" is applicable only after 1989, and is designated by the Secretary of the Department of Housing and Urban Development. HUD publishes information regarding which areas are "qualified census tracts" and "difficult development areas" in the Federal Register. If a project is initiated in such an area, the state agency would indicate such on line 3B of Form 8609, which specifically asks if the high cost area provisions of IRC section 42(d)(5)(C) have been applied. The state agency would then fill in the appropriate percentage increase.

## EVALUATING THE VALIDITY OF COSTS INCLUDED IN BASIS (*THE CORBIN WEST TAX COURT CASE*)

In some cases, the facts and circumstances surrounding the transactions giving rise to the costs for which basis is claimed will lead to the conclusion that the transactions lack economic substance. In ***Corbin West Limited Partnership v. Commissioner***, Docket No. 2203-97, T.C. Memo. 1999-7, the Tax Court analyzed the validity of a variety of costs included by a limited partnership in the basis of a low-income housing project for purposes of claiming the low-income housing tax credit and depreciation deductions. The court focused on the economic substance behind the transactions which generated the costs, examined the parties' practices, and evaluated the limited partnership's justifications under the Code for each specific cost included in basis. The court's analysis may be applied to costs characterized under a variety of names and labels.

In ***Corbin West***, the court considered whether a recourse note lacked economic substance and was, therefore, not includible in eligible basis nor a valid debt for purposes of deducting interest on the note. The court noted that, while recourse notes are normally included in basis because the taxpayer has a fixed, unconditional obligation to pay a specified sum of money, with interest, the mere fact that a note is recourse is not determinative of whether a note should be included in eligible basis for purposes of IRC section 42. The court reasoned that if a recourse debt has no reasonable likelihood of being paid, then the recourse note lacks economic substance and should not be included in basis.

In determining whether there is a likelihood of repayment, the court noted that the facts and circumstances of each case need to be evaluated. In ***Corbin West***, the court examined a host of factual criteria concerning the economic substance of the transaction. First, the court examined the relationship between the purchase price and the fair market value of the property. In ***Corbin West***, the purchase price of $3.1

million greatly exceeded the $1.8 million fair market value of the property. Second, the court noted that repayment of the note was subordinate to the repayment of various obligations on the property, including a first mortgage, a second mortgage, the limited partners' loans, capital contributions, and the general partners' loans. Third, the property was the sole asset held by the limited partnership. Fourth, the limited partnership utilized a surrogate party to buy and then sell the property for the benefit of the limited partnership, partially in exchange for the note. Specifically, the court noted the surrogate party was not a negotiating party in the transaction, performed no independent analysis concerning the fair market value of the property or the likelihood of repayment of the note by the limited partnership, and never recorded the note as an asset. Further, the surrogate party had nothing at risk in the transaction because of the existence of a hold harmless agreement in its favor. In totality, the court held that there was no reasonable likelihood that the limited partnership would pay off the note and that, therefore, the note lacked substance, was not includible in the property's basis, and did not constitute a valid debt for interest deduction purposes.

The court also held that the limited partnership was not entitled to capitalize into its basis in the property a tax credit guarantee fee paid by the partnership to its general partner to ensure that the property would be operated in a manner that would guarantee the limited partnership's entitlement to low-income housing tax credits. The court denied this deduction because the limited partnership failed to demonstrate that this cost was associated with the acquisition of the property and failed to cite a Code section or other authority that would permit a deduction for this cost. Similarly, citing the absence of a specific rationale and support in the Code, the court held that the partnership was not entitled to capitalize into its basis a cash flow guarantee fee, which was paid to the general partner in return for the general partner agreeing to make loans to fund any operating deficits.

The court did allow the limited partnership to capitalize an acquisition fee and developer's fee, based on its finding that these costs were incident to the partnership's acquisition of the property. The court noted a number of services performed in return for the expenditures, including the evaluation of zoning and environmental requirements and the securing of an option to acquire the property.

## AUDIT TECHNIQUES

The determination of the appropriate eligible basis figure is critical to a low-income housing project since the tax credit computations use this as a starting point. Due to this impact, record keeping of this basis should be accurate. There are a variety of documents available to support the components of eligible basis. These include, but are not limited to the following.

**Closing Documents and Settlement Sheets**

These documents specify such items as the purchase price and terms, various transfer and real estate taxes, professional fees, and other related expenses. These documents may also identify "soft costs" such as development fees. These costs will be discussed in detail in Chapter 11, but as a brief synopsis, under Treas. Reg. section 1.42-6(b), fees are includible in carryover allocation basis only to the extent:

1. the fee is treated as paid or incurred under the method of accounting used by the taxpayer;

2. the fee is reasonable;

3. the taxpayer is legally obligated to pay the fee;

4 the fee is capitalizable as part of the taxpayer's basis in land or depreciable property that is reasonably expected to be a part of the project;

5. the fee is not paid (or to be paid) by the taxpayer to itself; and

6. if the fee is paid (or to be paid) by the taxpayer to a related person, and the taxpayer used the cash method of accounting, the taxpayer could properly accrue the fee under the accrual method of accounting.

All items on these documents should be reviewed to ensure that they qualify, and in what amount, for inclusion into basis. An example would be legal expenses. Should review of the cost indicate that all or part of the expense relates to services rendered in preparing an offering memorandum, these expenses should be removed if included in eligible basis. Although it is not inappropriate for such items to be recorded on the settlement sheets, they are not allowable in eligible basis for purposes of computing the credit.

Keep in mind that these documents provide background and support for the transaction impacting eligible basis, but they are not meant to be tax make-up sheets. Do not assume that all items on these documents have been included in basis; instead, a further inspection of unusual or questionable categories should be performed.

**AIA (American Institute of Architects) Statements or Construction Vouchers**

These documents can provide details regarding the specific addresses and units for which work was done, types and amounts of costs, and the related percentages of completion. These documents are helpful in reviewing eligible basis, and especially the issue of disproportionate standards because they make a unit-to-unit comparison

(construction and amenities) available. Of particular interest is what is referred to as the "punch list," which shows the review made right before occupancy, describes last minute upgrades, and to which units they relate.

**Development Agreements**

These agreements may provide detail for the intended eligible basis figure and its components. It may also detail soft costs which are subsequently found to have been incorrectly included in eligible basis. Once again, the discussion of "hard versus soft" costs will be detailed in Chapter 11, but it is important to understand that having a full picture of all costs involved with the project will allow the examiner to determine which are properly includable in eligible basis and which should be excluded.

**Certificate of Occupancy**

This document provides a description of the property and states when it was placed in service. In some areas it also describes zoning and the type of units offered -- such as whether commercial areas exist or not.

**Prospectus/Offering Memorandum**

This is an important document because disclosure is factual and thorough. By providing this document to prospective investors, a developer eliminates the threat of civil liability by providing detailed information regarding the project. It includes the intent and purpose of the developer, detail of soft and hard costs, and information regarding any related entity involvement.

**State Housing Credit Agency File**

The state housing credit agency will maintain files for all approved projects. These files provide information and also serve as a check against the information given by a building owner during an audit. The reconciliation between the figures provided by the building owner to the state and the figures provided during the examination is an essential audit step for eligible basis issues. There are situations when these source documents may not agree. Examiners should inspect any differences and be familiar with all forms involved so that an appropriate determination of the audit scope can be made. Do not assume an automatic adjustment if the information does not reconcile.

The state's file may provide detail regarding any "walk-thru" inspection by the state agency prior to the placement in service of the building. This information should tell not only the approved placed-in-service date, but may also detail the actual conditions regarding the building's suitability for occupancy.

The documents described above should be available in the "permanent file" of the CPA on the project. Record retention is generally maintained for all items affecting basis, and recordkeeping practices should be particularly strong for low-income projects.

In addition to the inspection of the above documents, an examiner should always consider a local property check. This can be accomplished by researching property records or by accessing ProComm on the computer. Information such as a description of the real estate, mortgage information, details regarding the existence of any covenants, various sale terms, and the names of prior owners may provide insight into related tax issues.

An example is the issue of whether the land cost excluded from basis appears appropriate. Review of records from the tax assessor's office may provide at least a ratio of land to improvements, which can serve as a preliminary test of the land valuation reported. Examiners should be cautioned against using the direct valuations of the tax assessor's office, as they often do not provide current values and rarely reflect a figure which would be derived by appraisal.

These issues are addressed on the **"Initial Interview IDR"** as items 1, 2b, 6, 7, 8, 15, 16, and 17. For a more extensive listing of items includable or excludable from eligible basis, refer to Exhibit 3-1.

**EXHIBIT 3-1**

| DETERMINATION OF ELIGIBLE BASIS | |
|---|---|
| **INCLUDES:** | **EXCLUDES:** |
| * Acquisition, Rehabilitation and Construction Costs | * Depreciation |
| * Reasonable Developer's Fees | * Land |
| * Land Preparation Costs Related to a Specific, Depreciable Asset | * Federal Grants |
| * Costs of Comparable Non Low-Income Units | * Costs Attributable to Non-Comparable Units |
| * Certain Personal Property | * Historic Rehabilitation Tax Credit Claimed |
| * Certain Site Improvements | * Property for which accelerated depreciation under IRC section 167 was claimed |
| | * Commercial Portion of "Mixed-Use" Properties |

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**EXHIBIT 3-2**

## Costs Capitalizable to Land Not Allowable For LIHTC Eligible Basis

The following court cases and related expenditures should be considered in determining the correct basis of the land.

1. Excavating and earth-moving expenses. ***Aurora Village Shopping Center, Inc.***, 29 T.C.M. 126, Dec. 29,963(M), T.C. Memo., 1970-39.

2. Finders/brokerage fees for assistance in acquiring title to property. ***M.A. Mathiasen***, 20 T.C.M. 1681, Dec. 25,155(M), T.C. Memo. 1961-325, 63-1 U.S.T.C. 9153; ***J.H. Vestal***, CA-8, 74-1 U.S.T.C. 9407, 498 F.2d 487.

3. Costs for excavation of water retention ponds. ***W.K. Coors*, **60 T.C. 368, Dec. 32,003; Rev. Rul. 77-270, 1977-2 C.B. 79.

4. Cost of land surveys, ***C.H. Ashworth***, (DC) 7102 U.S.T.C. 9710.

5. Unpaid back real estate taxes and similar assumed costs must be added to the land's basis. ***P.W. Havener***, 23 T.C.M. 539, Dec. 26,735(M), T.C. Memo. 1964-91.

6. Legal and professional fees related to the acquisition of land. ***P.W. Havener***, Ibid; ***J.M. Haddock***, 57 T.C.M. 274, Dec. 45,654(M), T.C. Memo. 1989-200; ***P.W. Davis Est.***, 79 T.C. 503, Dec. 39,361; ***V.M. Cramer***, 55 T.C. 1125, Dec. 30,697; ***Indopco v. Commissioner***, 112 S.Ct. 1039 (1992).

7. Environmental impact tests and perk tests. IRC section 263.

8. Overhead expenditures and soft costs allocated to land. IRC section 263A.

9. Impact fees require capitalization and are depreciable over 50 years, ***Oriole Homes***, 89-2 U.S.T.C. 9433.

10. Land lease costs prior to acquisition of land, but during the construction period, are capitalized.

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## Audit Techniques for Land-Basis Class

1. Secure the closing agreement and/or settlement statement for the purchase of land.

   -- Analyze the statement for closing costs which require capitalization to land.

2. Ask for the accountant's workpapers on basis computations for all the assets included in the sale.

3. Secure the depreciation schedules.

   a. Check the purchase price of the land against the depreciation schedule and accountant's workpapers.

   b. Determine what, if any, costs have been capitalized to land.

4. Review the AIA turnkey contract schedule of costs looking for expenditures requiring capitalization.

   -- Request invoices for items which may require capitalization to land or a proration between land and buildings.

      a. Earth-moving/sitework (could be costs associated with digging retention ponds, drainage ditches, or similar activities).

      b. Fill/dirt (could represent excessive amounts of dirt for stabilizing marshy or reclaimed land).

      c. Mobilization/General conditions (contains elements of overhead requiring proration).

      d. Inquire about any other Large, Unusual, or Questionable (LUQ) items appearing on the schedule.

5. Review handout on Costs Capitalizable to Land Not Allowable from LIHTC Eligible Basis.

   -- Make determination of item applicability and secure additional source documents.

6. Secure written description of duties performed by the developer. Determine what portion of developer fees is related to land acquisition.

   a. Ask the developer for contemporaneous records to verify the amount of time spent on land acquisition activities.

   b. In instances where the taxpayer refuses to provide records, the agent should consider disallowing the entire developer fee. Reference ***Carp & Zuckerman v. Commissioner***, T.C. Memo. 1991-436.

## Major Considerations in Computing Eligible Basis for New Construction Projects

**BASIS**

Defined in Committee Report to P.L. 99-514 to be synonymous with basis as calculated under IRC section 1016. In other words, we calculate the LIHTC basis similarly to other asset basis'. However, the eligible basis for a building is its adjusted basis at the close of the first taxable year of the credit period, with certain adjustments.

**EXPENDITURES SPECIFICALLY EXCLUDED FROM ELIGIBLE BASIS**

**Land**

1. Land is specifically excluded from the LIHTC eligible basis, P.L. 99-514.
2. Handout of Costs Capitalizable to Land.

**Other Ineligible Costs**

1. Bridge Loan Interest
2. Bridge Loan Origination Fee
3. Permanent Loan Cr. Enhancement
4. Permanent Loan Origination Fee (Amortized)
5. Reserves Required by Lender
6. Closing costs -- Permanent Loan (Amortized over loan life)
7. Marketing/Advertising
8. State Housing Compliance Fee

Note: 1 and 2 above may be capitalized during the construction period.

**DEVELOPER FEES**

1. Allowed under Treas. Reg. section 1.48-12(c), however not defined.

2. Developer Fees may be disguised payments for:

   a. Land Acquisition Services (Capitalizable to land).

   b. Syndication activities under IRC section 709.

   c. Burden is on taxpayer to provide records, ***Carp & Zuckerman v. Commissioner***, T.C. Memo 1991-436.

3. Additional Considerations for Developer Fee Notes.

   a. Determine whether notes are recourse, non-recourse or qualified non-recourse under IRC sections 752 and 49(a).

   b. Ascertain whether notes are collateralized.

   c. Do the At-Risk rules of IRC sections 42(k), 49(a), and 465(a)(1) apply?

   d. Have income and expenses been mismatched under T.R. 1.446-1?

   e. Are the notes subject to contingent liabilities?

      -- Are the contingencies a "condition precedent" or a "condition "subsequent," see ***Burnham Corp. v. Commissioner***, 90 T.C. 953 (1988).

4. Payment of Developer Fees as an Account Receivable rather than a Note.

   -- Lacks the legal weight of a promissory note.

5. Developer Fees Excessive under IRC 42(m)(2)

   a. Are developer fees disguised as construction management fees or similar payments due to state limits?

b. Is the developer or a developer controlled entity receiving payments from the general contractor? Determine the nature of the payments and secure all written agreements.

c. Check state rules on aggregation of payments made to related entities.

## ALLOCATION OF PARTNERSHIP OVERHEAD/SOFT COSTS TO LAND

1. IRC section 263A requirements.

2. ***Algernon Blair, Inc.***, 29 T.C. 1205 (1958), discusses proper allocation of expenditures between assets.

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## Chapter 4

## QUALIFIED BASIS

### INTRODUCTION

The **qualified basis** of a low-income building is that portion of the building's eligible basis which is attributable to low-income tenants.

### APPLICABLE FRACTION

Applicable Fraction Qualified basis is arrived at by multiplying the eligible basis of a building by the **applicable fraction** of the building. The applicable fraction of a low-income housing building is the lesser of:

1. **Unit Fraction** - the ratio of the occupied low-income units to all residential rental units in the building.

**OR**

2. **Floor Space Fraction** - the ratio of the occupied low-income floor space to the total residential rental floor space in the building.

### DETERMINATION OF QUALIFIED BASIS

| QUALIFIED BASIS | = | ELIGIBLE BASIS x APPLICABLE FRACTION |
|---|---|---|

| APPLICABLE FRACTION | = | LESSER OF | (1) UNIT FRACTION<br>OR<br>(2) FLOOR SPACE FRACTION |
|---|---|---|---|

**Example 1**

The eligible basis of a qualified low-income housing building is $1,000,000. The building consists of 100 units, 60 units of which represent IRC section 42 rent restricted units while the remaining 40 units are rented to market-rate tenants. The floor space of each low-income unit is 500 square feet, while the market-rate units are slightly larger at 600 square feet.

In this example the unit fraction would be 60 percent, representing the 60 low-income units over the 100 units in the building. The floor space fraction would be 56 percent, calculated as follows:

| | | |
|---|---|---|
| 60 low-income units x 500 sq. ft. | = | 30,000 sq. ft. |
| 40 market rate units x 600 sq. ft. | = | 24,000 sq. ft. |
| | | 54,000 total footage |

30,000 low-income square feet / 54,000 total = 56%

Since the lesser amount is the 56 percent, this becomes the applicable fraction. The applicable fraction is multiplied by the eligible basis of $1,000,000 to arrive at a qualified basis of $560,000.

The **qualified basis** is initially determined based on units occupied by low-income tenants on the last day of the taxable year in which the building is placed in service or, at the owner's election, on the last day of the following taxable year. This initial qualified basis must be maintained continuously throughout the 15-year compliance period. A failure to meet the minimum set-aside level results in full recapture of the credit. Also, once selected, after the year the building is placed in service or the first year of the credit period, the qualified basis amount on the accelerated portion cannot be increased.

**Example 2**

A building's eligible basis is $5,000,000. John, the building owner, states on his application for the credit that the building would be a 100-percent low-income occupancy building, with a placed in service date of October 1, 1994. The following facts apply:

| Date | Floor Space Fraction | Unit Fraction |
|---|---|---|
| 10-1-94 | 50% | 50% |
| 12-31-94 | 75% | 77% |
| 12-31-95 | 85% | 90% |

The qualified basis as of December 31, 1994, is $3,750,000 ($5,000,000 x 75 percent). If the election had been made by the building owner to use the following year's occupancy levels instead, the qualified basis for the building would be $4,250,000 ($5,000,000 x 85 percent).

If the situation arises where the qualified occupancy rate decreases (either due to vacancy or a rise in the income level of the low-income tenant above 140 percent of the area median income ceiling) the building owner is allowed reasonable efforts to rent the unit. If such efforts are successful, the unit in question is still considered to be a qualified unit for the purpose of calculating the applicable fraction, as long as no other comparable or smaller unit has been rented to a tenant other than a qualifying low-income tenant.

## INCREASES TO QUALIFIED BASIS

An **increase** to the qualified basis of a low-income building may, in fact, occur after the initial determination. This increase would only result from either an increase to the number of low-income units or if the floor space of these units increased. This situation will occur in a year subsequent to the initial credit year, as any variances occurring in the first credit year are given consideration in the year-end computation. **Unlike the credits claimed on the initial qualified basis, the amount of the credit relating to any subsequent increases are limited to two-thirds of the appropriate credit percentage.** Additional points to remember with regard to subsequent increases in qualified basis are as follows:

1. The credit must be prorated based on the number of months of low-income occupancy.

2. The credit on the initial qualified basis is taken over the 10-year credit period, while the additional credit relating to the increase is taken on however many years remain in the 15-year compliance period.

3. The combination of the initial credit and the additional two-thirds credit cannot exceed the original allocation granted to the building by the state housing credit agency. If the combination of the two credits (the initial credit and the additional credit) exceeds the original allocation, a new allocation must by requested and granted to the building owner before the excess credits can be claimed.

4. The increase in qualified basis can be claimed only as a result of an increase in the applicable fraction and not due to an increase in the eligible basis of the building. If the increase is due to a change in the eligible basis, then a new allocation by the state housing credit agency must be granted before any additional credit can be claimed by the building owner.

**Example 3**

A low-income building receives an allocation by the state housing credit agency for $400,000 of credit. The qualified basis of the building for the first year of the credit period is $4,000,000. The examiner notes that the third year of the credit period's tax return reflects a qualified basis of $4,100,000. During subsequent inquiry, it is determined that the increase was due to an increase in the eligible basis of the building. A swimming pool which had previously charged for membership had been made available to all tenants free of charge. No new allocation was granted to the property for this increase to its common use space. As no new allocation was made for this increase to eligible basis, this increase would not be allowed and the qualified basis would be limited to the original $4,000,000. It should be noted that if a new allocation had been granted, the new, related credit would be considered separately from the original $400,000 credit. It would have its own 10-year credit period and 15-year compliance period beginning after its allocation.

As previously stated, the qualified basis of a low-income housing building is arrived at by multiplying the eligible basis of the building by the applicable fraction. The applicable fraction of a low-income housing building is based on the lesser of the unit fraction or the floor space fraction of the occupied low-income units. Therefore, a **low-income unit** must be identified before the applicable fraction can be determined.

## LOW-INCOME UNIT REQUIREMENTS

Generally, a low-income unit is any unit in a building if it is both rent restricted and occupied by tenants who meet the income limitation applicable to the project. There are other requirements placed on a unit before it can be considered a low-income unit. These requirements are discussed below.

1. The unit must be suitable for occupancy, meaning that the unit must meet the local health, safety, and building code requirements. For guidance in these areas, look to the local code requirements relevant to the building, as well as guidelines provided by the Department of Housing and Urban Development.

2. The unit cannot be used on a transient basis. This rule focuses on the intent of the low-income housing credit to provide long-term solutions for affordable housing to low-income households. The Committee Reports lend some guidance in this area, stating that a unit will not be considered as used on a transient basis as long as the initial term of the lease is at least 6 months. Month-to-month leases can then follow the initial 6-month term.

3. The Omnibus Budget Reconciliation Act of 1989 revised the term "transient housing," such that a single room occupancy **unit** will not be considered as being used on a transient basis merely because it is rented on a month-by-month basis.

This change is retroactive to the enactment of the Tax Reform Act of 1986.

4. A unit also will not be considered as used on a transient basis if it provides **transitional** housing for the homeless, as provided for under section 103 of the Stewart B. McKinney Homeless Assistance Act (42 U.S.C. 11302). Transitional housing encompasses both housing and appropriate supportive services provided by a governmental entity or qualified non-profit organization for homeless persons, designed to enable them to move to independent living within a 24-month period. The units must also contain sleeping accommodations, kitchen, and bathroom facilities.

   Under IRC section 42(c)(1)(E), a building which provides supportive services to the homeless (namely assistance in locating permanent housing opportunities), must include in its qualified basis the lesser of:

   a. the eligible basis attributable to such services,

   **OR**

   b. 20 percent of the qualified basis of the building.

**Example 4**

For this example, assume that the low-income building qualifies as new construction and that the costs includible in eligible basis are $10,000,000. The percentage of the costs relating to supportive services is 2 percent, while the applicable fraction is 80 percent. The increase to the eligible basis would be computed in the following manner:

**STEP ONE:**

| | |
|---|---|
| New Construction Costs | 10,000,000 |
| Supportive Services % | X .02 |
| Eligible Basis Attributable to Services | = 200,000 |

**STEP TWO:**

| | |
|---|---|
| New Construction Costs | 10,000,000 |
| - Supportive Services Costs | - 200,000 |
| Subtotal | =9,800,000 |

**STEP THREE:**

| | |
|---|---|
| Subtotal | 9,800,000 |
| Applicable Fraction | X .80 |
| Qualified Basis without Supportive Service Costs | =7,840,000 |

**STEP FOUR:**

| | |
|---|---|
| Qualified Basis without<br>Supportive Service Costs | 7,840,000 |
| Statutory Rate | X .20 |
| 20% of Qualified Basis | =1,568,000 |

The allowable qualified basis increase due to supportive services will be 200,000. The qualified basis for this project is $8,040,000 ($7,840,000 + 200,000).

## STUDENT OCCUPANCY RULES

IRC section 42 originally provided that a unit would not be considered a low-income unit if all the **occupants are students**, and none is entitled to file a joint tax return. However, if the student was enrolled in a job training program receiving assistance under the Job Training Partnership Act, or similar Federal, State, or local programs, they could be considered eligible tenants. IRC section 42(I)(3)(D) was amended by the Omnibus Budget Reconciliation Act of 1990 to provide that a unit is not disqualified merely because it is occupied by a student who is receiving assistance under Title IV of the Social Security Act.

Another change to the original law occurred with the enactment of the Omnibus Budget Reconciliation Act of 1993, to provide for students who are single parents. IRC section 42(I)(3)(D)(ii)(I) provides that a unit will not cease to be a low-income unit if it is occupied by full-time, single-parent students and their children, and none of the tenants can be claimed as dependents on another return. In addition, an exception exists for full-time students who are married and file a joint return. The OBRA 1993 change is effective for allocations made after June 30, 1992 (or buildings placed in service after June 30, 1992).

**Example 5**

A low-income housing building that received an allocation in 1990, and was placed in service in 1991, filed its tax return claiming 80 percent as the applicable fraction. The building consisted of 50 residential rental units and an area that provided supportive services for the homeless by a non-profit organization. Upon review of the records, it was determined that of the 40 low-income units the owner used in calculating the applicable fraction:

* 3 were in violation of the local safety codes.
* 2 were single-room occupancy units with month-to-month leases.
* 10 were transitional homeless housing units.
* 4 units had student tenants, none of whom could file a joint return, (but 2 of the units were leased to single parents receiving assistance under the Job Training Partnership Act, while the other 2 units were leased to full-time students).
* 21 remaining low-income units were eligible tenants.

In this case, the applicable fraction should be reduced to 70 percent. The 3 units that are in violation of the local safety standards, and 2 of the student tenant units (the ones occupied by the full-time students) are not to be considered as low-income units.

## ON-SITE MANAGER'S UNIT

Rev. Rul. 92-61, 1992-2 C.B. 7, provides that an **on-site manager's unit** (a unit occupied by on-site maintenance personnel will be treated as a manager's unit), whether rented or provided free of charge, will not be considered as a low-income unit for the purpose of determining the applicable fraction. The unit is included in the eligible basis of the low-income building. With this issue, the need for an on-site manager's unit must be considered. The number of units in the building, in conjunction with the normal practice for property controlled by the Department of Housing and Urban Development, can be used as a guide for determining whether the unit occupied by a manager is appropriate.

## PROJECTS WITH FOUR OR FEWER UNITS

IRC section 42(I)(3)(C) provides that for a building consisting of four or fewer units, if the building owner or any person who is related to the owner occupies one of the units, the entire building would be disqualified for purposes of IRC section 42. No unit would then be considered a qualified low-income unit. In determining whether a person is related, the rules pertaining to IRC sections 52, 179, 267, and 707 are applied, with a substitution of 10 percent for 50 percent.

The Omnibus Budget Reconciliation Act of 1989 added an exception in IRC section 42(I)(3)(E) to provide that, if a building is acquired or rehabilitated under a development plan that is sponsored by a state or local government or a qualified nonprofit organization, the rules as explained under the four or fewer unit buildings shall not be applied. If the building meets this requirement, however, then the applicable fraction cannot exceed 80 percent of the unit fraction. In addition, if a unit is unoccupied for 90 days or more, that unit shall be considered as occupied by the owner as of the first day it was not rented. The relationship rules between the owner and the person occupying a unit remain in existence. In a multiple building project with four or fewer unit buildings, this rule would apply on a building-by-building basis. This rule does not apply to credits allocated before 1990, or to any project that does not require a credit allocation and was placed in service before 1990 or was financed by bonds issued before 1990.

**Example 6**

A low-income building was rehabilitated under a development plan. The project was granted an allocation during 1990, and the building was placed in service in 1991. The

building consists of four units, with one of the units being rented to a related party. The related party unit is a one- bedroom unit while the other three units are two-bedroom units that are qualified low-income units. The square footage of the low-income units totals 2100 sq. ft., with a total square footage of all the units being 2500 sq. ft.

Since the applicable fraction cannot exceed 80 percent of the unit fraction, the applicable fraction in this case would be:

60% (75% x 80% = 60%).

## AUDIT TECHNIQUES

One aspect of qualified basis issues is verifying the computation of the applicable fraction by the building owner. (Eligible Basis x Applicable Fraction = Qualified Basis). Check for any fluctuations in the low-income occupancy rate from year to year. This may be accomplished by sampling the tenant files to ensure that the households in such units were qualifying. Additionally, the examiner should ensure that only these qualifying units were included in the calculation.

Also identify any changes to qualified basis, and whether or not these are acceptable fluctuations. This can be accomplished by determining the first year of the credit period, and the qualified basis reported for such period. Then verify the allocation granted for each building by the state housing credit agency. Matching of the first year's qualified basis against that of subsequent periods will indicate whether or not a qualified basis figure which is greater than allowable is being claimed. If a greater figure is reported, determine that the source of this increase is not an unallowable increase to the project's eligible basis. Additionally, the calculation for an allowable applicable fraction increase should be reviewed to ensure that only the allowable two-thirds of the credit is taken and the additional credit was prorated for the first year of the increase. In all cases the auditor should ensure that the total credit claimed does not exceed the state allocation amount.

In any situations where a building is occupied by individuals who are receiving supportive services, the project's qualified basis should be reviewed to determine the proper handling of the portion of the building used to provide such services.

The examiner will also find it helpful to determine where and how the building owner is obtaining tenants. Verify that lease-up information is detailed and thorough. The examiner should not automatically assume that tenants from another low-income housing program qualify for the IRC section 42 program.

There are situations where the building and/or unit does not qualify -- such as failing the "suitable for occupancy test." These types of issues may be identified through an

inspection of the building. Another source of information would be to request any inspection documentation available from either the local "Licenses & Inspections" agency or the state housing credit agency -- either of which could have performed such an inspection.

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# Chapter 5

## CALCULATING THE LOW-INCOME HOUSING CREDIT

This guide has so far introduced the basic components of the low-income housing credit. Having reviewed the various definitions, concepts and rules, it is now appropriate to pursue the mechanical aspects of the credit computation. A basic concept to keep in mind is that the allocated credit is available in each of 10 years, known as the "credit period." In exchange for this credit the building owner must to comply with the IRC section 42 requirements for a period of 15 years, known as the "compliance period." Each year the building owner must file the appropriate annual information, including specifics regarding any changes made to the components of the credit, via Form 8609 and Form 8609 Schedule A. The low-income housing credit is a component of the general business credit, and as such, may also be encountered on Form 3800 of the tax return.

As stated above, the credit is claimed annually over a 10-year period. The credit, as defined by the Code, is calculated to provide a yield over this 10-year period equal to 70 percent and/or 30 percent of the building's qualified basis. For 1987, the first year the credit was available, the applicable percentages were 9 percent and 4 percent, respectively. In subsequent years monthly credit tables published in the Internal Revenue Bulletin provide the actual percentage amounts to be used in calculating the credit. These tables effectively adjust the 9 percent and 4 percent rates on a monthly basis, so that the present value over 10 years will continue to yield the 70 percent and 30 percent figures.

The appropriate monthly credit percentage is determined either on the date the building is placed in service, or by election, the month in which the binding allocation commitment has been entered into with the state housing credit agency. In the case of tax-exempt bond financed projects, a taxpayer's monthly credit percentage is determined by the building's placed-in- service date or the month bonds are issued. For both types of projects, the election is irrevocable and must be made by the fifth day of the month subsequent to the month elected. Notice 89-1 and Treas. Reg. sections 1.42-8 and 1.42-12a provide guidelines with regard to making the election. (Notice 89-1 generally applies to elections made before May 2, 1994.)

The applicable credit rate applied to the qualified basis is contingent on the category of project developed:

1. **New Construction**

    These projects are eligible to receive the 70-percent present value credit. It should be noted, however, that any buildings receiving federal subsidies must either take a 30-percent present value credit on the entire cost of construction or exclude federal subsidies from eligible basis and use the 70-percent present value credit against the remaining eligible basis in calculating the credit amounts. Refer to Chapter 6 for additional discussion on federal subsidies.

2. **Substantial Rehabilitations Which Qualify As a Separate Building**

    These projects are eligible to receive the 70-percent present value credit. Again where federal funding is involved, the 30-percent present value credit could be applicable.

3. **Acquisitions**

    Prior to 1990, the acquisition of an existing building was eligible to receive the 30-percent present value credit. The cost of acquisition included any rehabilitation costs which did not exceed the threshold described in Chapter 3. After 1989, however, the 30-percent present value credit is only available to those buildings which also meet the substantial rehabilitation qualification which would allow treatment as a separate new building. The maximum credit on the acquisition of such property is the 30-percent present value credit, regardless of the source of financing.

The Code specifies that the credit with respect to a specific building cannot exceed the amount allocated by the state in any taxable year. However, as previously discussed in Chapter 4 (regarding increases in qualified basis), the initial credit can increase as a result of an increase in the occupancy of the low-income portion of the building, indicated by the "applicable fraction." This increase, in addition to the initial credit amount, cannot exceed the allocation granted to a qualified low-income building. Additionally, the increase in credit is limited to two-thirds of the annual credit percentage used in the first year prorated by the number of months the increase took place, and is claimed over the remainder of the 15-year compliance period.

The 10-year period over which the credit extends generally begins in the taxable year the low-income property is placed in service. An election, made by checking line 5(a) of Form 8609, is available to the taxpayer to begin the credit period in the year immediately subsequent to the year the building was placed in service. Regardless of the option chosen by the taxpayer, the selected minimum set-aside must be met no later than the end of the first year of the credit period, as discussed in Chapter 2. It should be noted that the amount of the credit allocated by the state housing credit

agency will generally stay the same for each year in the credit period.

Notice 88-116, 1988-2 C.B. 449, provides guidance on the definition of the "placed-in-service" date. This definition applies to acquisitions, new construction, and substantial rehabilitation expenditures which qualify for treatment as a separate building. For new and existing buildings the placed-in-service date is the date (per state or local law) that the first unit is certified as being suitable for occupancy. For substantially rehabilitated buildings, the placed in service date commences at the end of the selected 24-month period used to aggregate the expenses as discussed in Chapter 3.

For the first taxable year of the credit period, a special "averaging" rule applies. This "averaging convention" is used to reflect only the months during the tax year for which the units were actually occupied by low-income tenants. In calculating the credit in the first year, the sum of the applicable fractions as of the close of each full month the building is placed in service is divided by 12. Any reduction of the credit attributable to the first year averaging computation is allowable in the eleventh year. It should be noted that actual occupancy levels are determined as of the last day of each month.

When the first year of the credit period is a short tax year, the credit period begins on the first day of that credit period as if it was not a short tax year. Thus, if the taxpayer is on a calendar year (regardless of the month the building is placed in service), the first day of the credit period is January 1.

A proration of the tax credit is necessary for partial years. This applies to the first year of the credit period as well as when a disposition of the property occurs during the year. If a disposition occurs during any year the credit is allowable, the credit is to be prorated between buyer and seller based on the number of days during the year each party owned the property. Settlement sheets can be examined to determine the necessary proration. See Chapter 7 for further discussion on a recapture due to disposition.

The following examples provide an illustration of a newly constructed building with substantial rehabilitation expenditures which is treated as a separate building. The examples provide the mechanics of the first year proration, as well as a subsequent increase to the project's qualified basis. The consideration of any federal subsidies has been omitted in both examples. It is assumed that the applicable credit rates exactly equal 4 percent and 9 percent, respectively, to simplify these illustrations. With regard to the applicable fraction, it is assumed that the "unit" percentage is less than the "floor space" percentage.

**Example 1**

Assume the following facts relate to the newly constructed building:

A low-income housing building (net of land) was constructed for $500,000. The building contained 50 rental units of which 40 units were designated as low-income units. The state credit housing agency allocated the credit based on 40 units. At the end of the months of October, November, and December, the low-income occupancy was 10, 20, and 30 units, respectively. In January of the following year, the final 10 low-income units were rented.

From the above facts, calculate:

1. The low-income tax credit before the proration of the first year calculation.
2. The credit after the proration of the first year calculation.
3. The increase in the tax credit in the following year due to the increase in qualified basis.

**Solution 1: The Low-Income Tax Credit (without first year proration)**

| | |
|---|---|
| Eligible Basis: | $500,000 |
| Applicable Fraction: | |
| 30 LIHC Units /50 | x 60% |
| Qualified Basis | = $300,000 |
| Applicable Percentage | x 9% |
| Annual Credit | = $ 27,000 |
| | ========= |

**Solution 2: Proration For First Year Calculation:**

| | | |
|---|---|---|
| Annual Credit | | $27,000 |
| | | |
| Months of Low-Income Occupancy: | | |
| October(10/50) | .20 | |
| November(20/50) | .40 | |
| December(30/50) | .60 | |
| Total Divided by 12 | 1.2 / 12 | x 10% |
| | | |
| Credit Allowed In Year 1: | | $ 2,700 |
| | | ======= |
| Disallowed Credit; Available in Year 11 | | |
| | ( $27,000 - $2,700 ) | $24,300 |
| | | ======= |

**Solution 3: Credit Due To Increase In Qualified Basis**

| | | |
|---|---|---|
| Annual LIHC<br>(Based on 30 low-income units<br>occupied 12 full months) | $27,000 | |
| Increase In Qualified Basis:<br>(Based on 10 additional units<br>occupied since January of year 2) | | |
| Eligible Basis | $500,000 | |
| Additional LIHC Units<br>(10 LIHC units / 50) Qualified | x 20% | |
| Basis | $100,000 | |
| Credit Percentage | x 9% | |
| Subtotal | $ 9,000 | |
| Credit Limitation | x 2/3 | |
| *Credit Amount | $ 6,000<br>======= | + $ 6,000 |
| Total Credit Available For Year 2: | $ 33,000 | |

* Amount available for each year of the remaining compliance period. No proration is necessary as the units were occupied 12 full months.

**Example 2**

Assume the same scenario as Example 1, with the following facts relating to the acquisition of a low-income building with rehabilitation expenditures treated as a separate new building:

An existing building was purchased for $500,000, and the rehabilitation expenditures were $1,000,000. It is assumed that the rehabilitation expenditures were aggregated within a 24-month period. The expenditures also exceed the following requirements:

Total Expenditures:

$1,000,000: **EXCEEDS** 10% of building's adjusted basis
(10% x $500,000 = $50,000)

**AND**

$3,000 per low income unit
($1,000,000/30 = $33,333)

**Solution 1: Calculation of Credit Before Proration**

| | Acquisition | Rehab. Expenses |
|---|---|---|
| Eligible Basis: | $500,000 | $1,000,000 |
| Applicable Fraction<br>30 LIHC Units/50 | x 60% | x 60% |
| Qualified Basis | $300,000 | $ 600,000 |
| Applicable Percentage | x 4% | x 9% |
| Annual LIHC | $ 12,000<br>======== | $ 54,000<br>========== |

**Solution 2: Proration For First Year Calculation**

| | | Acquisition | Rehab. Expenses |
|---|---|---|---|
| Annual LIHC | | $ 12,000 | $ 54,000 |
| Months of Low-Income Occupancy: | | | |
| October (10/50) | .20 | | |
| November (20/50) | .40 | | |
| December (30/50) | .60 | | |
| Total Divided By 12 | 1.20/12 | x 10% | x 10% |
| Credit Allowed In Year 1: | | $ 1,200<br>========== | $ 5,400<br>========== |
| Disallowed Credit, Available<br>In Year 11: | | | |
| Acquisition ($12,000 - $1,200)<br>Rehab. Exp. ($54,000 - $5,400) | | $ 10,800<br>========= | $ 48,600<br>========== |

**Solution: 3 Credit Due To Increase In Qualified Basis:**

| | Acq. | Rehab. |
|---|---|---|
| Annual LIHC For Year 2<br>(Based on 30 low-income units<br>occupied 12 full months) | $ 12,000 | $54,000 |

Increase In Qualified Basis: (Based on 10 additional units occupied since January 2 of year 2)

| | Acquisition | Rehabilitation | |
|---|---|---|---|
| Eligible Basis | $500,000 | $1,000,000 | |
| Addit'l L.I. Units | | | |
| 10/50 | x 20% | x 20% | |
| Qualified Basis | $100,000 | $ 200,000 | |
| Credit Percentage | x 4% | x 9% | |
| Subtotal | $ 4,000 | $ 18,000 | |
| Credit Limitation | x 2/3 | x 2/3 | |
| *Credit Amount | $ 2,667 | $ 12,000 | + $ 2,667 + 12,000 |

* Available to the end of the remaining compliance period.
No proration necessary. Units were occupied for 12 months.

| | | |
|---|---|---|
| Total credit available for year 2. | = $ 14,667 | = $66,000 |

## AUDIT TECHNIQUES

As noted in the above paragraphs, the determination of the first year credit period is dependent upon the placed-in-service date and the meeting of the elected minimum set-aside. The following techniques address both of these issues:

1. When examining the building's placed-in-service date, several factors should be considered to determine the validity of the date. Form 8609, which is filed with the tax return, requests in Part II, Line 1(a), the placed-in-service date of the building. This form is also requested in item #2 of the Information Document Request. For newly constructed buildings, it is useful to examine applicable certificates of occupancy, as well as several of the initial leases issued in the first year to see how they correspond to the date listed on Form 8609. Both of these items are requested on lines #7 and #8, respectively, on the Information Document Request. For substantial rehabilitation projects, the taxpayer's 24-month period selected to aggregate the expenses necessary to be treated as a separate new building should be examined. Source documents examined should include the

breakdown of rehabilitation cost and applicable AIA (construction vouchers) documents as requested in items #15 and #16 of the Information Documentation Request.

2. As previously stated, the taxpayer's minimum set-aside must be met by the end of the first credit period. Item 2(d) of the Information Document Request asks the taxpayer to provide documentation showing how the minimum set-aside requirement was met. This documentation could include leases, rent rolls, and third party verification of income documents.

Additionally, the taxpayer should provide the necessary calculation which was employed to prorate the applicable fraction based on the first year averaging convention. The prorated percentage should agree with line 2 of Form 8609 Schedule A. Applicable source documents include the rent rolls and leases.

# Chapter 6

# FEDERAL FINANCING

## IMPACT OF FEDERAL FINANCING ON A LIHC PROJECT

The examination of a low-income project will include several issues involving the project's financing. One issue is the effect of **federal financing** on such a project. The low-income housing tax credit is generally smaller for those projects that receive federal funds. These funds could be in the form of a **federal grant** or **federal subsidy**. If federal grants are used to fund the cost of acquiring, developing, or operating a building, the eligible basis must be reduced by the amount of the federal grant. The year of receipt of the grant has no bearing on whether the reduction is required, and once received, the eligible basis must be reduced for the remaining years of the compliance period. Projects which receive a federal subsidy for new construction or rehabilitation can either reduce their eligible basis by such subsidy, to obtain the 70-percent present value credit on the remaining eligible basis or elect not to reduce the eligible basis by the federal subsidy and have the 30-percent present value credit apply to their project. In addition the owner can pay off the federal subsidy before the project is placed in service and receive the 70-percent present value credit on the projects eligible basis. A federal subsidy is either an obligation the interest on which is tax exempt under section 103, or a direct or indirect loan, that is both federal and below market.

| **Federal Grant:** | Funds which originated from a federal source and which do not require repayment. |
|---|---|

| **Federal Subsidy:** | Any obligation which is tax-exempt per IRC section 103, and direct and indirect loans which are from a federal source and bear a below-market interest rate (less than the applicable Federal rate in effect under IRC section 1274(d)(1) as of the date on which the loan is made) |
|---|---|

The following key points are noteworthy with regard to federal grants:

1. It does not matter if the grant is directly or indirectly received from the Federal Government. If the state or local government makes a grant to the project out of federal funds, the grant is considered a federal grant and the eligible basis must be reduced. This rule would hold true for funds coming from private sources as well. This means that if the private source received a grant out of federal funds and passed this on to the project, it would still be considered a federal grant and the resulting basis reduction must be made.

2. It does not matter whether the grant received is includible in gross income or not. If the grant is generated from a federal fund source, the eligible basis must be reduced by the amount of the grant.

3. If the project receives a loan out of federal grant money and this loan is not expected to be repaid, then it will be considered a federal grant resulting in a reduction of the eligible basis.

4. If the grant is identified by law for a specific purpose, then no portion of the funds can be redirected for a different use.

   **Example 1**

   If a federal grant is required to be made for rehabilitation expenditures, then such funds can not be redirected for use with acquisition costs.

5. Generally, federal grants are attributable to an entire project and not just the portion of the project that is low-income.

**Exception**

Eligible basis does not have to be reduced if the proceeds of a federal grant are used as a rental assistance payment under section 8 of the United States Housing Act of 1937 or any comparable rental assistance program.

## TYPES OF FEDERAL GRANTS

**Types of Federal Grants:**

1. **Housing Development Action Grants (HoDAG)**
   (HOUSING AND URBAN -RURAL RECOVERY ACT OF 1983)

2. **Community Development Block Grants (CDBG)**
   (TITLE I OF THE HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1974)
   These funds must benefit low and moderate income tenants, aid in the prevention or elimination of slums and blight, or other community development needs that present a serious and immediate threat to the health or welfare of the community.

3. **Urban Development Action Grants (UDAG)**
   (SECTION 119 OF THE HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1974)

4. **Rental Rehabilitation Grants**
   (SECTION 17 OF THE U.S. HOUSING ACT OF 1937)

5. **Grants made under the HOME Program**

**Example 2**

Henry, a project owner, receives a rental rehabilitation grant in the amount of $5,000,000 for the development of a low-income housing project. The total cost of the project was $10,000,000 consisting of the following:

| | |
|---|---|
| $ 1,000,000 | acquisition cost |
| $ 9,000,000 | rehabilitation costs |

The eligible basis for the project would be as follows:

| | |
|---|---|
| $ 1,000,000 | acquisition basis |
| $ 4,000,000 | rehabilitation basis |

These figures reflect the fact that the eligible basis had to be reduced, and specifically, the rehabilitation basis had to be decreased by the amount of the grant received because no portion of rental rehabilitation funds can be used for another purpose (that is, acquisition).

**Example 3**

Larry, a project owner, receives a loan from a local housing authority to rehabilitate a building for the purpose of providing low-income housing. The local housing authority was able to make this loan to Larry because it received a community development block grant to fund the loan. A clause on the loan stated that if the project provided housing for eligible low-income tenants during the entire compliance period, at the set-aside of 40-60, then the loan would not require repayment. Additionally, no loan payments would be required during the compliance period. Larry elects the 40-60 minimum set-aside and is in the first year of the compliance period.

Larry would have to reduce the eligible basis of the low-income building by the amount of the funds received from the local housing authority because the loan originated from federal funds and no expectation of any repayment exists.

**Example 4**

Susan Jones, a project owner, is in the third year of her compliance period. Ms. Jones receives a grant from a state agency for the operation of the low-income building. The state was able to provide this grant because it received a community development block grant.

The eligible basis must be reduced by the amount of this grant for this year as well as all subsequent years in the compliance period. The CDBG Grant was considered the source of the funds received by the project owner and as such the reduction was necessary.

## FEDERALLY SUBSIDIZED LOANS

A **federally subsidized loan** is defined by the following criteria:

1. Any obligation upon which the interest is **tax-exempt** under IRC section 103; or

2. A direct or indirect loan which is both **federally funded** and **below market**. Below market is defined as an interest rate less than the applicable federal rate, as determined by IRC section 1274(d)(1), on the date the loan is made.

These two types of financing for new construction and rehabilitation require the building owner to make an election to either:

1. Reduce the eligible basis of the low-income building by the principal amount of the loan or the proceeds of the tax-exempt obligation. (This election is made on Part II of Form 8609, Low-income Housing Credit Allocation Certification). The remaining basis is subject to the 70-percent present value (9 percent) credit.

**OR**

2. Do not reduce the eligible basis and claim the 30-percent present value (4 percent)

credit on the eligible basis which includes the loan principal or tax-exempt obligation amount.

The previous election is considered the "general rule" for treatment of federally subsidized loans. In addition to this rule, the following exceptions exist:

1. The first exception applies to loans made after August 10, 1993, from the HOME Program (HOME Investment Partnership Act) for newly constructed or substantially rehabilitated properties. For this loan to be exempted, a change to the occupancy requirement is required for the project; otherwise the loan would be considered a federal subsidy and the general rule would apply.

   Specifically, the change to the occupancy requirement is that 40 percent of the units must be rented to persons whose income is 50 percent or less of the median area gross income.

   Note: It is not clear whether the 40-50 occupancy requirement under the HOME Program is a new minimum set-aside requirement (similar to the 20-50 or 40-60 requirements under IRC section 42(g)(1)), or a targeted income rule that complements the 20-50 or 40-60 minimum set-aside requirements.

   If it is a new minimum set-aside requirement, a minimum of 40 percent of all residential rental units in the project must be occupied by persons whose incomes are 50 percent or less of area median gross income (AMGI) for the project to qualify for any credit. If this test is met, the credit would always be available at the higher credit percentage. Further, all low-income units would have to be occupied by persons whose incomes were 50 percent or less of AMGI.

   If it is <u>not</u> a new minimum set-aside requirement but a targeted income rule, the following results could occur:

   a. [Taxpayer elects the 20-50 minimum set-aside requirement]
      If HOME Program funds are used, the project qualifies for the higher credit percentage if 40 percent or more of the units are occupied by persons whose incomes are 50 percent or less of AMGI. If 20 through 39 percent of the units are occupied by persons whose incomes are 50 percent or less of AMGI, the project qualifies for credit at the lower credit percentage. No credit is allowed if less than 20 percent of the units are occupied by persons whose incomes are 50 percent or less of AMGI.

   b. [Taxpayer elects the 40-60 minimum set-aside requirement]
      If HOME Program funds are used, the project qualifies for the higher credit percentage if 40 percent or more of the units are occupied by persons whose

incomes are 50 percent or less of AMGI. If the 40-50 minimum is not met, credit may be claimed at the lower credit percentage if 40 percent or more of the units are occupied by persons whose incomes are 60 percent or less of AMGI. No credit is allowed if less than 40 percent of the units are occupied by persons whose incomes are 60 percent or less of AMGI.

2. In the case of a tax-exempt obligation or below market federal loan which is used for new construction or substantial rehabilitation and the obligation or loan specifically identifies the building or rehabilitation expenditures are, and such obligation or loan is redeemed or repaid before the building is placed in service, the obligation or loan will not be considered a federal subsidy.

3. For projects allocated credits after 1989, a building will not be considered as federally subsidized, solely because of funds received from the community development block grant program (pursuant to sections 106, 107 or 108 of the Housing and Community Development Act of 1974, as in effect on November 21, 1989).

4. A building will not be considered as federally subsidized solely because it is receiving funds from the Affordable Housing Program (as established under section 721 the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, otherwise known as FIRREA). This rule is effective for loans made after August 8, 1989. Ref: Treas. Reg. section 1.42-3.

**Example 5**

A low-income housing building received an allocation during 1997, and the building was placed in service in 1998. A federal loan was obtained which was funded thru the community development block grant program. The interest rate on this loan was 1 percent while the applicable federal rate was 4 percent. The loan was not repaid prior to the building being placed in service. The tax return was filed without any reduction to the eligible basis and the 70 percent present value credit was used in determining the low-income housing credit.

The owner should have made the election either to reduce the eligible basis to use the higher (70 percent) present value credit, or use the lower (30 percent) present value credit. The owner did not **elect** to reduce eligible basis on its filed income tax return and inappropriately claimed the 70-percent present value credit. The owner's return should be adjusted to reflect a 30-percent present value credit.

**Example 6**

On August 11, 1993, a project owner received a loan funded by the HOME Program for new construction. The interest rate was 1 percent, while the applicable federal rate was 4 percent on the date the loan was made. The owner elected the occupancy requirement of 40-50, but on review it was discovered that the project did not comply

with the 40-50 occupancy requirement, and the owner had claimed the 70-percent present value credit.

Since the project did not comply with the 40-50 occupancy requirement as required under the federal subsidy exemption rule relating to the HOME Program, the loan would be considered a below-market loan that was federally funded, and the project is eligible only for the lower 30-percent present value credit.

**Example 7**

On October 13, 1990, a project owner received a loan, the interest on which is tax-exempt under IRC section 103. The loan was a construction loan and the loan documents identified the building for which the funds were to be used. The building was placed in service on October 1, 1992, and one-half of the loan was repaid on September 15, 1992.

The project owner would have to make an election to either reduce the building's eligible basis by the amount of the loan outstanding to use the 70-percent present value credit, or use the 30-percent present value credit.

## MECHANICS OF ELECTION FOR USE OF LOWER CREDIT AMOUNT

As indicated in IRC section 42(I), if any portion of the eligible basis of a building attributable to new construction or to rehabilitation expenditures is financed with federal subsidies, the building is only entitled to a 30-percent present value credit unless the federal subsidy is paid before the building or rehabilitation expenditures are placed in service or the owner elects to reduce the project's eligible basis. This reduction would be for the amount of the federal subsidy and the building would then be eligible for the higher 70-percent present value credit. The taxpayer will determine which method provides them with the maximum credit and select that option accordingly. The earlier portion of this chapter addresses what constitutes federal subsidies and financing. Having made such a determination, it will then be necessary to analyze all sources of financing prior to making a calculation. (See also the audit techniques mentioned at the end of this chapter.)

The following example illustrates the application and mechanics of IRC section 42(I) for a single building project. This example will assist you in determining the character of the financing and the appropriate calculation.

**Example 8**

A building is rehabilitated at a cost of $7,000,000 with $3,000,000 of the costs financed with federal subsidies. The remaining $4,000,000 of the rehabilitation costs are financed by partnership proceeds and conventional financing. The owner would calculate the two options as follows to maximize the credit.

| FEDERAL SUBSIDY REMOVED & HIGHER CREDIT | | | FULL ELIGIBLE BASIS & LESSER CREDIT | |
|---|---|---|---|---|
| Election to remove | | $7,000,000 | Election to leave | $7,000,000 |
| federal subsidy from | | - 3,000,000 | federal subsidy in | - -0- |
| eligible basis and to take | | --------------- | eligible basis and take | -------------- |
| the higher 70-percent | $4,000,000 | | the lower 30-percent | $7,000,000 |
| present value credit | | x 9% | present value credit | x 4% |
| *************** | | --------------- | | --------------- |
| Maximum Credit. | | 360,000 per year | | 280,000 per year |

In this situation the maximum credit is earned by removing the federal subsidy and applying the 70-percent present value credit (which equals a 9-percent rate in this example) to the remaining nonfederal subsidy amount of $4,000,000. The difference is $80,000 per year or $800,000 over the 10-year credit period. See general discussion after the example for audit techniques to be employed for both example scenarios.

An additional technical issue could arise in situations where the project includes multiple buildings, with federal subsidies involved. In this general scenario the owner should have the same two options as discussed in this chapter. The federal subsidy can be removed and the 70-percent present value credit taken on the remainder, or the federal subsidy can be included in the eligible basis and the 30-percent present value credit is then applied to the entire amount of permissible basis. The issue created by the multiple building scenario emerges when the owner decides to attribute the federal subsidy to a portion of the project, while attributing the nonfederal subsidy to the remainder. The potential result of this type of attribution is reflected in an example below.

**Example 9**

Same facts as in the previous example except that costs were incurred for a multiple building project, and the owner used an improper variation of the election. The owner treated the six buildings within the project differently by attributing all of the federal subsidies to three of the buildings, and all the nonfederal subsidy funds to the other three buildings. Upon audit, the facts and circumstances indicate that all six buildings were cross- collateralized under the project's financing plan, and the loan documents made no distinction between the financing for any of the buildings. Thus, the facts did not support the taxpayer's "hybrid" allocation method. As a result, the federal subsidies are attributable to all six buildings in the project.

| | | | |
|---|---|---|---|
| BLDG..<br>#1 | $ 3,500,000<br>x 4%<br>-----------------<br>$ 140,000 | BLDG.<br>#4 | $ 3,5000,000<br>x 9%<br>------------------<br>$ 315,000 |
| BLDG.<br>#2 | Federal subsidy fully attributed to bldgs # 1, 2 & 3. Therefore owner indicates that election made to leave subsidy in and take lesser 4% (30% PV Credit) | BLDG.<br>#5 | No federal subsidy attributed to bldgs # 4, 5 & 6.) Therefore full 9% (70% PV) credit taken.<br>**Total Credit Taken By Owner:** |
| BLDG.<br>#3 | | BLDG.<br>#6 | $ 140,000<br>315,000<br>---------------<br>$ 455,000<br>======== |

**Service Position**

Because all six buildings are federally subsidized, buildings #4, #5, and #6 are limited to the 30-percent present value credit (4 percent), resulting in a credit of $140,000 for these buildings. Only $280,000 would be allowable for the project (that is, $7,000,000 x 4 percent = $280,000). The difference the project owner sought to attain by using this attribution in its multiple building project yielded an increased credit of $175,000 per year and an additional credit of $ 1,750,000 over the 10-year credit period.

Issue should be taken with this type of attribution, where cross-collateralization exists between the buildings in the project, unless a valid exception exists for allocating of the federal subsidy to a particular building, or buildings, and not to the entire project. This is particularly appropriate given the structuring variances and practical differences with the low-income housing credit projects. As with all issues involving IRC section 42, examiners should ask the taxpayers for all facts and circumstances before arriving at a technical position.

## AUDIT TECHNIQUES

There are specific steps the examiner can take in the development of an issue relating to federal financing. Obtain the application document filed by the building owner with the state housing credit agency. This document should identify the sources of all funding used to develop the project. Trace the funding back to its original source. For example, if the state provided funding, obtain the source of the funds the state used to provide the funding.

If the examiner determines any funding to be a federal grant, the purpose of the grant should be determined to ensure the funds have been expended for a permissible purpose under the grant program (for example, rental rehabilitation grants are funds granted for rehabilitation expenditures and not for acquisition costs). Since grants can

be issued to the building owner at any time, the receipt of federal funds should be an issue during any taxable year in the compliance period. The examiner should ensure that no part of these funds were included in the eligible basis of the project at any time.

Additionally, when tracing the financing of a project, determine (1) the date the loan or grant was issued, (2) the year the building received its allocation, and (3) the placed-in-service date. These times (for example, a loan made out of funds from the Affordable Housing Program issued after August 8, 1989, may be excludable from treatment as a federal subsidy), in addition to the type of financing (proceeds from the HOME Program, received after August 10, 1993, require a change to the occupancy requirements), are keys in determining the appropriate application of the law. Remember that the building owner has an election to either reduce the eligible basis to the extent of a federal subsidy and use the 70-percent present value credit, or use the 30-percent present value credit with the federal subsidy.

Whether a single or multiple building scenario is encountered, it is important for the examiner to establish the facts of the case. Useful tools available to the examiner for the factual development of the case include both the interview questions as well as some of the Information Document Request (IDR) items found in Appendix A and B. Question #2 in the interview is intended to obtain information as generated by the respective state agency regarding the project. The number of buildings and potential sources of financing will probably be discussed in the state information, and will assist in establishing the facts and circumstances. Questions #3 and #4 also are intended to obtain details regarding the project. Question #6, although geared to development of syndication and organization costs, may also touch on amortized financing costs and should help establish the facts regarding the financing structure of the project.

IDR items should also serve as a source of information in establishing project and financing structure. Item #1 is the prospectus and generally will include a description of the property, the project, and sources of financing. Although the prospectus is prepared prior to the offering, in most instances the actual facts and circumstances of the case closely follow the detail contained in the offering materials. Projections and calculations will probably include the methodology used to arrive at the credit to be taken.

Another important IDR question is Item #2 which includes the Form 8609 evidencing the allocations; other subparts of question #2 will also assist in establishing your facts. Questions #3 and #4 specifically address sources of grants, loans, and tax-exempt bond financing. The information as submitted by the building owner should be consistent with that as detailed in any independent third party sources. As with any audit item, any disparity in information should be pursued and reconciled in order to establish the correct facts.

Item #6, which determines how many buildings are involved, should assist in reviewing any calculations for single or multiple buildings. Finally, Item #10 which is a review of the accountants workpapers, should prove very helpful in determining what has taken place with the project. As the accountant will serve his or her client in many different capacities, it is normally customary for the accountant to maintain workpapers and a "permanent file." This file should explain and support calculations for various aspects including fixed assets and the methodology used to determine their basis. Finally, it should be noted that many of the other questions which establish the hard and soft costs and many of the documents submitted in support of those items will help to establish all of the facts and circumstances necessary to isolate federal subsidies, as well as to verify that the correct calculations of the credit have been made.

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## Chapter 7

## RECAPTURE OF THE CREDIT

In exchange for the tax benefits derived from the low-income housing credit, a building owner commits to compliance to the program requirements for a 15-year period. In particular, qualified basis must be maintained until the end of the 15-year compliance period. In addition to attempting to dissuade noncompliance, a recapture provision is necessary based on the allowance of the credit over a 10-year period while the compliance period is generally 15 years. As such, a mechanism was created under IRC section 42(j) which imposes recapture provisions in certain situations. It is important to emphasize that although the term "recapture" is used, it is actually only the accelerated portion of the credit that is recaptured for all prior years.

Recapture can be triggered by the following situations:

1. A complete disposition of the low-income building.

2. A significant partial or full disposition of an interest in a partnership which owns a low-income building.

3. A reduction in the qualified basis of a low-income building, which is usually attributable to a reduction in the applicable fraction.

The first scenario identified above represents the full disposition of the low-income building. The second situation is similar to the first. It reflects the fact that, until recently, under partnership tax law, a disposition of a significant interest (50 or more percent) in a partnership may effectively be considered a disposition of the partnership's property. This scenario would also trigger the recapture provisions. However, this may not be true for dispositions occurring on or after May 9, 1997 (see IRC section 708 (b)(1)(B) and the regulations thereunder).

The third scenario is a situation where the qualified basis on which the credit has been taken decreases. Generally this decrease would occur if the number of qualifying low-income units in the building decreases. It is also important to remember that if the number of units not qualifying is still above the number necessary to maintain the elected minimum set-aside of the building, then the recapture should be applied against the actual decrease in qualified basis only.

If the number of units (and the commensurate qualified basis) decrease to a level below that necessary to satisfy the elected minimum set-aside, then recapture would be warranted based on the entire qualified basis. Once the project goes below the

minimum set-aside, the project is deemed to no longer qualify as a low-income housing project and the eligible basis becomes zero. However, the building is eligible to again generate credits if the minimum set-aside is subsequently satisfied.

If recapture is warranted for whatever reason, the accelerated portion is recaptured for all prior years, and generally interest is calculated at the overpayment rate of IRC section 6621 for each prior taxable period starting with the due date for filing the return for the prior taxable year involved. The recapture is made only to the extent that the taxpayer received an actual tax benefit. It would be necessary to adjust any carrybacks or carryforwards which would generally be allowable as per IRC section 39. There will be no recapture to the extent of a decrease in qualified basis caused by a casualty, as long as that decrease is restored within a reasonable period.

Recapture of the accelerated portion of the credit, as necessitated by the owner's disposition of a building or an interest therein, can generally be avoided if the owner posts a surety bond as required by IRC section 42(j)(6). The taxpayer is required to file Form 8693 (Low-Income Housing Credit Disposition Bond) to post a bond and avoid the recapture. The surety used by the owner must be a valid surety, having a Certificate of Authority from the Department of the Treasury, and generally should be a valid surety that is listed in Circular 570. It should be noted that not all sureties that are listed in Circular 570 are currently engaged in providing surety services for purposes of the low-income housing tax credit. The liability on the bond remains in effect for 58 months after the end of the compliance period which is generally the 15-year period beginning at the start of the first taxable year in which the low-income housing credit is claimed. Note that Rev. Proc. 95-11, 1999-2 I.R.B. 14, allows taxpayers to use Treasury Securities as an alternative to a surety bond.

In the case of dispositions of partnership interests, IRC section 42(j)(5) provides the circumstances of how recapture occurs when the partnership consists of at least 35 partners. Generally, any change in ownership of a low-income building within the compliance period is a disposition subject to recapture. IRC section 42(j)(5) provides that in a large partnership (35 partners or more), that no change in ownership is deemed to occur upon the disposition of any partner's interest provided, within a 12-month period, that at least 50 percent (in value) of the original ownership is unchanged and the partnership maintains ownership of the low-income building(s). Any increase in tax resulting from a recapture event is allocated among the partners in the same manner as partnership taxable income for the year is allocated among the partners.

## AUDIT TECHNIQUES

In developing an issue related to recapture, it will be necessary to identify the facts and

circumstances surrounding the event which triggered the recapture. Different audit techniques will be appropriate depending upon the situation. Many of the lead packages sent to the Field are based on Form 8823 (Low-Income Housing Credit Agencies Report of Noncompliance) which indicates that the state agency has discovered that the building was disposed. The Compliance Unit has the ability to then check to determine if Form 8693 was timely filed, and if the surety bond has been properly posted.

An additional step for the examiner would be to review local property records to ascertain the facts surrounding the disposition. These facts include the date of disposition, how the property was disposed of (sale or foreclosure), who now has the property (as that party may now also be taking the credit), etc. This factual development is important to support issues and conclusions. It should also be noted that although the disposition should trigger recapture as a technical adjustment, do not overlook the possibility of fraud as the reason for the event causing the disposition.

In the second recapture situation, disposition of a partnership interest, a state housing agency may not realize that a disposition has occurred. When examining partnership returns, consider whether partners have left or joined the partnership. Review the partnership books, and particularly the capital account which may also support a conclusion that some partners have disposed of their partnership interests. One of the interview questions, as well as an item on the Information Document Request (IDR) (#14) addresses this issue. Unlike a full disposition of the building, a disposition of a partnership interest will make it necessary to determine the disposing partners' share of the partnership items including the credit, and how much credit that partner actually benefited from in any tax returns filed. You should also adjust any carrybacks or carryforwards.

The third type of recapture situation addressed in this chapter relates to a reduction in the qualified basis of the low-income building. Generally this will be caused by a reduction in the number of qualifying units in the building. As with the other type of issues addressed, the actual audit lead package should contain preliminary information regarding a potential decrease. The states conduct compliance monitoring on a regular basis and also go to a number of projects to conduct reviews. Once reported on Form 8823 to the compliance unit, that information should then be a part of the lead package that the examiner receives. In addition to noncompliance information the lead package should also contain a copy of Form 8609 (Low-Income Housing Credit Allocation Certification) as transmitted to IRS in the year the allocation was made. That form will show which minimum set-aside has been selected, and thus how much of a decrease in the qualified basis can be allowed before a full recapture is warranted for the entire building. If the decrease causes the basis to be above the minimum set-aside, but less than the original qualifying basis, then a recapture will still be warranted on the difference.

Question #2 on the interview sheet addresses any reviews or audits by the state housing agency, and requests copies of any reports or correspondence related to the review. Item #2 on the IDR also addresses information regarding the level of low-income occupancy, as well as requesting a copy of the application package from the state as originally filed for the application. If the taxpayer submitted application copies that appear incomplete or raise questions, it may be necessary to secure a copy from the respective state where the building is located. It should be noted that cases will be disseminated based on the location of the owners, yet the building may be located in another state. It should additionally be noted that the state housing agencies generally have separate functions and personnel handling the allocation process and the compliance monitoring function. For purposes of this issue, you may want to discuss the subject property with someone responsible for compliance monitoring at that state. If the reduction in qualified basis appears to be early on in the project's compliance period, then you may also want to review items #7 and #8, (Occupancy Certificate and first leases executed), to ascertain if the project ever in fact qualified. As with all other issues, if a possible underlying reason for the projects shortcomings appears to be fraud, then the technical issue at hand should become secondary to addressing that potential fraud.

# Chapter 8

# RELATED TAX TOPICS

The previous chapters of this guide have provided an introduction to the technical and administrative issues of the low-income housing credit. Once the low-income credit has been defined, and its components calculated, additional issues exist which require consideration before reporting the credit on a tax return.

## RELATED TAX LIABILITY RESTRICTIONS

1. **At-Risk Limitations**
2. **Passive Activity Restrictions**
3. **Alternative Minimum Tax**

Each of these tax law topics has special rules, exceptions or concessions for the low-income housing credit. As such, one must be familiar not only with the related topic, but also must know the special application of that section of the law in coordination with the low-income housing credit. The issues in relation to IRC section 42 must be anticipated and recognized when conducting a low-income housing credit audit. Each topic will be given consideration below, arranged in the same topical order as a taxpayer would encounter when preparing a return.

To better understand the relationship between IRC section 42 and its related tax topics, a review of the applicable tax forms used in reporting the credit is helpful. The low-income housing credit forms specifically reference a taxpayer to related issues, such as passive activity restrictions, with the actual form instructions directing the user to fill out Form 8582-CR (Passive Activity Credit Limitations). Other considerations are built into the low-income housing credit forms, such as the application of the alternative minimum tax considerations.

Form 8586, "Low-Income Housing Credit," is the vehicle used by owners of residential rental buildings providing low-income housing to claim the credit. Part One of the Form 8586 reports the current year credit and various basis information. It also refers taxpayers to Form 8582-CR, so that consideration can be given to passive activity restrictions. The second part of the form relates to the tax liability limitation and gives special consideration to the order of other tax credits and the alternative minimum tax application to the low-income housing credit. The last line of this form shows the computed low-income housing credit for the current year. It states that this is the taxpayer's general business credit for the year, which is reported on the

taxpayers federal tax return. This is the case when the taxpayer has no other general business credits or carryovers. If the taxpayer has more than one general business credit or has a carryback or carryover, the Form 8586 information is reported on the Form 3800 "General Business Credit."

## AT-RISK LIMITATIONS

Previously, the Code excluded real estate activities from the at-risk rules. The Tax Reform Act of 1986 (which also had introduced the low-income housing credit) changed this and held that the at-risk limitations would, in fact, be applied to such activities. The Tax Reform Act responded to concerns voiced by both the real estate industry and the government over the abuses of tax shelters. The goal of these changes was to ensure that a taxpayer would actually incur an **economic risk** from the investment of their assets in the real estate project.

The at-risk limitations of IRC section 465 will be discussed where relevant to the topic. However, the main focus of this text will be on the credit at-risk rules. These rules are provided by IRC sections 42(k) and 49(a), and basically revolve around the issue of nonrecourse financing. Section 49(a)(1)(B) of the Code provides that property which is subject to the at-risk provisions for losses, under IRC section 465, and is placed in service during the taxable year by an individual or a closely held C-Corporation (where 50 percent or more of the total value of the stock is held by 5 or fewer people), must also be subjected to the credit at-risk rules. Further, it is IRC section 49(a)(1)(A) which provides that the taxpayer's risk basis (which for purposes of IRC section 42 equals its eligible basis) must be reduced by the amount of any nonqualified nonrecourse financing. Therefore, if a taxpayer is subject to the credit at-risk rules, they will be required to reduce the portion of the project's eligible basis by the amount of any nonqualified nonrecourse financing. This decrease to eligible basis results in a corresponding decrease to the low-income housing tax credit generated by the project. Accordingly, this issue should be given adequate attention by both the taxpayer and the examiner.

In general, IRC section 465(b)(1)-(3) provides that a taxpayer is considered "at risk" for the following:

1. the amount of money and the adjusted basis of any property contributed by the taxpayer,

and

2. amounts borrowed with respect to the activity for which the taxpayer has a personal liability, or has pledged property as security (recourse financing).

Nonrecourse financing, however, refers to an arrangement whereby the taxpayer is protected in some way from loss (for example, guarantees, stop-loss agreements, other similar arrangements). The term also applies to financing provided by a related party. It should be noted that creditors are not considered related parties or parties "having an interest" in the low-income activities. With respect to corporations and partnerships, the determination of whether financing is nonrecourse is made at the shareholder or partner level.

Under IRC section 49(a)(1)(A), a taxpayer's basis for purposes of calculating the investment tax credit must be reduced by the "nonqualified nonrecourse financing" with respect to such property as of the close of the taxable year in which such property is placed in service. "Nonqualified nonrecourse financing" is any nonrecourse financing which is not "qualified commercial financing." IRC section 49(a)(1)(D)(ii) defines it as follows:

**Extract**

IRC section 49(a)(1)(D)(ii)

> * * * "qualified commercial financing" means any financing with respect to any property if--
> (I) such property is acquired by the taxpayer from a person who is not a related person,
> (II) the amount of the nonrecourse financing with respect to such property on which the credit is calculated does not exceed 80 percent of the credit base of such property, and
> (III) such financing is borrowed from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government.

* * * * * * *

A "qualified person" under IRC section 49(a)(1)(D)(iv) is a person meeting the following four criteria:

1. The person is actively and regularly engaged in the business of lending money;

2. The person is not a related person with respect to the taxpayer;

3. The person is not a person from which the taxpayer acquired the property, or a related person to such person; and

4. The person is not a person who receives a fee with respect to the taxpayer's investment in the property, or a related person to such person.

The credit at-risk rules relating to low-income housing projects under IRC section 42(k) were basically designed to follow the investment tax credit at-risk rules of IRC sections 49(a)(1), 49(a)(2) and 49(b)(1). There are, however, several provisions regarding nonrecourse financing which apply exclusively to low-income housing investments:

1. Loans for low-income housing projects are not treated as nonqualified nonrecourse financing merely because the lender is a related person with respect to the taxpayer;

2. Low-income housing properties are not limited to 80 percent of the credit base allowance for nonrecourse financing specified under the general investment credit at-risk rules of IRC section 49(a)(D)(ii)(II). There is no credit base limitation for the low-income housing credit; and

3. Loans from certain nonprofit lenders are allowed to be considered as qualified nonrecourse financing. This is true even if the lender is not a commercial lender as well as if the lender is the seller (or is related to the seller) of the property. Due to the generous nature of this allowance, additional qualifications were added as follows:

   a. The lender must be a qualified tax-exempt nonprofit organization, under IRC section 501(c)(3) or (4), not be affiliated with or controlled by a for-profit organization, and have one of its exempt purposes be fostering low-income housing.

   b. The loan must be applied to and secured by a qualified low-income building. (Does not apply to a federally assisted building if a security interest in such building is not permitted by a federal agency holding or insuring the mortgage and the proceeds from the financing are applied to acquire or improve such building).

   c. The outstanding loan balance cannot exceed 60 percent of the eligible basis of the building at the end of any taxable year in the compliance period. Wrap-around loans stemming from government funds are not included in this limitation.

   d. If the interest rate of the financing is greater than 1 percentage point below the AFR at the time the loan is made, the qualified basis relating to such financing is reduced by an amount equal to the present value of the principal and interest over the course of the loan using the AFR as the discount rate.

e. The loan must be paid off by the <u>earliest</u> of:

   1) the maturity date;

   2) 90 days following the end of the 15-year compliance period of the project; or

   3) the date the building is sold or the loan is refinanced.

   An additional benefit applies to the repayment rules in the case of a qualified nonprofit organization that is not the entity (or a related entity) from which the taxpayer acquired the property. In this case the rule is redefined as the earlier of 90 days after:

   1) the date the building ceases to be a qualified low-income project, or

   2) the date which is 15 years after the close of a compliance period for such building.

4. If the repayment terms described above (in 3) are not met, recapture is triggered for this transaction. The amount of credit recaptured relates directly to the tax benefit derived from the inclusion of these nonprofit loans in the project's eligible basis. In addition, a nondeductible interest charge is assessed on the full term of the loan. This interest computation is based on the higher underpayment rate of IRC section 6621. General recapture rules under IRC section 42 employ the lower interest rate used for overpayments.

5. Recharacterization rules are applied to qualified nonprofit loans which bear an interest rate which is more than 1 percent below the AFR. These loans would instead be deemed a financing arrangement and the eligible basis would be computed based on the AFR being used. This adjustment would result in a loss of credits as originally calculated.

**<u>Audit Techniques for At-Risk Issues</u>**

First the examiner should verify that the taxpayer is subject to the credit at-risk rules. Since the primary vehicle used to develop the low-income housing credit is the limited partnership, it is likely that the exam will only involve individual investors who are subject to these requirements. Having ascertained that these rules apply, the next appropriate step would be to determine if they have been used and, if so, done in a technically correct manner.

The credit at-risk rules are considered by most tax professionals to be a rather obscure area of the Code. To add to the confusion is the fact that they are generally referred to as the "at-risk rules," which does not make clear that they are the at-risk CREDIT rules. As such, in communications between taxpayers, practitioners and examiners, it may be misconstrued that consideration was given to these limitations. Given the impact that disallowing a portion of eligible basis has, this is an area in which to ensure that accurate accounting has occurred.

As stated in the text above, the credit at-risk rules focus on the qualification of certain financing. As such, the examiner should not only request a general schedule indicating all sources of financing on the project (both debt and equity), but should investigate the source documents appropriate to these agreements. Requesting this information should not be deemed burdensome to the taxpayer. This information is relevant to other issues in the low-income housing credit examination, such as the eligible basis determination, review of appropriate credit percentages, etc. Often the state housing finance agency will have a record of this information in their allocation files. These records should generally be requested as a matter of procedure during an examination, and should be used to verify the documents provided by the taxpayer.

In all cases, the documents should be requested from the taxpayer and not simply the state housing agency. Often, allowable changes occur in a project, which may include financing, between the time of allocation and the first year of the credit period. If a discrepancy exists between information provided by the state and that provided by the taxpayer, request an explanation and reconciliation from the taxpayer.

One issue concerns deferred development fees (the payment of which is made, in whole or part, after the close of the first year in which the developed property is placed in service). The agent may invoke the at-risk rules to assert that the deferred development fee represents nonqualified nonrecourse financing. (See IRC sections 49 and 42(k).) A taxpayer's amount at risk with respect to property is increased only through increases in the actual investment in the property, such as by repayment of nonrecourse debt for the property. Repayment must be made with amounts for which the taxpayer is at risk. If the amount at risk with respect to property is increased, the credit for the property is redetermined as if the increased amount at risk had been taken into account when the property was first placed in service. Any increase in the credit attributable to the increased amount at risk is considered a credit earned in the taxable year the amount at risk was increased. See Senate Report No. 97-144, p.67, Economic Recovery Tax Act of 1981.

When dealing with nonprofit organizations, seller financing and "soft seconds" (loans made from the nonprofit general partner back to the limited partnership, which consist of little or no current interest payments and principal and are generally not due for 15 years), require consideration to determine their impact on investors subject to the

credit at-risk rules. Recall that the basic way for a nonprofit to have this funding qualify is to structure the loan as qualified nonrecourse financing. Refer to the Code and text and ensure that the rules have been followed.

The basic at-risk rules should be considered when examining the financing source documents. Prior to application of the special rules for nonqualified nonrecourse financing, determine whether the funding sources were accurately classified into those with recourse and those without. When inspecting documents, give attention to any narrative describing guarantees, stop loss agreements or any other arrangements by which the liability of the investor would be limited, regardless of how the taxpayer classified it.

Relationships between the parties should always be questioned and considered when reviewing funding sources. Because the credit at-risk rules employ special exceptions to related entities, the examiner must ensure all possible issues are addressed. For example, question parties related to a related party, parties related to a seller, parties receiving a fee related to an investors investment in the project, etc. Keep in mind that a nonprofit can and does "wear many hats" in their activities on a project. Although this is allowable, it does impact the credit in certain ways. If, for example, a nonprofit developer is found to have acted as a syndicator for a project (receiving a fee related to the investors' investment in a project), then any loans from this entity would be disqualified and eligible basis would be reduced accordingly. It is important in the development of such a sensitive issue that an agent have a good working knowledge of the differences between development fees and syndication fees. (See also Chapter 11). In such issues it becomes critical to develop the "substance versus form" argument, although it is always possible that a source document will be presented which clearly supports the syndication activities.

While considering developers' fees, be aware of related issues which are created through the act of an audit adjustment. (See Treas. Reg. section 1.42-6(b)(2)(iv).) For example, the development of an issue regarding the amount of a developer fee received by a nonprofit is a fairly common issue. The IRS has not established formal guidelines regarding amounts which are considered reasonable (although many state housing agencies have). If the agent reclassifies a portion of the fee as a nondeductible syndication expense, the proportion of the allowed loan in regard to the project's eligible basis also changes. As indicated in the above text, in order for a nonprofit loan to qualify, one of the conditions is that it cannot exceed 60 percent of the project's eligible basis. As the returns were prepared, this limitation may have been met. However, the agent must ensure that the taxpayers are still within the 60-percent range after the recharacterization issue. (See also Chapter 11 for additional issues.)

If an examiner encounters a situation where a taxpayer is not only aware of these credit restrictions, but has determined that they adversely affect their project,

additional inspection should be pursued. Under no circumstances should the examiner determine that no additional issue exists soled based on oral testimony. Although the specific facts and circumstances surrounding the examination need to be considered before an audit scope can be determined with confidence, at a minimum the adjustments accomplished by the taxpayer should be inspected for mechanical and technical accuracy.

For example, an issue arises regarding whether or not the amount of credit basis reduction related to the disallowed financing (due to the failure to repay) was computed accurately. The entire credit is not disqualified, only the portion of the credit corresponding to the financing is adjusted. In this situation, the examiner might take a "quick look" to see if the appropriate (underpayment) interest rate was applied. If a material amount of credit is affected, this may be a worthwhile effort.

## LIH CREDITS AND THE PASSIVE LOSS LIMITATIONS

### Introduction

While a large portion of the text addresses low income housing issues at the partnership level, this lesson focuses on potential adjustments at the individual investor level.

When an individual purchases an interest in a partnership, a limited liability company (LLC) or an S-Corporation, losses may be limited due to the passive loss rules contained in IRC section 469. Limited partners by Code are presumed passive. As most investors, particularly in low income housing partnerships, are limited partners, there is a high probability that the passive loss rules will apply. **Both passive losses and passive credits generated by rental activities are limited to the tax** deduction **equivalent of $25,000.** Passive losses are reflected on Form 8582, and passive credits are reflected on Form 8582CR.

Since most LIH losses and credits are generated by partnerships, this chapter will use only the term partnerships. However, the reader should understand that the same rules apply to investors in any pass through entity.

### Overview of the Passive Loss Limitations

#### General Rules

Generally, **passive losses and credits can offset only passive income**. If there is no passive income, no passive loss or credit is allowable. In other words, passive losses are generally not deductible unless the taxpayer has passive income. Conversely, if the

taxpayer has passive income of any kind, it will trigger deductibility of passive losses or the deduction equivalent of credits under any circumstance. For suspended passive losses and credits, there is an indefinite carryforward.

**An individual taxpayer generally cannot deduct losses and credits from partnerships in which he or she does not materially participate or from rentals** unless he or she has passive income from other activities on the tax return. See IRC sections 469(a) through 469(c). Material participation means working on a regular, continuous and substantial basis in the operations of the activity. See IRC section 469(h) and Treas. Reg. section 1.469-5T.

Passive activity credits include the following: low-income housing; rehabilitation credit; and virtually any credit generated by a rental or a business in which the taxpayer does not materially participate. Passive losses and credits generally cannot offset nonpassive income such as wages, interest, dividends, capital gains, royalties, or investment income (except upon sale or other disposition of the taxpayer's entire interest in the passive activity). Passive income is net income generated by a passive activity in the ordinary course of its business, but it is not portfolio or investment income, typically reflected on Schedules B or D. There are two kinds of passive activities:

1. **Rentals** (except real estate professionals discussed later) and

2. **Businesses in which the taxpayer does not materially participate** on a regular, continuous and substantial basis.

Thus, income and losses are divided into two categories:

1. Passive: Rentals and businesses without material participation. If losses or credits are passive, they must be entered on Form 8582 or Form 8582CR to determine how much, if any, is allowable.

2. Nonpassive: Businesses in which the taxpayer materially participates. Also, any type of personal service income, guaranteed payments, portfolio income and investment income.

## Exception for Rental Real Estate

For rental real estate only, there is a limited exception to the general rule that passive losses and credits may offset only passive income. IRC section 469(I) permits an individual taxpayer to deduct up to $25,000 in losses and/or the deduction equivalent credits from rental real estate each year if he or she actively participates in the rental activity.

The low-income housing and rehabilitation credits may be claimed by owners of qualifying residential rental properties that are rented to low-income tenants at restricted rental rates. A rental activity such as a **low-income housing project is specifically defined to be a passive activity**. See IRC section 469(c)(2).

**Real Estate Professionals**

Beginning in 1994, there is an exception to the passive loss limitations for qualifying real estate professionals who materially participate in their rehabilitation or low income housing activities. If a taxpayer spends the majority of his or her time in real property businesses AND works more than 750 hours a year AND materially participates (works on a regular basis) in each rental real estate activity (or the aggregate of all rental real estate activities if the appropriate election is made under IRC section 469 (c)(7)) then losses and credits will be fully allowed. IRC section 469(c)(7) is restrictive and **it is unlikely that most investors who are limited partners materially participate in the partnerships generating low-income housing credits.** Stated differently, even real estate professionals may not be able to deduct LIH losses if they are limited partners -- as limited partners generally do not work on a regular, continuous, and substantial basis in the LIH partnership.

**Application to Low Income Housing**

As stated earlier, for individuals, a special loss and/or credit allowance permits the taxpayer to claim up to $25,000 of losses (or the deduction equivalent of credits) from rental real estate activities. However, the low-income housing credit receives special treatment for purposes of this allowance. There is no participation requirement. Therefore, even a limited partner may take the credit. Remember, however, the aggregate amount of total losses and credits (deduction equivalent) are limited to $25,000. In other words, the taxpayer receives only one $25,000 offset annually.

As with any passive loss or credit, low income housing credits are allowable up to passive income reported on the return. However, passive income is not particularly common as it can only be generated by a rental activity or a business without material participation (both of which are more apt to produce losses than income). Large amounts of passive income should be reviewed on examination to determine that the character is truly passive. On an entire disposition to an unrelated party in a fully taxable transaction, suspended losses and credits from the disposed of activity may be utilized in full (subject to basis and at-risk limitations).

The remainder of the chapter will discuss specific rules applicable to the low income housing credit in depth. See the audit checksheet at the end of the chapter which is designed to be used as a workpaper and addresses common LIH issues.

## LIH Losses

Low income housing partnerships are rental activities and are, therefore, subject to the passive loss limitations contained in IRC section 469. Low income housing LOSSES and low income housing CREDITS are each treated differently.

### LIH Losses Treated Like Any Other Rental Loss

For current years, **low income housing LOSSES are subject to the passive loss limitations -- just like any other rental real estate activity**. The taxpayer must actively participate to qualify for the $25,000 offset. Furthermore, the $25,000 special allowance is phased out at the rate of 50 cents for every dollar over modified AGI of $100,000. If AGI exceeds $150,000, no LIH losses may be deducted (unless the taxpayer has passive income). Since most investors are limited partners, and limited partners do not qualify for the active participation standard, losses generally should be entered on Form 8582 line 2b (not line 1b). Consequently, no $25,000 offset is available, and losses are deductible only up to passive income reported on the return.

However, a qualifying investor who owned a low income housing partnership interest on **December 31, 1988**, and the property was placed in service between December 31, 1985 and August 17, 1986, (a mere 8-month period) may deduct all losses.

Needless to say, this exception is very restrictive and applies to very few taxpayers.

**Audit Tip.** Many taxpayers automatically place any rental activity on Form 8582, line 1. For LIH losses to be entered on line 1, a taxpayer must actively participate. IRC section 469(I) provides that limited partners do not actively participate. Examiners should carefully review Form 8582, line 1b (and worksheet 1) to verify that LIH losses have not been improperly entered there. Entering LIH losses from limited partners on line 1b (instead of 2b where they belong) erroneously permits deductibility of up to $25,000 in losses against wages and portfolio income.

**Audit Tip.** The absence of an entry on Form 8582, line 1b or 2b for LIH losses is an indicator that the taxpayer may have erroneously deducted LIH losses as nonpassive. Some taxpayers presume that LIH losses and credits are not subject to the passive loss limitations and ignore Form 8582 and Form 8582CR entirely. Thus, the examiner should review the nonpassive column on the back of Schedule E to verify that LIH losses have not been entered there. Placing LIH losses in the nonpassive column permits them to be deducted without any passive limitation.

**LIH Credits**

**No Participation Nor AGI Requirement**

IRC section 469(I)(6)(B) provides an exception for low income housing CREDITS. There is no active participation requirement. Thus, **even a limited partner may use the low income housing CREDIT.** Furthermore, for tax years after 1989, there is no phaseout of the credit based on modified AGI. Therefore, a taxpayer with any amount of income may use the credit. However, it is important to remember that the **credit is still limited to the tax** deduction **equivalent of $25,000**. That does not mean the taxpayer gets a $25,000 credit. He or she receives the **tax** deduction equivalent of $25,000. For instance, the maximum credit due to the $25,000 offset available for a taxpayer in the 39-percent bracket is $9,900.

**Audit Tip.** Check Form 8582CR, line 37 to see if passive credits exceed $9,900 (39.6 percent x $25,000). If so, it is an indicator that there may be an issue.

The following are the only reasons an individual could have LIH credits which exceed the tax deduction equivalent of $25,000:

-- There is tax attributable to net passive income on Form 8582CR, line 6. See comments later in the lesson on passive income.

-- The taxpayer is a real estate professional (IRC 469(c)(7)) AND materially participates in the rental real estate activity generating the LIH credits. For example, the taxpayer owns a construction company and works on the LIH project.

**Only One $25,000 Offset**

IRC section 469(I) provides only **one** $25,000 offset for both losses and credits. The sum total of passive losses on Form 8582, line 11 and the credit equivalent on Form 8582CR line cannot exceed $25,000 (unless the taxpayer has passive income).

There is not one $25,000 offset for losses, and one $25,000 offset for the rehabilitation credit and one $25,000 offset for low income housing tax credit as some taxpayers erroneously believe.

**Issue.** If the taxpayer has used the $25,000 offset for rental losses, there is nothing left for credits. If Schedule E, line 23 (deductible rental real estate losses) is nearly $25,000, it is a strong indicator that rental losses have absorbed the $25,000 offset, and little or none remains for the low income housing credit. If the taxpayer failed to complete line 25 of Form 8582CR (portion of the $25,000 offset used for losses from

Form 8582 line 9), the taxpayer should not be allowed any low-income credit.

Similarly, if the taxpayer in the 28-percent bracket uses $12,500 of the $25,000 offset for losses, he or she has only $3,500 (28 percent x $12,500) remaining which can be used to trigger his or her low income housing credit or any other passive credit.

**Audit Tip.** Always peruse Schedule E, line 23, for losses allowed as well as partnerships or S-Corporation losses on the reverse side of Schedule E which appear to be rental real estate. Then compare to Form 8582CR, lines 25 and 37. A quick method to estimate the correctness of Form 8582CR, line 37 is to multiply the allowable credit by the taxpayer's bracket and add that figure to rental losses allowed. If it exceeds $25,000, it is an indicator that Form 8582CR may not have been correctly computed. (While not commonly seen, the figure could, in fact, exceed $25,000 if there was tax attributable to net passive income triggering the credits OR there was a qualifying disposition triggering passive losses.)

**Audit Tip**. Verify that the amount from Form 8582, line 9 has been entered on Form 8582CR, line 25 and/or line 35. If there is no Form 8582, check for rental losses on Schedule E, line 23. If taxpayer's modified AGI is less than $100,000, he or she may not have completed Form 8582. However, rental losses on Schedule E, line 23 reduce the tax deduction equivalent of $25,000 on Form 8582CR (either line 22 or line 35). The instructions for Form 8582CR provide worksheets for the computation. If the taxpayer failed to complete Form 8582CR, the amount of passive rental losses on line 23 should generally be entered on Form 8582CR, line 25 -- (unless taxpayer is a qualifying real estate professional). **Allowable rental losses reduce the amount allowable for passive credits**! Thus, a taxpayer who used $25,000 in losses has no amount of his or her $25,000 offset left for credits -- unless he or she has passive income.

## Ordering Rules

Under IRC section 469 (I)(3)(D), the **$25,000 offset is absorbed first by passive losses**, then by any other passive activity credit, then by the rehabilitation credit, and finally by the low income housing credit. In other words, passive losses and other passive credits, are absorbed before the rehabilitation credit, which is absorbed before the low income housing credit.

If the $25,000 offset is completely used up by passive losses, no low income housing credit may be used. For example, if the taxpayer deducts $25,000 in rental real estate losses under the provisions of IRC section 469(I), no low income housing credit or any other passive credit may be used -- unless the taxpayer has passive income. Similarly, if the taxpayer deducts $20,000 in rental real estate losses, only the tax deduction equivalent of $5,000 (approximately $2,000 credit for someone in the 39.6

percent bracket) remains for passive credits.

**Audit Tip.** If an individual taxpayer deducts low income housing losses, check Schedule E, line 26 to see if significant passive losses have been deducted, leaving little or no $25,000 offset available for passive credits.

## Passive Income Issues

**Passive income on line 6 of Form 8582CR should be reviewed carefully as it is relatively rare**. Since rentals generally produce losses, and businesses without material participation are more apt to generate losses (the only two sources for passive income), substantial amounts of passive income should be reviewed.

Legitimate passive income from any source will trigger deductibility of low income housing losses and the allowance of credits. However, passive losses first absorb passive income, followed by certain passive credits, the rehabilitation credit and, lastly, if any income remains, it may be used to trigger the LIH credit.

### Tax Equivalent of Passive Income

The entry of Form 8582CR, line 6 is not the total amount of passive income the taxpayer has on the return. **Line 6 is the tax** deduction **equivalent of any remaining income after passive losses.** Stated differently, before line 6 can be completed, passive income must be reduced by any losses triggered by it -- and the tax **deduction** equivalency of that figure computed. The instructions to Form 8582CR provide a worksheet to do this computation.

**Audit Tip.** If passive income on Form 8582CR is the same as the sum of Form 8582, lines 1a and 2a, clearly the taxpayer has not performed the required tax **deduction** equivalency calculation. Since passive credits may be used only to the extent of the tax liability on passive income and up to the tax equivalency of $25,000 under IRC section 469(I), incorrectly entering the total passive income instead of the tax **deduction** equivalent will erroneously trigger the use of more passive credits. Furthermore, if losses exceeded line 9 of Form 8582 (the allowable portion of the $25,000 offset), passive income should have been reduced.

### Not Passive Income

Several types of income are not passive, but are often erroneously entered on either Form 8582 or Form 8582CR; incorrectly triggering deductibility of losses and credits. Royalties, while income on Schedule E, are specifically designated as nonpassive in IRC section 469(e) and do not belong on Form 8582. For every dollar of income removed from Form 8582 or Form 8582CR, a dollar in adjustment generally results.

Remember, passive losses are deductible only to the extent of passive income (except for the $25,000 offset).

Rental income is generally passive. However, if a taxpayer owns a building or equipment personally and leases it to a partnership or corporation in which he or she materially participates (even if the activity is conducted through a C-Corporation subject to IRC section 469), the net rental income is nonpassive. See Reg. section 1.469-2(f)(6). It should not be on Form 8582, line 1a. Many computer systems take **all** net income from Schedule E, including self-rented property, and enter it on Form 8582, expecting the preparer to manually override his or her system for income which is nonpassive.

Rental income from leased land or the gain on sale of land is also treated as nonpassive where less than 30-percent of the unadjusted basis of the property is depreciable. See Treas. Reg. section 1.469-2T(f)(3).

## Dispositions

On disposition of a passive activity to an unrelated party in a fully taxable transaction, excess current and suspended losses are fully deductible (after having been subjected to basis and at-risk limitations). However, for low-income housing, credits are not triggered on disposition, but instead a basis adjustment is made. The taxpayer may elect to increase the basis on the LIH property by completing Form 8582CR, Part VI OR he or she must continue to carry forward the credit until he or she has passive income or the $25,000 offset available.

**Audit Tip.** If passive credits are being claimed which exceed the tax **deduction** equivalent of $25,000, it may be that the taxpayer is erroneously deducting LIH credits on disposition instead of making a basis adjustment. Reminder: IRC section 1211 restricts the deductibility of capital losses; there is an unlimited offset with capital gains, but a $3,000 limit on deductibility against ordinary income.

## Forms

If the activity giving rise to LIH losses and credits is passive, they are reflected on several complex forms as follows:

**LIH losses** (from Form K-1) are entered on Form 8582, line 2b (presuming the investor is a limited partner). Line 11 of Form 8582 reflects the total allowable passive losses. Worksheet 5 of Form 8582 breaks down which schedule the losses are reflected on.

**LIH credits** are reflected on Form 8586 which is carried to Form 8582CR which is carried to Form 3800, line 1f which is ultimately carried to Form 1040, line 42.

## Rehabilitation Credit

Rehabilitation credits are frequently generated by the same partnership generating LIH credits or are on the same tax return. The passive loss limitations are very similar to LIH credits. A limited partner may use the rehabilitation credit. As a passive credit, the rehabilitation tax credit will generally only offset the tax liability on passive activities. If the rehabilitation credit is generated by a rental activity, IRC section 469(I) generally limits the **credit** to the tax **deduction** equivalent of $25,000 ($7,000 deduction equivalent in the 28 percent bracket). Furthermore, while the active participation standard is not required for the rehabilitation credit, it is phased out beginning at a modified AGI of 200,000. Thus, if **taxpayer**'s modified AGI exceeds $250,000, generally no rehabilitation credit may be used under IRC section 469(I).

**Audit Tip.** Whenever there is a rehabilitation credit on Form 1040, check modified AGI to see if it exceeds $250,000. There could be an automatic adjustment, dollar for dollar tax, due to the AGI limitations in IRC section 469(I). Modified AGI simply means AGI computed without any passive losses or several other minor modifications.

## Additional Help

For more information on passive losses:

* Passive Activity Losses Reference Guide, Training 3149-115 (Revised 2/96), TPDS No. 83479V. It should be in your library or available from your MSSP Coordinator. It is also on the Internet at the IRS web page.

* Passive Loss Issues with Real Estate, Training 3318-001, TPDS 89430Y. This is a companion guide to the May 1997 teleconference. A copy of the video may be obtained from your MSSP Coordinator.

* MSSP Bulletin Board -- Cross Industry Files: The Passive Loss Library contains approximately 100 files with audit checksheets AND language on numerous issues.

* Publication 925, Passive Activity and At-Risk Rules.

## Summary of Passive Loss Limitations

1. As low income housing is a rental activity, it is passive. Thus, for those individual taxpayers who are not real estate professionals, both LIH losses and credits are

**allowable** only to the extent of passive income and up to the $25,000 offset, if available.

2. LIH losses are treated in the same manner as any other rental real estate activity. Since most LIH investors are limited partners, losses are not deductible unless the taxpayer has passive income.

3. There is no participation requirement for the $25,000 offset and no AGI income limitation for the low income housing credit. Thus, even a limited partner may take the LIH credit up to the $25,000 deduction equivalent offset.

4. Both LIH losses and credits are limited to the $25,000 offset. There is only one $25,000 offset available, and passive losses use the $25,000 offset before passive credits.

5. Passive income on Form 8582CR is the tax equivalent of what remains after triggering passive losses.

6. Unlike losses, an LIH credit is not **allowable** on disposition. The taxpayer may elect to increase the basis on the LIH property by completing Form 8582CR, Part VI, <u>OR</u> he or she must continue to carry forward the credit until he or she has passive income or the $25,000 offset.

7. Rules similar to the LIH credit apply to the rehabilitation credit. However, unlike the LIH credit, the rehabilitation credit has an income limitation. When modified AGI exceeds $200,000, the $25,000 offset is reduced 50 cents for every dollar. At $250,000, no rehabilitation credit may be taken (unless the taxpayer has passive income).

## Low Income Housing and Passive Loss Limitations

### Law

Low-Income housing partnerships are rental activities and are, therefore, subject to the limitations of IRC section 469, the passive loss rules. Low income housing LOSSES and low income housing CREDITS are treated differently. For current years, LOSSES are generally subject to the passive loss limitations -- just like any other rental real estate activity. As most investors are limited partners who do not qualify for the $25,000 offset, losses are deductible only up to passive income reported on the return.

IRC section 469(I)(6)(B) provides an exception for low income housing CREDITS. There is no participation requirement. Thus, even a limited partner may use the low

income housing CREDIT up to the $25,00 offset. Furthermore, for tax years after 1989, there is no phaseout of the credit based on modified AGI. Therefore, a taxpayer with any amount of income may use the credit. However, the credit is limited to the tax **deduction** equivalent of $25,000. LIH credits are only allowed IF any $25,000 offset remains after rental losses and the rehabilitation credit. Beginning in 1994, there is an exception for a qualifying real estate professional. Under IRC section 469(c)(7), if the taxpayer materially participates in the LIH project, current losses and credits are fully **allowable**.

**Note:** The LIH credit is reflected on Form 8586 which is carried to Form 8582CR which is carried to Form 3800, line 1f which is ultimately carried to Form 1040, line 42. LIH losses from limited partners should be entered on Form 8582, line 2b, and, if allowable due to passive income, would be carried to the back of Schedule E, the passive loss column.

For taxpayers claiming to be real estate professionals (entry on Schedule E, line 42), complete the following two steps.

If TAXPAYER is not a real estate professional, SKIP first two steps.

* **For 1994 and later years, verify that the taxpayer qualifies as a real estate professional** (spends more than half of his or her personal services and more than 750 hours per year in real property businesses in **which he or she materially participates). The taxpayers' occupation next to his or her signature on Form 1040 is an indicator. A real estate professional** (IRC section 469 (c)(7) and Treas. Reg. section 1.469-9) is a **taxpayer** who spends the majority of time on REAL PROPERTY businesses. **(Reference: PAL Guide #3149-115 page 2-15.)**

* **If the taxpayer is a real estate professional, verify that he or she materially participated** (worked on a regular, continuous and substantial basis -- IRC section 469(h), Treas. Reg. section 1.469-5T) in the activity generating the low-income housing losses and credits. Since most investors are limited partners (see Form K-1), they will not meet the material participation standard -- unless a timely written election was filed with the return to group ALL rental real estate activities as one activity. If a **taxpayer** does not materially participate, losses are entered on Form 8582, line 2b and credits should be on Form 8582CR, line 3a (or 2a if in service before 1990).

  **If taxpayer is a qualifying real estate professional AND materially participates in the LIH partnership, STOP! LIH losses and credits are fully allowable.**

**LIH Credit Issues**

__ **Verify LIH credits on Forms 8586 and 3800 are on Form 8582CR.**

LIH credits are most often on Form 8582CR, line 3. If there is no Form 8582CR, complete the form and make your adjustments.

__ **Review Form 8582CR and verify that the low income housing credit has been limited to the tax deduction equivalent of $25,000**

($9,900 for 39.6-percent bracket, 9,000 at 36 percent, 7,000 at 28 percent, 3,750 at 15 percent.) The sum of the rehabilitation credit and LIH credit is limited to the tax deduction equivalent of $25,000. Thus, unless there is passive income on Form 8582CR, line 37 should not be greater than $9900 (tax deduction equivalent of $25,000 at 39.6 percent). IRC section 469(I). See page 10 of Form 8582CR for worksheet computing tax equivalent.

__ **Verify that the amount from Form 8582, line 9 has been entered on Form 8582CR, line 25 and/or line 35. If there is no Form 8582, check for rental losses on Schedule E, line 24.**

(If losses are on Schedule E, line 2, Form 8582 should have been completed with rental losses allowable up to $25,000 presuming taxpayer's modified AGI is less than $100,000.) If taxpayer failed to complete Form 8582, the amount of passive rental losses on line 24 should generally be entered on Form 8582CR, line 25 -- unless taxpayer is a qualifying real estate professional). Allowable rental losses reduce the amount allowable for passive credits! Thus, taxpayer who used $25,000 in losses has no amount of his or her $25,000 offset left for credits.

__ **Verify that income on Form 8582CR, line 6 is not the tax deduction equivalent of income on Form 8582 line 10** (from L1a or L2a), that is, a duplication!

**REMINDER:** Legitimate passive income from any source will trigger deductibility of low-income housing losses and use of credits. However, passive losses first absorb passive income, followed by certain passive credits, the rehab credit and, lastly, the LIH credit. Furthermore, since rentals generally produce losses and businesses without material participation are more apt to generate losses (the only two sources for passive income), substantial amounts of passive income should be scrutinized carefully. See incomewp.wpf.

__ **Verify LIH credits have not been taken on disposition.** Passive credits may be claimed only in future years when there is passive income (after absorbing passive losses) OR TAXPAYER may elect to increase his or her basis in the property by any unused credits.

__ **Review Form 4797 for dispositions of passive activities** (rentals or businesses without material participation). Overall losses (loss absorb after considering

current and suspended losses/income) passive income (IRC section 469(g)(1)(A)(ii)). Thus no income may remain to absorb passive credits. In other words, there may be no income to enter on Form 8582CR, line 6 in order to trigger passive credits. Passive credits may be used only up to passive PLUS the tax **deduction** equivalent of $25,000. See instructions for Form 8582CR, pg 8.

__ **Verify via review of supporting documentation that taxpayer has correctly computed the tax deduction equivalent of passive income in line 6**. In other words, verify that **taxpayer** has not entered the exact dollar amount of passive income from his or her documentation, but instead has computed the tax **deduction** equivalent at his or her tax bracket. See page 8, Form 8582CR instructions.

__ **Verify taxpayer has not used credits on disposition of the LIH activity**. **Taxpayer** may elect to increase the basis on the LIH property by completing Form 8582CR Part VI OR he or she must continue to carryforward the credit until he or she has passive income or the $25,000 offset.

## LIH Loss Issues

__ **Verify that losses have been properly elected on Form 8582 line 2b.** Since most investors are limited partners and limited partners do not qualify for the active participation standard under IRC section 469(I), losses should be entered on Form 8582, line 2b (not line 1b which would erroneously give taxpayer benefit of the $25,000 offset). Thus, LIH losses will not be deductible -- unless taxpayer has passive income on Form 8582, line 1a or 2a OR an entire disposition.

__ **Verify that losses have not been erroneously deducted in the nonpassive column on the back of Schedule E**.

A qualifying real estate professional may be able to deduct LIH losses IF he or she materially participated in the LIH activity. Most investors are limited partners and thus will not meet the material participation standard. See reprof.wpf and material.wpf -- IRC sections 469(c)(7) and 469(h). Also note that a qualifying investor who owned a low income housing partnership interest on **December 31, 1988,** and the property was placed in service between December 31, 1985, and August 17, 1986, may deduct all losses. Needless to say, this exception is very restrictive.

## ALTERNATIVE MINIMUM TAX

The low-income housing credit, like all credits included under the general business credit, is limited by the amount of the taxpayer's actual total tax liability. As such, the low-income housing credit can be used to reduce a taxpayer's income tax liability, but not below the "tentative minimum tax." Specifically, IRC section 38 provides the

following restriction:

**General Business Credit Limitation**

**Income minus the greater of:**

**1. Tentative minimum tax (net)**

**or**

**2. 25 percent of the net regular tax liability in excess of $25,000**

As such, the low-income housing credit can be used to reduce a taxpayer's income tax liability, but not below the tentative minimum tax.

**Example**

John, an individual taxpayer, has $50,000 of low-income housing credit in 1989. This credit is the only component of his general business credit. John's regular tax liability is $100,000. John's tentative minimum tax is $80,000. Since his regular tax liability exceeds the tentative minimum tax, John would not be liable for alternative minimum tax. The amount of credit is limited as follows:

1. $ 80,000 (tentative minimum tax)

or

2. $100,000 (regular tax liability)
   - 25,000
   75,000
   x .25
   18,750

| | | |
|---|---|---|
| Net income tax | 100,000 | |
| - (1) | 80,000 | |
| | 20,000 | amount the credit is limited to for that year. |

| | | |
|---|---|---|
| * | $ 50,000 | total LIHC |
| | - 20,000 | allowed for 1989 |
| | 30,000 | to be carried back or over. Credit is first carried back (normally 3 years for a 1989 credit, but LIHC cannot go past 1987) to 1987, then 1988 and any unused credits would then be carried to 1990 and forward. |

If this restriction results in a limitation on the amount of credit allowable in a year and the credit arises in a taxable year beginning on or before December 31, 1997, any excess will be carried back to 3 preceding years and carried forward to each of the succeeding 15 taxable years. The unique aspect of this rule, as applied to the low-income housing credit, is that no carryback may be made to years ending prior to 1987. In other words, Congress will not allow this credit to be carried to a return which is earlier than the credit itself. If the credit arises in a taxable year beginning after December 31, 1997, the carryback period and carryforward period are, respectively, 1 year and 20 years.

## AUDIT TECHNIQUES

As with the other techniques of this "related issues" chapter, examiners pursuing an issue relating to the alternative minimum tax should ensure that these restrictions were applied correctly during the preparation of the return. Examiners should make at least a cursory review of this issue for all affected entities.

# Chapter 9

## EXTENDED USE COMMITMENTS

IRC section 42(h)(6)(A) provides that a building owner must agree to a **long-term commitment** to the low-income housing program for a building to be eligible for the low-income housing tax credit. This rule applies to post-1989 tax years and is one of the requirements which must be met for a building owner to claim the credit. The term "extended use period" means the period beginning on the first day in the compliance period on which such building is part of a qualified low-income housing project, and ending on the later of: 1) the date specified by such agency in such agreement with the building owner or 2) the date which is 15 years after the close of the initial 15-year compliance period.

This extended low-income housing commitment is a required agreement between the building owner and the state housing agency, and, per IRC section 42(h)(6)(B), is to consist of the following elements:

1. The agreement must include a requirement which establishes an applicable fraction which will apply to the entire extended use period. Failure to maintain this low-income participation level will be deemed an issue of noncompliance. With respect to the low-income tenants included in this applicable fraction if the extended use agreement terminates under IRC section 42(h)(6)(E)(I), two additional requirements are imposed on the building owner for the 3-year period following termination:

   a. no eviction or termination of a lease can occur for any reason other than "good cause"; and

   b. the gross rent of low-income units cannot be increased unless otherwise permitted under IRC section 42.

2. A requirement must be included which allows qualifying tenants (past, present or future) the right to enforce the guidelines provided by restriction **(1)** above in any state court.

3. It must be stated in the agreement that no partial dispositions of the building will be allowable. Full dispositions, however, are permissible.

4. A requirement must be included which states that the building owner cannot refuse to lease to section 8 (of the United States Housing Act of 1937) tenants merely because the tenants are section 8 tenants.

5. It must also be stated that this agreement will be binding on all subsequent owners of the property.

6. This agreement must be recorded as a restrictive covenant attached to the property under state law.

If it is determined during a taxable year that an extended-use agreement was not effective as of the beginning of that year, then the owner has one year from the date of the determination to correct any failure or the credit is disallowed for that year and any prior year.

Rules are provided for certain instances in which an extended use agreement will terminate before the extended use period is over. Specifically, termination can occur on the following three occasions:

1. **<u>Foreclosure</u>:** An extended use period will terminate on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure). Nevertheless, a foreclosure arranged by the building owner (with the purpose to effect a termination of the agreement) will not terminate the extended use commitment. See IRC section 42(h)(6)(E)(I)(I).

2. **<u>Qualified Contract</u>:** In addition, the extended use period will terminate if the allocating agency is unable to present to the owner a qualified contract from a buyer who will continue to operate the building as a qualified low-income building. The building owner is provided an opportunity, after the 14th year of the compliance period, to make a written request to the applicable state housing agency to find a buyer who is willing to step into the shoes of the owner with regard to the project. The date this request is submitted starts a one-year clock running during which the state housing agency will attempt to secure a "qualified contract" for the acquisition of the low-income portion of the building by a buyer who is willing to operate it as a qualified project. If, on the last day of this one-year period, the state housing agency has not presented the building owner with a qualified contract, the extended-use period for the building will be considered terminated.

   The qualified contract is defined as any bona fide contract to acquire the non low-income portion of the building for fair market value, and acquire the low-income portion for an amount not less than the applicable fraction of the sum of:

   * the outstanding indebtedness related to the building,
   * the "adjusted investor equity" in the building, plus
   * the amount of any other capital contributions, reduced by any cash

distributions made or available to be made from the project.

The term "adjusted investor equity" is defined by the Code as the aggregate amount of cash taxpayers invested with respect to the project plus an amount reflecting any appropriate cost of living adjustments (not to exceed 5 percent per year).

3. An extended use agreement's terms may also be terminated or suspended after the compliance period when a tenant exercises a right of first refusal to purchase the low-income building under IRC section 42(I)(7). See Rev. Rul. 95-49, 1995-2 C.B. 7.

The drafting of the extended low-income housing commitment also has significance in that this document specifies the amount of credit appropriate to be allocated to a building. This allocation amount, as provided in IRC section 42(h)(6)(C), may not exceed that amount of credit necessary to support the applicable fraction indicated in the agreement.

The examiner should note that the Code does provide for an amendment to the extended use agreement in the case of an increase to the qualified basis of a building after the first year of the credit period. The document reflects this as an increased applicable fraction.

## AUDIT TECHNIQUES

Item 2(f) of the Information Document Request (IDR) asks the taxpayer to provide a copy of the restrictive covenant discussed above. Given the importance of the existence of this agreement, as well as the specific items agreed to for this period, it is important that the examiner review this covenant.

Because the extended low-income housing commitments became a requirement for credit allocations after 1989, the issue of any terminations based on a building owner's request will not be effective until at least the year 2005. Examiners will, however, encounter terminations due to the foreclosure of the property. Foreclosure does constitute a disposition, and will disqualify the former owner from taking future credits, as well as triggering recapture on credits claimed. See Chapter 7 for more information on recapture.

As indicated in the above text, if the Service determines that a foreclosure was "staged" to free the building owner from the restrictions of the extended use commitment, the agreement would not be considered terminated. This is a difficult area to pursue, and relies more heavily on the judgment of the examiner than other

issues encountered with IRC section 42. Communication with the state housing agency may prove valuable in this area in that they may have additional information relevant to this issue. Aside from being provided with an actual information report, the state housing agency may have received subsequent requests from the building owner for allocations for new projects -- indicating perhaps that a financing arrangement could have been negotiated for the foreclosed property instead. Similarly, the examiner should inspect the balance sheets and P&L's for the taxpayers to determine if foreclosure was the only available option for this project. The related facts and circumstances will need to be thoroughly reviewed during the exam and developed accordingly.

# Chapter 10

# QUALIFIED NONPROFIT ORGANIZATIONS

A discussion of the low income housing credit would be incomplete without a look at the role **nonprofit organizations** play in this program. The tax-exempt purpose of these entities often relates directly to the same goals intended to be advanced by Congress in the establishment of the low-income housing credit -- the provision of decent, safe, and affordable long-term housing to the low-income sector of the population. As such, examiners auditing low-income housing tax credit projects must become familiar with the unique tax considerations, as well as the special benefits awarded by Congress to these entities. Such knowledge will be key to the development of issues involving nonprofit developers, syndicators, joint ventures and their related transactions.

Congress was aware of the important role played by nonprofit organizations in the development of tax credit projects and provided additional tax incentives to these entities in order to maintain their level of involvement, whether direct or indirect, in the program. A list of these special benefits is provided as follows, with each concession discussed in greater detail below.

## SPECIAL BENEFITS AWARDED TO NONPROFITS

**SPECIAL BENEFITS TO NONPROFITS**
**INVOLVED IN THE LOW-INCOME HOUSING TAX CREDIT PROGRAM**

**(1) 10 PERCENT NONPROFIT SET-ASIDE**

**(2) AT-RISK LIMITATION CONCESSIONS**

**(3) EXCEPTION TO THE RULE FOR OWNER-OCCUPIED BUILDINGS**

**(4) EXCEPTION TO THE RULE FOR TRANSITIONAL HOUSING FOR THE HOMELESS**

**(5) RIGHT TO PURCHASE AT THE END OF THE COMPLIANCE PERIOD**

**(6) EXCEPTION TO THE RULE FOR FEES FOR SUPPORTIVE SERVICES**

**(7) EXCEPTION TO THE 10 YEAR RULE**

**Nonprofit Set-Aside**

IRC section 42(h)(5) provides that each year, every state must set aside a minimum of **10 percent of their total credit ceiling** exclusively for projects involving qualified nonprofit organizations. Nonprofit organizations must have an ownership interest in and materially participate in, the development and operation of the low-income housing project throughout the 15-year compliance period. In addition, the following requirements must be met to qualify for the 10-percent set-aside allocation:

1. The organization must be tax-exempt under IRC section 501(c)(3) or 501(c)(4).

2. The state housing credit agency must have determined that the organization is not affiliated with or controlled by a for-profit organization. This was added under the Omnibus Budget Reconciliation Act (OBRA) of 1990.

3. One of the exempt purposes of the organization must be to foster low-income housing.

4. The ownership and material participation test can be met by the organization if it owns stock in a qualified corporation that owns and materially participates in a low-income housing project. A qualified corporation must be a corporation that is 100-percent owned at all times during its existence by one or more qualified nonprofit organizations.

**At-Risk Limitation Concessions**

IRC section 42(k) provides special rules for the determination of whether or not a person is deemed "qualified" under the at-risk provisions of IRC section 49. If qualified nonprofit organizations meet the at-risk rules for providing financing, then the determination of whether such financing constitutes qualified commercial financing is made regardless of:

1. Whether such qualified nonprofit is actively and regularly engaged in the business of lending money;

**OR**

2. Whether the nonprofit is a person from which the taxpayer acquired the property (or a related person to such person).

The prior two concessions apply specifically to qualified nonprofits. However, other general at-risk rules apply which must be met by all entities -- nonprofit or otherwise. These general at-risk rules consist of the following and are used to determine whether

or not the funds constitute qualified commercial financing:

1. The financing must be secured by the low-income property. Exceptions are provided for federally- assisted buildings (described in IRC section 42(d)(6)(B)) if a security interest in the low-income building is not permitted by the federal agency holding or insuring the mortgage, and proceeds from this financing are used for the acquisition or improvement of such building.

2. During any taxable year in the compliance period, not more than 60 percent of the eligible basis of the building is attributable to the qualified commercial financing. For purposes of making this 60-percent determination, the principal and interest portion of any governmental financing which is a part of a wrap-around-mortgage is excluded.

3. The repayment of this financing must be accomplished on or before the earliest of:

   a. the stated maturity date, or

   b. 90 days after the end of the building's 15-year compliance period, or

   c. the date the building is sold or refinanced. (See the nonprofit exception below.)

A special exception applies to the 90-day repayment rule for a qualified nonprofit that is not the entity (or related entity) from which the taxpayer acquired the property. In this case the loan must be fully repaid 90 days after the earlier of:

1. the date the building ceases to be a qualified low-income project, or

2. the date which is 15 years after the close of the compliance period for such building.

If a qualified loan is not repaid accordingly, the amount of credit related directly to the inclusion of such loan in basis must be recaptured, along with a nondeductible interest charge due on the full term of the loan. This interest computation is based on the underpayment rate of IRC section 6621. These recapture provisions are found in IRC section 42(k)(4).

IRC section 42(k)(3) also provides **recharacterization rules** in the instance of a qualified nonprofit loan which is 1 percentage point below the applicable Federal rate (AFR) as of the time such financing is incurred. In such a case the loan would be "recharacterized" and the related qualified basis (to which the financing relates) of the project is deemed to equal the present value of this financing based instead on the

AFR. Such an adjustment will result in the loss of tax credits as originally computed.

An additional issue which is related to the at-risk rules is the classification of deferred development fees. These fees may be reclassified as a type of financing, which would then subject them to the at-risk rules. All facts and circumstances must be developed in such an issue. A full discussion of development fee issues is found in Chapter 11.

## Exception to the Rule for Owner Occupied Buildings

The general rule under IRC section 42(I)(3)(C) states that a building having **4 or fewer units** will not qualify for the low-income housing credit if one of the units is owner occupied. IRC section 42(I)(3)(E)(I) provides a partial exception for acquisition or rehabilitation of a building pursuant to a development plan of a qualified nonprofit as long as all units are rented for 90 days or more.

## Exception to the Rule for Transitional Housing for the Homeless

IRC section 42 generally disqualifies projects involving transient housing. Such projects are in conflict with the intentions of Congress in providing long-term housing solutions to qualifying tenants. An exception, however, was created under IRC section 42(I)(3)(B)(iii), whereby certain transitional housing for homeless individuals (homeless as defined within the meaning of section 103 of the Stewart McKinney Homeless Assistance Act (42 U.S.C. 11302)), would be eligible for the credit if the building is used exclusively for the transition of homeless individuals into independent living situations within 24 months. For these efforts to qualify, it is stipulated that the temporary housing and supportive services must be provided to qualifying tenants by a qualified nonprofit organization or governmental entity. Also, each unit must contain sleeping accommodations and kitchen and bathroom facilities.

## Right to Purchase at the End of the Compliance Period

A benefit found in IRC section 42(I)(7), provides that a **right of first refusal**, which applies to nonprofit organizations among others, will not affect the tax benefits generated by a project. The right of first refusal allows the property to be purchased by the qualified nonprofit organization after the close of the compliance period for a minimum purchase price. This price is equal to the principal of any outstanding indebtedness incurred before the 5-year period ending on the date of sale to the qualified nonprofit organization, as well as the taxes (federal, state, and local) which would be generated in a transaction involving the sale of the property.

**Exception to the Rule for Fees for Supportive Services**

IRC section 42(g)(2)(B)(iii) dictates that the gross rent limitation on qualified units does not include any fee for a supportive service paid directly to a building owner on behalf of a low-income tenant, if such payment is made by either a governmental program, or a **tax-exempt organization** under IRC section 501(c)(3), that provides rental assistance and the rental assistance is inseparable from the assistance provided for the supportive services.

**Exception to the 10-Year Rule**

The **"10-Year Rule"**, relating to acquisitions under IRC section 42(d)(2)(B)(ii), states that there must be a period of at least 10 years between the date of acquisition by the building owner and either the date the building was last placed in service or the date of the most recent nonqualified substantial improvement. One of the exceptions to the 10-year rule, provided by IRC section 42(d)(2)(D)(ii)(III), states that this rule does not apply to placements-in-service by a qualified nonprofit organization. Under this exception, if a qualified nonprofit places an existing building in service within 10 years, the building may still qualify for an acquisition credit if ten years have elapsed since the prior owners' placed in service date.

## NONPROFIT ORGANIZATIONS DEFINED

To better understand the involvement of nonprofit organizations in the low-income housing tax credit program, a definition of "nonprofit" should be reviewed. IRC section 42(h)(5)(C) defines a qualified nonprofit organization, for purposes of the low-income housing credit, as any organization meeting the tax-exempt requirements of IRC section 501(c)(3) or 501(c)(4), and for which one of the exempt purposes includes the fostering of low-income housing. A qualified nonprofit organization is a tax-exempt entity. Not all tax-exempt entities, however, are nonprofits. This is because governmental units are also tax-exempt, but they are not nonprofit organizations per se. It is important to clarify that the nonprofits encountered in this program, which are generally of a charitable purpose, also have tax-exempt issues apply to them under additional Code sections. These will be given greater attention later in the chapter, as the focus here will be on IRC section 501(c).

## SAFE HARBOR

**IRC section 501(c)(3)** relates to exempt organizations and provides that an organization may be considered exempt if it is organized and operated exclusively for one or more of the following purposes:

1. Religious
2. Charitable
3. Scientific
4. Testing for public safety
5. Literary
6. Educational
7. Prevention of cruelty to children or animals

Within the realm of IRC section 42, entities pursuing a "charitable" purpose are generally the vehicles found to participate in the program. Treas. Reg. section 1.501(c)(3)-1(d)(2) defines the term "charitable," as relates to an organization's exempt purpose, as including those entities formed to provide "relief of the poor and distressed or of the underprivileged * * * lessening the burdens of Government * * * promotion of social welfare by organizations designed to accomplish any of the above purposes or * * * to eliminate prejudice and discrimination * * * to combat community deterioration." The second tax-exempt Code section referenced by IRC section 42 is IRC section **501(c)(4)**, and relates to low-income housing with its reference to "organizations operated exclusively for the **promotion of social welfare**."

Rev. Proc. 96-32, 1996-1 C.B. 717, provides guidance on the classification of tax-exempt organizations involved in low-income housing. The safe harbor guideline for low-income housing published in Rev. Proc. 96-32, provides that an organization will be regarded as charitable if the organization establishes for each project that at least 75 percent of the units are occupied by residents whose incomes are 80 percent or less of the area's median income, and either (1) 60 percent of the units are occupied by residents whose incomes are 60 percent or less of the area's median income or (2) 20 percent of the units are occupied by residents whose incomes are 50 percent or less of the area's median income.

As indicated by the definitions provided in the Code and regulations, a broad view would conclude that entities involved in low-income housing projects would qualify under these categories. In no area, however, is this activity specifically stated or included in a definition. In an attempt to provide some guidance in this area, **"safe harbor"** guidelines were issued by the Service in Rev. Proc. 96-32.

It should be noted that these guidelines are to be applied on a continual basis throughout the compliance period of the project. Additionally, it should be again noted that these provisions are merely guidelines and are not intended to represent a formal position on the tax-exempt status of an entity. If, in fact, an examiner develops an issue regarding the tax-exempt purpose or classification of an entity, all facts and circumstances should be thoroughly developed. Prior to any reclassification, a referral should be made to the **Employee Plans and Exempt Organizations Division** of the Internal Revenue Service for a formal determination.

## JOINT VENTURE

Nonprofits have played an important role in the development and success of the industry related to the LIHC. In addition to their own undertakings, the ability of these entities to form a **joint venture** with for-profit entities has not only increased the number of projects developed, but has added a degree of internal control to the projects created under such joint ventures. The nonprofit focuses on the actual housing project, while the for-profit's emphasis is on the financial aspects.

This arrangement is generally accomplished by the creation of a partnership with the for-profit entity who seeks to use these credits. The for-profit entity offers to become a partner through a contribution of cash which represents the amount they are willing to invest for use of the credit. The partnership is generally structured so that the nonprofit is designated the general partner with a 1-percent interest and the for-profit investors retain limited partner status with a combined ownership of 99 percent of the partnership.

This structure allows the nonprofit the control of the project and the ability to derive the special statutory benefits, while allowing the investors the tax benefits related to the credits obtained. The establishment of the partnership agreement presents many other issues and considerations, but the previous example provides the general circumstances under which the joint ventures are formed.

Aside from the issue of providing credits to partners who can receive a tax benefit from them, nonprofits and their for-profit partners are often on opposite sides of most other issues -- whether financial or operational. The nonprofit, for example, seeks to maximize occupancy as a social service, while charging the minimum rate necessary to keep the project operating. The for-profit partners seek to achieve the highest operating income allowable while maintaining compliance with IRC section 42. The nonprofit targets those most in need, per the HUD definition of AMGI, including Section 8 program participants. The for-profit, to reduce risk related to rental income, attempts to secure tenants at the highest allowable income level and without other program restrictions applied to their tenancy. The nonprofit will generally have and accept short-term (within the requirements of IRC section 42) leases. The for-profit partner will attempt to secure long-term tenants, who often qualify at initial lease-up but later have allowable increases to their income levels.

In addition to the consideration which must be given to these often conflicting goals, joint ventures involving nonprofits have additional tax issues which need to be addressed. These issues focus on the tax-exempt status of the nonprofits, which would need to be addressed even if no joint venture existed.

The first issue of concern is qualification for exemption under IRC section 501(c)(3) or 501(c)(4). This may result from the nonprofit failing to maintain control over the partnership; that is, a developer co-general partner controls the partnership. Tax-exempt entities also have to address the issue of **"private inurement."** Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii) provides that net earnings of an entity which inure, in whole or part, to the benefit of private individuals, disqualify the tax-exempt status of a nonprofit since it thereby fails its status as operating "exclusively" for an exempt purpose. Thus, even a minimal benefit inured to a private individual can cause the loss of its tax-exempt status.

## UNRELATED BUSINESS TAXABLE INCOME

A lesser issue of concern is **"Unrelated Business Taxable Income,"** which is the term applied by the Code to income generated by a nonprofit through activities which are not directly related to their tax-exempt purpose. IRC section 512 provides guidance on unrelated business taxable income (UBTI). Nonprofit developers must give consideration to the UBTI issue to ensure that this tax is not imposed on activities related to their low-income projects. In fact, if an entity is determined to have an excess of such unrelated business type activities -- it could jeopardize its status as a tax-exempt organization. Some activities created under a joint venture could put a nonprofit in a sensitive position regarding UBTI. Problems with unrelated business income will generally occur when some of the rentals are not related to the nonprofit's tax-exempt purpose. For example, commercial rental activities would not be related to the nonprofit's function of providing low-income housing. This is not to say that these partnerships automatically create a taxable taint on all activities, but merely that such involvement would require additional factual development.

A full discussion of the exempt purpose categorization and determination of a nonprofit is beyond the scope of this text. It is important, however, to be familiar with the operational test applied to make this determination. The operational test applicable to a tax-exempt organization's participation in joint ventures involves a two-prong test which (1) provides that the tax-exempt organization must carry out a charitable purpose through its participation in the joint venture and, (2) provides that it operates exclusively for charitable purposes without overly benefiting its partners.

In a Tax Court decision, ***Housing Pioneers, Inc. v. Commissioner***, T.C. Memo. 1993-120, 65 T.C.M. (CCH) 2191, ***aff'd***, 58 F.2d 1004 (9th Cir. 1995), the court determined private inurement to exist where the founders of the nonprofit organization operated it to privately benefit an existing housing partnership. This case should be reviewed in any case involving nonprofit joint ventures.

## TAX-EXEMPT USE PROPERTY

One of the last issues to be addressed in this chapter is whether any portion of the low-income housing project is **"tax-exempt use property"** for depreciation purposes. If so, that portion must be depreciated under the alternative depreciation system of IRC section 168(g). Under IRC section 168(g), depreciation deductions for tax-exempt use residential rental property or nonresidential real property are based on the straight-line method over the greater of (1) 40 years or (2) 125 percent of the lease term. Depreciation deductions for other tax-exempt use property are based on the straight-line method over the greater of (1) the property's class life (or 12 years if no class life exists) or (2) 125 percent of the lease term.

A full discussion of whether any portion of the low-income housing project is tax-exempt use property is beyond the scope of this text. The examiner, however, should be familiar with the situations that may cause the entire, (or a portion) low-income housing project to be tax-exempt use property. These situations are described in IRC section 168(h). For purposes of IRC section 168(h), tax-exempt entities generally include nonprofit organizations, such as charitable organizations, governmental units, and foreign persons or entities. Tax-exempt use property includes:

### Property Leased to a Tax-Exempt Entity (Other Than Nonresidential Real Property)

If a portion of property other than nonresidential real property is leased to a tax-exempt entity, the tax-exempt use rules may apply to that leased portion. Under IRC section 168(h)(5)(A), property leased to a partnership that has a tax-exempt entity (or a tax-exempt controlled entity that does not make the election under IRC section 168(h)(6)(F)(ii)) as a partner is treated as leased to such entity in an amount equal to its proportionate share of the property. See the discussion under (2) below for determining the proportionate share and the definition of a tax-exempt controlled entity.

### Failure to Make a Qualified Allocation (Any Depreciable Partnership Property)

If a partnership has both a tax-exempt entity (or a tax-exempt controlled entity that does not make the election under IRC section 168(h)(6)(F)(ii)) and a non-tax-exempt entity as partners and there is no "qualified allocation," the tax-exempt use rules may apply. A "qualified allocation" means any allocation to a tax-exempt entity which:

1. Is consistent with such entity's being allocated the same distribution share (that is, the identical percentage) of each item of partnership income, gain, loss, deduction, credit, and basis (and such share remains the same during the entire period such entity is a partner) and

2. Has a substantial economic effect, within the meaning of IRC section 704(b)(2).

**Note:** For this purpose, items allocated under IRC section 704© are not taken into account.

If the tax-exempt partner does not receive a "qualified allocation," the partnership property will generally be treated as tax-exempt use property to the extent of the tax-exempt entity's proportionate share of profit and losses. Proportionate share is determined on the basis of such entity's income or gain, whichever is larger.

The tax-exempt use rules described above can be avoided by creating a "tax-exempt controlled entity" to act as the general partner and by making the special election under IRC section 168(h)(6)(F)(ii). A tax-exempt controlled entity is a corporation (which is not a tax-exempt entity) in which 50 percent or more (in value) of the entire stock in the corporation is held by one or more tax-exempt entities (other than a foreign person or entity). If the election is made, dividends or interest received or accrued by the tax-exempt entity and gain recognized on disposition of an interest in such entity will be treated as taxable unrelated business income under IRC section 511.

**Disqualified Leases (Nonresidential Real Property)**

If a disqualified lease of nonresidential real property is found to have been entered into with a tax-exempt entity, the tax-exempt use property rules may apply. A disqualified lease is defined by IRC section 168(h)(1)(B)(ii) as having one or more of the following characteristics:

* All or part of the property was financed by tax-exempt debt, and the tax-exempt entity (or a related party) participated in this financing arrangement.

* A sale-leaseback situation exists whereby the property was originally used by a tax-exempt entity (or a related party), which then sold or leased the property to another entity. A subsequent sale or lease back to the originating tax-exempt entity would disqualify the lease unless the final lease occurs within 3 months of when the nonprofit first used such property.

* A fixed or determinable purchase or sales option exists involving the tax-exempt entity.

* The lease has a lease term in excess of 20 years.

If any portion of the low-income housing project is tax-exempt use property under IRC section 168(h) but is not depreciated under the alternative depreciation system of IRC section 168(g), a change from the taxpayer's method of computing depreciation

for such portion to the alternative depreciation system may be a change in method of accounting subject to IRC sections 446(e) and 481. A full discussion of a change in method of accounting is beyond the scope of this text. However, if the examiner changes the computation of depreciation for any portion of the low-income housing project, the rules and exceptions applicable to a change in method of accounting to make the proper depreciation adjustment need to be addressed.

## DEBT-FINANCED PROPERTY

In addition to these tax-exempt use property rules, Congress enacted rules related to debt-financed property in IRC section 514(b). The intentions surrounding these efforts was to limit the ability to inappropriately shift tax benefits between parties in joint ventures consisting of tax-exempts and for-profit entities.

The basic rule for the classification of a project as "debt-financed property" under IRC section 514(b)(1) is that property used to produce income that has an acquisition indebtedness attached to it will be taxed as unrelated debt financed income, unless substantially all the use of the property is substantially related to the nonprofit's charitable purpose. Additionally, any interest income related to nonprofit loans on such property may be subject to reclassification as unrelated business taxable income and taxed accordingly.

**Example**

A nonprofit organization provides a low-income housing project with secondary financing with terms providing for an interest-only loan at a rate of seven percent, payable from available cash flow. Typically, interest on this type of loan will accrue during the 15-year compliance period. If the project is classified as debt financed property, the nonprofit organization may realize unrelated business income as a result of the accrued interest, even though the nonprofit has received no cash from the project.

The rules, definitions, and examples presented in this chapter are intended to provide the basic knowledge required to examine a low-income housing tax credit project involving nonprofit organizations. Although the benefits related to the involvement of nonprofits can be great, the costs can also be significant. Section 42 of the Internal Revenue Code includes rules and exceptions specific to the low-income housing credit. This chapter introduces further benefits, rules, and exceptions within that Code section which apply specifically to nonprofits.

## AUDIT TECHNIQUES

Although the determination is originally made by the state housing credit agency as to whether or not the nonprofit organization is affiliated or controlled by a for-profit entity, additional consideration may be necessary by the examiner based on the facts and circumstances of the exam. The Code allows wholly-owned subsidiaries of the nonprofit organization to form joint ventures with for-profit entities; however, the relationship of the for-profit entity should be reviewed. An issue would be developed if the nonprofit organization had common officers and a board of directors with a related for-profit entity. Such facts and circumstances may reveal that the sole purpose of the nonprofit organization is to pass on the tax benefit to the related entity and shared officers.

Examiners should also review the financing package of the low-income project. It is not uncommon for nonprofit organizations to have federal funding as part of their financing, which could include grants and below market interest loans. Applicable source documents are requested in item 3 of the Information Document Request. As discussed in Chapter 6, federal funding could impact the eligible basis and applicable credit percentage.

In addition to federal funding, the nonprofit organization may receive syndication proceeds from the sale of the low-income tax credit. It is common for nonprofit organizations to use wholly-owned subsidiaries for participation in low-income projects with for-profit partners. The subsidiary may be used to acquire the property and then form a partnership with a syndicator who will purchase the credits. Expenses should be reviewed for miscategorized syndication fees. See Chapter 11 for more information on syndication.

The "**Not For Profit Rules**," per IRC section 183, do not apply to qualified low-income buildings with respect to the disallowance of losses, deductions, or credits. (See Treas. Reg. section 1.42-4.)

# Chapter 11

## DEVELOPMENT FEES AND SOFT COSTS

One of the significant issues encountered in low-income tax credit cases stems from the inclusion or general allowance of **developer fees** in the reported eligible basis of the respective real estate projects.

## DEVELOPER FEE REQUIREMENTS

Treas. Reg. section 1.42-6 provides guidance on whether certain developer fees qualify as part of carryover allocation basis for purposes of fulfilling the requirement that a project owner must incur at least 10 percent of the project's reasonably expected costs by the end of the year in which the allocation was made. Treas. Reg. section 1.42-6 also provides standards for determining whether fees, including developer fees, qualify for inclusion in eligible basis. Specifically, the fees must meet the following requirements:

1. The fee is reasonable;

2. The taxpayer is legally obligated to pay the fee;

3. The fee is capitalizable as part of the taxpayer's basis in land or depreciable property that is reasonably expected to be part of the project;

4. The fee is not paid (or to be paid) by the taxpayer to itself; and

5. If the fee is paid (or to be paid) by the taxpayer to a related person, and the taxpayer used the cash method of accounting, the taxpayer could properly accrue the fee under the accrual method of accounting (considering, for example, the rules of IRC section 461(h)). A person is a related person if the person bears a relationship to the taxpayer specified in IRC sections 267(b) or 707(b)(1), or if the person and the taxpayer are engaged in trades or businesses under common control (within the meaning of subsections (a) and (b) of IRC section 52).

In addition, there are other related **"soft costs"** which are routinely part of a syndicated and developed real estate project. Syndication fees relating to the selling of an equity interest in a project, and those legal and accounting expenses that are attributable to any such syndication, are not included in eligible basis. The "characterization" of these various fees as incurred for development, as well as the

percentages charged in relation to the actual **"hard costs"** of the various projects raise questions as to their proper characterization for tax purposes.

IRC section 42(m) affords the state housing credit agencies the authority to limit project costs to those that are feasible to bring the project to completion. One of the main areas addressed by the states under the authority of IRC section 42(m) is developer fees.

The text which follows attempts to identify the potential issues regarding developer fees as well as other soft costs. Additionally, an attempt will be made to highlight some potential forms the developer fees may take, the applicable Code sections, and positions successfully used to address the various issues. It should also be noted that other names may be used to characterize these types of fees and soft costs and which will be addressed later in this chapter.

## STEPS FOR ISSUE IDENTIFICATION

To address potential developer fee issues, an examiner must first identify various aspects regarding the developer fee as presented by the project under examination. The primary task is to identify the following:

1. The amount of the developer fee and how it was to be paid (cash or note). Determine if the cash payments and payments per any notes or financing were actually paid to date.

2. How the developer fee amount was determined (for example, based on arms-length negotiations, etc.). Fully understanding who controls any entities involved as well as who the key players are is important.

3. The developer. Note: If the developer is an entity, identify the ownership through any tiers, etc., which may have been layered to insulate the real owner of the developer entity. For #2 and #3 above, a chart may be helpful to outline the principals involved.

4. Trace the entire series of transactions to identify all entities and who owns/controls them. This also could be part of the chart.

5. The developer fee mechanism. It is also important to determine what type of development scenario is involved. Several potential types follow:

    a. **Turnkey Project** -- Consider a situation where the partnership enters into a development agreement with a developer to pay an amount which includes all

hard construction costs and the balance is earned by the developer as the developer fee. An example of this arrangement would be a situation where the development agreement calls for a payment of $2 million with the estimated hard costs of the project budgeted at $1,200,000. If the actual costs are consistent with the budgeted amounts, then the developer will have earned a fee of $800,000. NOTE: The key factor to establish in this case is what type of service the "developer" has performed to justify this compensation or fee, and how these amounts should be "characterized" for tax purposes. The partnership/owner usually acquires the building before the development contract is entered into. There may be a variation of this turnkey situation where, in addition to contracting for the development of the project, the shell purchase is also included in the contract price.

b. **Fixed Amount Developer Fee** -- A fixed amount developer fee occurs in a situation where the "hard costs" and the developer fee are separately-stated items. The developer fee is usually based on the estimate or budget for hard costs. For example, $1 million of hard costs with a developer fee added in a fixed amount of $150,000. In this situation, the partnership has usually already acquired the shell prior to entering into the development contract. Unlike a turnkey agreement, the developer fee does not decrease if the hard costs exceed their budgeted amounts.

c. **Completed Project Developer Fee** -- A completed project developer fee is one which is passed on to the ultimate purchaser of the building as a component of the purchase price. The building in this case is sold as a completed package after the new construction or the rehabilitation work is finished. The sales price includes components of costs for the original land, shell, rehabilitation costs, and any development costs or other "soft costs." The primary task is to determine what the components of the purchase price are, who was involved in the transaction, what their role in the transaction was, and what their role was in the transaction. This analysis may lead to conclusions which include "substance versus form" arguments. To make this argument, the facts and transactions must be established, and the players and their roles properly identified. These costs, if determined to be for syndication aspects, are not includable in the tax credit basis (or the depreciable or amortizable basis, etc.) for the low-income housing credit or rehabilitation credit. Depending on the size of the project or the materiality of the fees involved, adjustments may be needed to "re-characterize" these soft costs.

d. **Failed Project Developer Fee** -- A developer fee under either a turnkey agreement or a fixed amount developer agreement may be evident in another type of project which is commonly referred to as a "Failed Project." The key factor to remember in this situation is that the failure referred to is usually one

in terms of depleted finances or total bankruptcy of a former owner. Usually the salvaging of this project by the new developer depends upon their ability to syndicate and sell this project to a new group of investors. Enough capital must be generated to buy the project, complete the remaining construction or rehabilitation items, and also cover the "soft costs" incurred for the services of the individuals involved in completing the project. As in all the above scenarios, the identification of all the transactions and players is imperative.

There have been other situations where syndication fees or follow-up for **due diligence** purposes is referred to as construction monitoring fees, contingency fees, acquisition fees, etc. Whatever characterization is on the taxpayers books or tax returns, it is important to determine the true nature and propriety of the costs incurred.

In addition to the identification of the particular developer fee or soft cost scenario, there are various examination techniques which can be used and some Information Document Request (IDR) items which can be beneficial in developing these issues. Note that Items 1, 6, 10, 11, 12, 13, 15, 16, and 17 on the IDR (see appendix A for an example of an IDR) may pertain to this issue.

In most instances the **Offering Memorandum** for a syndicated partnership should discuss the transactions of the partnership, including any development contracts to be entered into or development fees to be paid, as well as any significant soft cost items. Offering Memorandums are also beneficial in that the parties to the various transactions will be disclosed; particularly if there are conflicts of interest which would signal transactions which are not at arms-length. On occasion, the settlement sheet will actually contain not only the purchase of the shell, but also all development costs or other separately stated items. Workpapers used to prepare the tax return and audit workpapers (if one was performed by the accountant) may also contain narratives and numbers related to a development contract or fees. Bank statements and canceled checks may evidence payments made as developer fees or related to a development contract. Financing agreements, particularly for construction financing, also assist in making determinations regarding the propriety of developer fees. Both the construction contract and the AIA (American Institute of Architects) formatted construction vouchers provide insight into the size of the project, the "hard costs," the time frames, and the degree of completion at various intervals throughout the construction period, etc.

## CHARACTERIZATION OF EXPENSES

Based on both past and current tax law provisions dating from 1986 through 1996, developer fees are an allowable component of the "qualified basis". However, when analyzing transactions and establishing facts for IRC section 42 low-income housing

credit projects and IRC section 47 rehabilitation credit projects, examiners may need to make adjustments to items that are characterized as development fees. Certain costs may be characterized as development fees to increase the qualifying costs for computing low-income housing or rehabilitation tax credit basis. Examples of expenses which may be incorrectly characterized to obtain tax benefits by their inclusion in basis are:

1. **Syndication Costs** -- These are the costs of syndicating a partnership and its related investment units. Syndication costs are normally items incurred for the packaging of the investment unit (the partnership unit), and the promotion as an investment, including any marketing of the actual units, the production of any offering memorandums or promotional materials, the mobilization of any brokers/dealers who will sell the partnership units, and the actual sales commissions paid to the sellers of the partnership (whether they are unrelated third parties or the individuals who promoted the investment). Other costs normally incurred as a part of syndication could include legal costs associated with the offering, opinions, inquiries as to certain aspects, etc. Finally, any due diligence related aspects also constitute syndication.

   Note that the individual or entity who acts as the developer may have been involved in the syndication aspects of the project, including the structuring of the investment unit, the work necessary to coordinate and effectuate the promotion of the investment units through syndication, and the subscription for the partnership units, or the training and coordination with broker dealers. Also note that the developer, in many instances, is the one who originally created the investment units. The individual or entities involved in the project may characterize all of their activities as "development" in nature, take out their fees for all aspects as development costs, and include the associated costs in the tax credit basis. Under IRC section 709, these costs should not be currently expensed or amortized and are not includable in the qualified tax credit basis for purposes of either the low-income housing or rehabilitation tax credit, nor are they includable for depreciation purposes.

2. **Organization Costs** -- The cost of organizing a partnership may be amortized over a period of time not less than 60 months (under IRC section 709(b)). The organizational costs should include the legal and accounting costs necessary to organize the partnership and facilitate the filings of the necessary legal documents and other regulatory paperwork required at the state and national level. In addition to the requirement that these costs be amortized, they are not includable in the tax credit basis for either the low-income housing or rehabilitation tax credit, nor are they allowable for depreciation purposes. There is a fine line which exists between syndication costs and organization costs. Generally syndication represents those costs associated with the sale of the actual investment units, while

organization costs are those necessary to legally create the partnership, filings, etc.

3. **Acquisition Costs** -- Under the provisions of IRC section 47, (formerly IRC section 48(g)), the rehabilitation credit, costs of acquiring the shell before rehabilitation, is not properly includable in the qualified rehabilitation basis. For purposes of IRC section 42, the costs may warrant inclusion in the qualified basis and generally will be subject to the lesser 30 percent present value credit. These costs may be passed on to the partnership in the purchase price of a completed project. If the partnership purchased the building before rehabilitation, then there are two components which must be identified. The actual cost of the land and shell can be identified through review of the settlement sheet while additional, indirect costs of acquisition are more difficult to determine. These indirect costs include amounts paid to the promoters' who have actually purchased the property on behalf of the partnership. The compensation for the promoter's services may be characterized as developer fees rather than acquisitional costs. These costs should be considered because promoters can complete feasibility studies to determine if they have selected the correct property. Also, buildings may be purchased months or years prior to rehabilitation and extensive "holding costs" may be incurred. Throughout this time period, the promoter's services may be necessary to effectuate the acquisition and reimbursements for these services.

4. **Rent Up/Lease Costs** -- "Rent up" or "lease up" costs are the costs necessary to fully rent the newly-renovated building. This initial rental can, in some situations, take several years and costs may be extensive. For example, costs may include: advertising, sample unit costs, on-site rental managers and staff, initial rental costs, and any other costs to fully rent out the buildings. These costs normally would be amortized over the life of the leases if long term, (for example, a commercial situation), but, if short term, then the amortization should be over the period necessary to rent out all units, (for example, 24 months or 36 months).

5. **Rental Management** -- "Rental management" is the continuing day-to-day management of the property including all dealings with the tenants, renewal of current leases, procurement of new tenants for any vacancies, etc. Rental management fees are usually a set amount plus 6 percent for any lease renewals and incentives for new tenants obtained to fill vacancies. These amounts should be expensed on a yearly basis and matched against current rental income.

The above costs are the most common expenses related to low-income housing and rehabilitation tax credit basis. If additional categories are encountered, determine what the costs were for, how they were paid, and who received the payment. An analysis will then be necessary to determine the proper tax characterization.

## POSITION OF THE SERVICE

Based on the above discussion and cases encountered over a number of years, a position has been developed to address cases involving developer fees. Notwithstanding arguments that to rehabilitate an existing building according to the historical standards or under tax credit provisions was more difficult than undertaking new construction, these fees can be high when compared to arms-length transactions. The development of the facts surrounding the fees and what services were provided to warrant the fees, are the important items that will support adjustments.

Refer to Exhibit 11-1. It is a sample report which can be used to address the development fee issue. This position was tested in a Tax Court case where the Service prevailed. Details regarding the Tax Court case will follow this position in synopsis form. For purposes of this guide, fictitious names have been used. This report can be adapted to address various developer fee scenarios. It should be noted that although the court case was for a rehabilitation tax credit situation, applications can be adapted for some low-income housing tax credit scenarios.

## SUMMARY

The case presented in the sample report (Exhibit 11-1) is ***Richard E. Carp and Minda Carp v. Commissioner***, and ***Franklin D. Zuckerman and Lois Zuckerman v. Commissioner***, T.C. Memo. 1991-436. The court determined that the partners/developers failed to establish that they performed any of the services relating to the renovation of the property as set forth in the development agreement. In addition, the court found, as developed by the examiner, that most of the services had actually been performed by a third party under a separate agreement and for which that third party was separately compensated.

Cases with similar fact patterns have been sustained in the courts using the above report as a guide. The significance of the case lies in the Court's acceptance of the analysis of purported development fees and determination of proper tax treatment.

Finally, examiners should be aware that there are regulations which address situations where a developer fee occurs upon the sale of a completed rehabilitation building first placed in service by the new owner. In these situations, examiners can use the following regulation sections which treat the developer fees added to the purchase price as costs of acquisition and thus not includible in the qualified rehabilitation tax credit basis.

NOTE: The regulation below only relates to the rehabilitation tax credit. For purposes of the low-income housing credit under IRC section 42, acquisition costs

may warrant a separate allocation of the 30 percent present value credit.

Treas. Reg. 1.48-12(c)(3)(iii) provides examples of expenses incurred by the taxpayer for purposes of qualified rehabilitation expenditures.

**Extract**

**Treas. Reg. section 1.48-12(c)(3)(iii), Examples (3) and (4)**

Example (3). D, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a building on January 11, 1982. Prior to May 1, 1982, D makes rehabilitation expenditures of $16,000. On May 3, 1982, D sells the building, the land, and the property attributable to the rehabilitation expenditures to E for $35,000. The purchase price is properly allocable as follows:

| | |
|---|---|
| land | $ 5,000 |
| existing building | 11,000 |
| property attributable to rehabilitation expenditures | 19,000 |
| total purchase price | $35,000 |

The property attributable to the rehabilitation expenditures is placed in service by E on September 5, 1982. E may treat a portion of the $35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by D ($16,000) are less than the portion of the purchase price properly allocable to property attributable to these expenditures ($19,000), E may treat only $16,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures ($19,000) over the rehabilitation expenditures paid by D ($16,000), or $3,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

Example (4). The facts are the same as in example (3), except that the purchase price properly allocable to the property attributable to rehabilitation expenditures is $15,000. Under these circumstances, E may treat only $15,000 of D's $16,000 expenditures as rehabilitation expenditures paid by D. The excess of the rehabilitation expenditures paid by D ($16,000) over the purchase price allocatable to rehabilitation expenditures ($15,000), or $1,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

## DESCRIPTION OF SYNDICATION SCENARIOS AND CURRENT INDUSTRY TOOLS FOR MARKETING THE LOW-INCOME HOUSING TAX CREDIT

The most common entity used for the promotion of real estate investments is a partnership. During the 1980's, the partnerships had numerous limited individual partners. This type of partnership with many limited partners worked well for purposes of the rehabilitation tax credit. Simultaneously with the creation of the low-income housing tax credit and as a part of the Tax Reform Act of 1986, the passive activity restrictions were enacted. Generally designed to curb tax shelters, the passive activity restrictions had a significant impact on real estate type investments.

For the above reasons, partnerships are the most popular entity used to solicit credit equity investments. Although there still may be some individuals who participate in those low income housing investment partnerships, most significant low-income housing credit partnership investment is coming from corporate investors. Partnerships and equity pools can own as few as one building or as many as dozens of multiple building projects. The larger the pools, the more equity required and usually more partners are necessary to make the projects feasible. Generally, although "tax credits can not be sold," one may buy an interest in an investment partnership (whether as an individual or corporation) to receive a share of the credits, as well as any tax attributes accruing from the partnership. Investors then must assume the burdens and benefits of ownership.

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# Sample Report

## FORM 886-A, EXPLANATION OF ITEMS

### General Background/Facts

ABC Historic Partnership started on October 15, 1990, per the 1990 partnership return and the partnership agreement as submitted during audit. Per the 1990 partnership return, there are 33 partners in ABC Historic. The partnership is a limited partnership and the sole general partner is "X". "X" has also been designated as the Tax Matters Partner per the partnership agreement, and based on recent correspondence, that Tax Matters Partner designation remains currently in force and effect.

The Offering Memorandum indicates that ABC Historic is a partnership formed under Pennsylvania law to acquire a four story building in the Old City Historic District of Philadelphia, Pennsylvania. The partnership rehabilitated the structure into 42 apartments and 8,000 square feet of commercial space. Per the Offering Memorandum and background obtained during the audit, the partnership intended to, and actually has, operated this project as an apartment rental project.

The partnership, from the outset, intended to obtain historical certification of the project's qualifying rehabilitation costs and take the 20-percent certified historical rehabilitation credit. Based on verification with the National Park Service and the Part III Certification as submitted by the partnership during audit, the rehabilitation work as performed has been "certified" by the National Park Service. As long as the costs are for "qualified rehabilitation expenditures" they can be included in the basis for the 20-percent historical rehabilitation credit.

ABC Historic was one of various partnerships promoted, syndicated, organized, and managed through various general partners on behalf of the "Y" Group. These partnerships were very similar in nature in that all were primarily formed to acquire, rehabilitate and subsequently rent the historic structures as residential/luxury apartments.

A major selling feature of these limited partnership interests was the 20-percent certified historic rehabilitation tax credit available for "qualifying rehabilitation expenditures" as defined by Federal tax law and subject to the rehabilitation works

approval by the National Park Service.

Adding to the attractiveness of these partnerships was their leveraged nature whereby usually less than 10 percent of the purchase price of the investors limited partnership interest was required to be paid by cash, while the remaining amounts were paid by notes from the investors to the partnership and which were payable over a 5-year period.

The partnerships were also similar in that various functions and services necessary to carry out the intended purposes of the partnerships were usually performed by the many affiliates which operate under the auspices of "Y" Group. These functions included but were not limited to the following:

1. The sponsoring, syndication, and promotion of the various limited partnerships to raise the necessary capital to acquire, rehabilitate, and subsequently rent out the projects. "Y" and its affiliates were responsible for creating an investment package (the limited partnership interests) that had an appeal to investors. Without this attractive investment package, as created and promoted by "Y", the functions performed by "X" as indicated below would be impossible to accomplish.

   After creation and formation of the various partnership investment vehicles it was then necessary to seek out and engage various broker dealers capable of selling these investments to the ultimate limited partner/investors throughout the country. Once engaged, "Y" had to mobilize these broker dealers to sell the units and complete syndication of the respective limited partnerships.

   One of the company's strengths was the creation of partnerships that had appeal to investors. Their staff had to communicate the merits of their programs. The limited partnerships were marketed through stock brokers, insurance agents, and financial planners who then communicated with and sold the partnership units to the investing public.

   "Y", through its employees, had to educate the registered securities dealers of the benefits of investing in the limited partnerships in addition to the economic and tax incentives. Additionally, for the later year projects, the company had a "Due Diligence Office" which provided detailed financial and tax information to broker/dealers on all more recent offerings.

   As indicated above, a substantial amount of time and work was invested in the creation of the investment package and the subsequent promotion, syndication, and sale of these limited partnership investments by "Y".

2. The placement of a general partner for the various partnerships to act in the capacity of, and to perform the normal functions and duties of the general partner. In this fiduciary role as general partner, the individuals or entities who acted as general partners had the exclusive right to manage the business affairs of the partnership. In most of the promotions, the general partners were either "key employees"/owners of "Y", entities owned by "key employees"/owners of "Y", or shared some "affiliation" with the "key employees"/owners of "Y" and usually acted under the guidance of "Y" in their role as general partner.

3. The work necessary to "organize" the partnership was more in the nature of an expenditure in relation to the creation of the partnership than of an expenditure relating to the carrying on of the intended business operations or "day-to-day business" of the partnership.

4. The "acquisitional" work necessary by "Y" and its "affiliates" was to find potential buildings and perform economic and feasibility studies of the buildings, and their general market areas including phone and on-site type reviews, and analysis, negotiations by "Y" and its affiliates on behalf of the partnerships for the purchase of the land and buildings, the settlements/closings on the ultimately selected land and buildings, and the work necessary to maintain, manage, and hold such land and buildings until the rehabilitation is commenced by a developer on behalf of the partnership.

5. The formation/engagement of a developer entity to directly perform (or to subjugate to an affiliate in order to have performed) the necessary development work performed for the rehabilitation of the "historically certified" building owned by the particular partnership. This development work/contract usually includes a commitment of the various "Y" entities to effect the rehabilitation and renovation of the particular project owned by the partnership under audit. The development agreements are usually "turn key" in nature and for a fixed price the "developer" will arrange for, manage, and pay for the construction and completion of the rehabilitation and renovations planned for the particular project. In all of the examined partnerships, the identified "developer entities" were determined to be owned by individuals or entities which were also determined to have been "key employees" or owners of "Y".

6. Two additional services included as "developer fees" were "cash flow guarantees" and "investor surety." While outside unrelated sureties were engaged to guarantee the payment of the "limited partners investor notes" for a non-refundable premium price, the "cash flow guarantees" were provided by an entity which was an affiliate of "Y". These affiliates would, for a set price, guarantee to lend to the particular partnership the cash amounts necessary to pay the obligations of the partnership under particular notes or, in some promotions, the guarantee was limited to a particular dollar amount.

7. A final category which appeared in the partnerships or promotions was the use of an affiliate of "Y" as manager of the subsequent rental operations of the particular projects as the buildings became available to be "placed in service." These management agreements usually addressed renting, leasing, operating, and managing the projects for various commissions based on gross annual rentals. Additional incentives were paid for re-rentals and renewals at the various apartment buildings.

**Additional Facts**

NOTE: The preceding pages included general facts and background regarding both ABC Historic and the promoter "Y". Additional facts will address the dates, amounts, and specifics regarding the transactions entered into by the partnership during the acquisition and rehabilitation phase of the project.

All of the information presented below was obtained during the examination through review of the offering memorandum, the books and records, legal documents (including but not limited to the settlement sheet for the acquisition of the property/ shell), the "development agreement," "development note," partnership agreement, AIA (American Institute of Architects) application and certificate for payment, statement/certificate of occupancy, the first lease executed after completion for occupancy, National Park Service application and responses Parts I, II, and III, which verify the historical certification of the rehabilitation work on the particular project, and any oral testimony as presented by attorneys or accountants acting as powers of attorney for the examined partnership, and officers or employees of the "Y" organization.

The partnership name is ABC Historic and is located in Philadelphia. The rehabilitated building is also located in Philadelphia. The building shell was purchased September 6, 1990. The purchase price of the shell was: $600,000, ($400,000 as cash and $200,000 as seller take back mortgage from a bank).

The developer entity is known as XYZ Development Company. The ownership of XYZ Development Company is as follows:

65% - Apartments Inc. (100 percent Owned By "Z")
15% - "X" (Current General Partner of ABC Historic)
15% - "A" (Key Employee of "Y")
5% - "B" (Key Employee of "Y")

The development contract is a "turn key contract" and the amount is $3,600,000 with $750,000 to be paid in cash while the remainder of $2,850,000 will be paid by note (development note).

The rehabilitation expenditures, reflected as basis for the rehabilitation tax credit, have been tied to the books and records and verified by documents submitted during the audit. Based on all items as submitted, and information obtained during the audit, the examining revenue agent isolated "non-qualifying" items. The "Fact Law and Argument" presentation follows:

## Issue

Whether syndication expenses in the amount of $650,000 are includable in the "qualified rehabilitation basis" for purposes of the historic rehabilitation tax credit and for depreciation basis purposes.

## Law

Tax treatment of syndication and organization expenses. Under IRC section 709, the following treatment is applied to organization and syndication fees.

**Extract**

**[IRC] Section 709. Treatment of Organization and Syndication Fees.**

**(a) General Rule.**
Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

**(b) Amortization of Organization Fees.**
**(1) Deduction.** Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations

prescribed by the Secretary), be treated as deferred expenses and shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

**(2) Organizational Expenses Defined.** The organizational expenses to which paragraph (1) applies, are expenditures which--

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

© are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Under Treas. Reg. sections 1.709-1 and 1.709-2, the following treatment is applied to organization and syndication fees.

**Extract**

**Treas. Reg. section 1.709-1**

**Treatment of organization and syndication costs. --** (a) General Rule. Except as provided in paragraph (b) of this section, no deduction shall be allowed under chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) Amortization of organization expenses. (1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in section 709(b)(2) and in § 1.709-2 (a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under § 1.709-2(c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses that have not been paid by the end of that taxable year. Portions of such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses had been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

(c) *** The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnership's return of income for the taxable year in which the partnership begins business. *** In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnership's original return and statement.

**Extract**

**Treas. Reg. section 1.709-2**

**Definitions. --**(a) *Organizational expenses*. Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

(1) are incident to the creation of a partnership;
(2) are chargeable to capital account; and
(3) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a)) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the

organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) *Syndication expenses*. Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) *Beginning business*. The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operation for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business. If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

## Revenue Rulings and Applicable Court Cases

Rev. Rul. 81-153, 1981-1 C.B. 387, states the following: An investor in a limited partnership may not deduct that part of the purchase price that is paid, through a rebate or discount arrangement, by the investor to a tax advisor on behalf of the partnership for services related to the sale of the partnership interest. The partnership may not amortize this amount under IRC section 709(b). The investor's basis in the partnership is the amount of cash contributed.

Rev. Rul. 85-32, 1985-1 C.B. 186, states the following: Syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

In ***Vandenhoff v. Commissioner***, 53 T.C.M. (CCH) 271, T.C. Memo. 1987-116 and ***Isenberg v. Commissioner***, 53 T.C.M. (CCH) 946, T.C. Memo. 1987-269, it was found that guaranteed payments by a motion picture partnership to the general partners were in the nature of syndication expenses and were required to be capitalized.

In ***Schwartz v. Commissioner***, 54 T.C.M. (CCH) 11, T.C. Memo. 1987-381, ***aff'd without opinion***, 930 F.2d 920 (9th Cir. 1991), it was found that payments made to a partner were syndication expenses that must be capitalized and were not deductible as guaranteed payments.

In ***Driggs v. Commissioner***, 87 T.C. 759 (1986), it was found that amounts paid to a general partner as "sponsor's fees" were not deductible because the partnership failed to prove whether the expenses were for syndication fees or for organization costs.

In ***Finoli v. Commissioner***, 86 T.C. 697 (1986), it was determined that amounts paid for preparation of a tax opinion, incurred to promote or facilitate the sale of partnership interests, and commissions and consulting fees constituted non-deductible syndication expenses.

In ***Surloff v. Commissioner***, 81 T.C. 210 (1983), it was found that fees paid to an attorney by partnerships mainly for the preparation of a tax opinion letter that was used in a prospectus given to potential investors were syndication expenses and had to be capitalized.

In ***Flowers v. Commissioner***, 80 T.C. 914 (1983), it was determined that expenditures for tax advice were incurred for purposes of obtaining the tax opinion letter that accompanied organization and sales promotion of limited partnership interests and were non-deductible capital expenditures.

In ***Tolwinsky v. Commissioner***, 86 T.C. 1009 (1986), and ***Law v. Commissioner***, 86 T.C. 1065 (1986), it was found that organizational expenses for a motion picture tax shelter were amortizable only to the extent that such expenses were substantiated.

In ***Wendland v. Commissioner***, 79 T.C. 355 (1982), ***aff'd***, 739 F.2d 580 (11th Cir. 1984) it was determined that legal expenses paid to a law firm by a coal mining tax shelter partnership constituted organizational expenses that had to be capitalized in the absence of evidence allocating such expenses between legal advice and tax advice.

In ***Johnsen v. Commissioner***, 83 T.C. 103 (1984), ***motion denied***, 84 T.C. 344 (1985), ***rev'd on other grounds***, 794 F.2d 1157 (6th Cir. 1986), it was found that a partner could not deduct his share of claimed expenses for legal and tax advice because the evidence showed that the services concerned the organization and promotion of the partnership.

In ***Egolf v. Commissioner***, 87 T.C. 34 (1986), it was held that a partnership could not currently deduct organization and syndication costs by indirectly paying them to a partner under the guise of management fees. Since no election was made by the partnership, no amortization of partnership organization expenses was allowed.

In ***Durkin v. Commissioner***, 87 T.C. 1329 (1986), the court ruled that payments made by a partnership to two general partners for services were for expenses in connection with organizing the partnership and the offering and such payments were not currently deductible as guaranteed payments. The partnership was entitled to amortize the expenses.

In ***Collins v. Commissioner***, 53 T.C.M. (CCH) 873, T.C. Memo. 1987-259, it was found that management and consulting fees paid shortly after the formation of a general partnership were held to be organizational expenses and were required to be amortized rather than currently deducted. Similarly, legal and accounting fees incurred shortly after formation were nondeductible organization and syndication expenses.

Rev. Rul. 88-4, 1988-1 C.B. 264, states that the fee paid by a syndicated limited partnership for the tax opinion used in the partnership prospectus is a syndication expense chargeable by the partnership to a capital account and cannot be amortized.

**Argument and Conclusion**

Syndication expenses have been adjusted as follows:

Development contract of $650,000 has been re-characterized as syndication expense, and as such is not includable in either the depreciable basis nor the "qualified rehabilitation expenditures" for purposes of the historic rehabilitation tax credit.

The promoter of the examined partnership was "Y" and its related and affiliated entities. Their primary function as sponsor, syndicator, and promoter of the various partnerships they syndicated was necessary to raise the required capital to acquire, rehabilitate, and subsequently place the projects in service. "Y" and its affiliates created an investment package and "trained" various brokers/dealers to sell the units to the ultimate limited partner investors. "Y" had an in-house "Investment Marketing Division" and "Syndications Department" which were responsible for

sponsoring, syndicating, and promoting their partnerships. A substantial amount of time was expended to create, syndicate, and market these investment packages or limited partnership units. Additionally, the primary source of compensation for these services are the development contracts as entered into with ABC Historic.

It has been determined, for the partnership ABC Historic, that the amounts as specified were attributable to the "syndicating aspects" of the project and as such these costs have been re-characterized to reflect their proper tax treatment.

> [**NOTE:** When an examiner determines costs are syndication expenses and, as a result, reduces the depreciable basis by the amount of such costs, the examiner should be aware that this change in treatment of the costs from depreciable property to nondepreciable property may be a change in method of accounting subject to IRC sections 446(e) and 481. While a full discussion of a change in method of accounting in this situation is beyond the scope of this text, the examiner must become familiar with the rules and exceptions applicable to a change in method of accounting in order to make the proper adjustment.]

**Taxpayer's Position**

The Tax Matters Partners have indicated they are in agreement with the adjustments as presented on this report.

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# Chapter 12

## STATE ADMINISTRATION OF THE LOW-INCOME HOUSING CREDIT

To properly administer the low-income housing credit program, IRC section 42(l) provides that certain reports are necessary from both the building owner and the state housing credit agency. These reports are generally administered through the use of various IRS forms which provide for this information to be transmitted in a consistent format.

The examiner should note that although the low-income housing tax credit is a federal tax credit sanctioned by Congress to create the incentive for owners to provide housing, a major portion of the administration has been delegated to the state housing credit agencies for the 50 states. IRC section 42(m) gives broad general authority to the state housing credit agencies to assume their role for both the allocation of the credits to competing owners, and for activities related to the monitoring of compliance regarding buildings where allocations have been previously made.

Under IRC section 42(l)(3), the state housing credit agency is required to notify the IRS of allocations made for the years including information necessary to identify the buildings to which allocations have been made, how much was allocated to each building, and any information to identify the taxpayer(s) who own such buildings. This specific requirement for allocations made other than those made pursuant to IRC section (h)(1)(E) or 42(h)(1)(F), is met by completing and filing Part I of **Form 8609**, (**"Low-Income Housing Credit Allocation Certification."**) For allocations made pursuant to IRC section 42(h)(1)(E) or 42(h)(1)F) (carryover allocation) this requirement is met by the housing credit agency filing the original carryover allocation document with Form 8610 (Annual Low-Income Housing Credit Agency Report) for the year the carryover allocation is made.

A Form 8609 is filed with the IRS by the state housing credit agency for each building for which an allocation is made. The top half of the Form 8609, which is referred to as Part I/Allocation of the Credit, is completed by the state housing credit agency. This form must be completed by the state in order for the owner to be entitled to the credit. In addition to its primary role as a form designed to evidence the allocation (other than carryover allocations), this form can be used for additions to qualified basis or to amend a previously submitted Form 8609. The portion of the Form 8609 as completed by the state housing credit agency (Part I) includes the address of the building; the name, address of the building owner receiving the allocation, and taxpayer's identification number; the building identification number which has been issued by the state housing credit agency; and the name, address, and employer identification number of the housing credit agency issuing the credit allocation

certification.

The Form 8609 also provides the date of the allocation, the maximum housing credit dollar amount allowable, as well as the maximum qualified basis, and the maximum applicable credit percentage allowable.  Finally, the form provides the date the building was placed in service, the percentage financed by tax-exempt bonds, and increases in the basis for high-cost areas, and whether the allocation is for new construction and/or federally subsidized projects, rehabilitation expenditures, or an existing building.

It should be noted that all of the information as furnished in Part I of Form 8609 is provided by the state housing credit agency.  When the agency reports and signs Part I of Form 8609, a copy is furnished to the owner, while the original, including the signature of the authorized official at the state housing credit agency and the date signed, is retained to be sent to IRS.  On an annual basis, the state housing credit agency transmits all Forms 8609 representing all allocations made by that state to the IRS (other than carryover allocations).  Form 8610 is used by each state as a transmittal form for all of the Forms 8609 and carryover allocation documents made by the state for the year.  The Form 8610 is also used to summarize all of the aggregate numbers for the allocations as made by the state.  This summary also serves the purpose of ensuring that the state has kept within its state credit ceiling or state cap amount.

The Form 8609 copy, once issued to the building owner, will then be used by that owner to support their credits as taken through the remainder of the compliance period.  After receipt of the Form 8609 from the state housing credit agency, the owner is then required to make a "First Year Certification" as required by IRC section 42(l)(1), which is Part II of the Form 8609.  The owner is then required to sign Part II and provide additional information regarding the project.  This information includes the date the building was placed in service, the eligible basis of the building, original qualified basis of the building, whether the building is part of a multiple building project, and various elections including the minimum set-aside target.  After Part II of the Form 8609 is signed by the owner, the Form 8609 and Schedule A (Form 8609), known as the "Annual Statement," are then filed with the Form 8586 (which is the form used by a taxpayer to claim the low-income housing credit).  For all years after the first year, Form 8609 and a Schedule A will also be filed by the owner.

In summary, it should be noted that the Form 8609 and the Form 8610 (with any attached carryover allocation documents) will be used by the state housing credit agency to fulfill the reporting requirements of section 42(l)(3).  When filed with the IRS, the Forms 8609 and carryover allocation documents provide specific information about buildings allocated credits during a reporting period by the state housing credit agency.  The Form 8610 summarizes the aggregate numbers as allocated by the state housing credit agency.  The Form 8609 copy, as furnished to the owners, will then

have to be photocopied and used for each of the years remaining in the 15-year compliance period.

The owner will also be filing the Schedule A (Form 8609) for each of those subsequent years, as well as a Form 8586 which is used to actually take the credit in a given year. Note that proposed regulations were issued on January 8, 1999, that would require state housing credit agencies to file a new form summarizing the carryover allocation documents with Form 8610.

The two areas addressed above mainly deal with the allocation of the credit by the state housing credit agency, and the Form 8609 that may be used to evidence that allocation An allocation also may be made by the state housing credit agency furnishing to the owners a carryover allocation document. The Form 8609 then can be used by the owner as well as the state housing credit agency to fulfill the reporting requirements of IRC section 42(l)(1) and (3). Per the cited Code sections, the state housing credit agency must properly report the allocation to IRS, and then the owner has additional requirements to report additional information based on that allocation, through the remainder of the 15-year compliance period. It should be noted that there are numerous other forms that are used in conjunction with the low-income housing tax credit; these forms are addressed in other parts of this text. The remainder of this chapter will cover the compliance monitoring responsibilities and related forms.

IRC section 42(m) outlines the responsibilities of the state housing credit agencies. IRC section 42(m)(1) addresses the "Qualified Allocation Plan" among the projects which the state would have to formulate. In general, these qualified allocation plans will outline the selection criteria which are used to "score" projects and to determine which of those applying will receive an allocation. This is particularly important because each state has a limited number of credit dollars to allocate based on the credit ceiling. Once the qualified allocation plan is adopted, it is up to the state housing credit agency to follow that criteria in selecting projects to receive allocations. The examiner should review IRC section 42(m)(1)(C) at the end of this chapter to ascertain certain selection criteria that is mandated by Code.

Pursuant to IRC section 42(m)(1)(B)(iii), a qualified allocation plan must, among other things, provide that a state agency, contractor, or state agent must monitor a building owner's compliance with IRC section 42. This procedure is mainly intended to ensure proper notification to the IRS in instances where the provisions of IRC section 42 have been violated. The Form 8823 (Low-Income Housing Credit Agencies Report of Non-compliance) is currently the form used by the state agencies to report the noncompliance to the IRS.

The National Compliance Unit has developed letters which are sent to building owners in response to reports of noncompliance. In many instances, the infractions which are

reported can be rectified by interaction between the state housing credit agency and the building owner. In other, more serious situations, audit activity will be initiated in addition to the issuance of the letter.

Under IRC section 42(m)(2), state housing credit agencies are directed to limit the credit allocated to a project to any amount necessary to assure project feasibility. This is particularly important to the states due to the state credit ceiling. This also may assist the IRS in reducing the number of non-includible or improperly characterized expenses as the project passes through the allocation process. This section is particularly important in the area of development fees and other soft costs. Refer to Chapter 11 for a discussion of the various issues uncovered with regard to the improper tax characterization of many soft cost items. Chapter 11 also includes an exhibit which is a sample report used to address various soft cost type recharacterizations. It should also be noted that the area of development fees has been addressed by most states and many have invoked development fee ceiling schedules based on the projects size. As the examiner conducts the audit and obtains a copy of the project's application package from the state housing credit agency, it will be evident where the states have limited the project to some amount less than that which may have been incurred, based on their IRC section 42(m) authority.

**Appendix A**

## LOW INCOME HOUSING TAX CREDIT INTERVIEW QUESTIONS

**4444444444444444444444444444444444444444444444444444444444444444444444**

Taxpayer Name:

Taxpayer Address:

Taxpayer Identification Number:

1. Have you been audited by the IRS or by any other Federal or State Agency?

   If yes, obtain details and a copy of the audit report.

2. Have you been audited/reviewed by the state housing agency?

   Obtain copies of all correspondence and reports as per the audit/review.

3. Does the Low-Income Housing Project use the same name as the partnership. If not, obtain any fictitious names filed for and used by the partnership for each of the buildings.

4. Obtain background information and history of the project.

   - Where is the property or properties located?
   - What are the BIN's for the property or properties?
   - Who was the developer of the project?
   - Who was the Builder/General Contractor for the project?
   - Who manages the units in the project?
   - Who syndicated the Offering/Partnership as the Promoter?
   - Was there an appraisal done on the project, and who performed the appraisal?
   - Were Broker/Dealers used by the Promoter to ultimately sell the partnership units.
   - Who are the accountants for the partnership and what services do they provide? Were they also involved in the offering for projections, or prospectus materials?

- Who are the attorneys for the partnership and what services do they provide? Were they also involved in the offering for the review of the prospectus, or for opinion letters, etc.

5. Who is the general partner of the partnership, and what percentage interest do they own in the partnership? Are they the sole general partner, and if not obtain the names and percentages for the other general partners.

6. Were there costs amortized for the syndication of the partnership? Determine their nature.

   Are there costs being amortized by the partnership related to its organization? Determine their nature.

> Note: The interview questions are intended to obtain some basic and preliminary info regarding the owner, project, and the investment structure. If other non low-income issues are apparent on the return, include your own questions based on the situations you encounter. It should also be noted that many detailed questions are included on the Information Document Request, and are best suited on the IDR due to the detailed nature of the type info requested. Many of the IDR questions will require a written response or possibly calculations. You will also have to include any general mandatory items which are of a national or local scope in your interview.

## Appendix B

| Form 4564<br>Rev. 6/88 | Department of the Treasury<br>Internal Revenue Service<br>INFORMATION DOCUMENT REQUEST | Request Number |
|---|---|---|
| TO: Name of Taxpayer and Co. Div. or Branch<br><br>Please return Part 2 with listed documents to requester identified below. | | Subject<br>______________________________<br>SAIN No. \| Submitted to:<br>__________ \| __________________<br>Dates of Previous Requests |

**Description of Documents Requested**

Please present the following documents and information regarding the partnership examination for tax year(s) __________________________.

1. A copy of the Prospectus/Offering Memorandum relating to the above partnership activity.

2. Low-Income Housing Credit Allocation Certification Form 8609 from the state housing credit agency for each building. State if the building is a multiple building project.

   a. Exact addresses or locations of each buildings.

   b. Number of total units in each building, the number of low-income units in each building eligible basis and qualified basis. Please provide a schedule of any fluctuations in the qualified basis since the first year of the credit period.

   c. The application documents as filed with the respective state housing agency in order to have a credit allocated. Also please provide copies of any subsequent correspondence from or to the state housing agency. If any audits or reviews were conducted by the state housing agency please provide any documentation regarding same.

   d. Minimum set-aside requirement test elected. Documentation that the minimum set-aside requirements were met. Documentation if applicable for deep-skewed-rent projects or projects located in a qualified census tract or difficult to develop area.

   e. Please provide tenant file information including the schedule of rents charged, number of occupants in each unit, income certifications of each tenant, documentation of Section 8 payments and rent subsidies. Also please indicate if there are any on site manager units or security units, and their treatment for calculating the low income housing credit. Also include copies of any reports as submitted to the state housing agency in regard to tenants and their qualification.

**Information Due By__________ At Next Appointment [ ] Mail In [ ]**

| FROM: | Name and Title of Requester | Date |
|---|---|---|
| | Office Location | |

| Form 4564<br>Rev. 6/88 | Department of the Treasury<br>Internal Revenue Service<br>INFORMATION DOCUMENT REQUEST | Request Number |
|---|---|---|
| TO: Name of Taxpayer and Co. Div. or Branch<br><br>Please return Part 2 with listed documents<br>to requester identified below. | | Subject<br>SAIN No. \| Submitted to:<br>Dates of Previous Requests |

f. Copies of all tax credit allocation carryover agreements and if applicable, support that 10 percent of the reasonably expected basis has been incurred, restrictive covenants, elections of low-income housing tax credit percentage, and if a credit allocation was received before 1990, copies of any elections regarding deep-rent skewing and maximum rent for rent-restricted apartments.

g. Documentation of 10-year holding period, or waiver, if applicable.

3. Documentation for all grants and loans received, including all below market federal loans. Please provide mortgages, notes and any other documentation for the financing, as well as any records of all loan repayments.
4. Documentation for tax-exempt bond financing. Percentage of financing from tax-exempt bonds. Was the low-income housing credit allocation as received based directly on the tax-exempt bond financing.
5. If the property was sold, provide documentation regarding the sale, and any surety bonds as posted.
6. Please provide a list of all buildings as owned by the partnership. Also settlement sheets and deeds for the acquisition of any properties relating to the Form 1065 filed.
7. Certificate and/or statement of occupancy applicable to any buildings as owned by the partnership.
8. Copies of the first 3 leases executed for the project.
9. A copy of the partnership Form 1065 for all tax years evidencing a low income housing credit from the first year forward.

**Information Due By__________ At Next Appointment [ ] Mail In [ ]**

| FROM: | Name and Title of Requester | Date |
|---|---|---|
| | Office Location | |

| Form 4564<br>Rev. 6/88 | Department of the Treasury<br>Internal Revenue Service<br>INFORMATION DOCUMENT REQUEST | Request Number |
|---|---|---|
| TO: Name of Taxpayer and Co. Div. or Branch<br><br>Please return Part 2 with listed documents<br>to requester identified below. | | Subject<br>SAIN No. / Submitted to:<br>Dates of Previous Requests |

10. Workpapers used in preparing the return.

11. Copies of any partnership agreements executed.

12. All bank statements and canceled checks for the partnership.

13. Documentation or records pertaining to the capital contributions made by all of the partners including all notes.

14. Please provide documentation for all sales of partners interest of 1 percent or greater since the first year the partnership has taken a low income housing tax credit.

15. Construction contract including a specific breakdown of rehabilitation costs and any construction loan agreements.

16. Ledger Account/AIA statements for the construction mortgage showing draws for work performed.

17. Copies of any development agreements or related notes regarding either the construction, or rehabilitation of the low-income housing project.

Note: The above IDR should be modified for different types of owners including Corporations and Individuals, and should also be expanded to address any other issues that the examiner determines to warrant review. It can also be incorporated with the Rehabilitation Tax Credit IDR if the project is a combination Low-Income/Rehab credit project. Also for example, if you were examining a corporate taxpayer then the Corporate Minutes might be requested instead of a Partnership Offering Memorandum

**Information Due By__________ At Next Appointment [ ] Mail In [ ]**

| FROM: | Name and Title of Requester | Date |
|---|---|---|
| | Office Location | |

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## Appendix C

| | | |
|---|---|---|
| CHAPTER 2 | QUALIFIED LOW-INCOME HOUSING PROJECT<br><br>Applicable Law:<br><br>IRC § 42(g)<br>Treas. Reg. § 1.42-9<br>Treas. Reg. § 1.42-10<br>Treas. Reg. § 1.42-11 | To be considered a qualified low-come project, a building must be residential rental property. This property must also be rented to a targeted low-income population at restricted rental rates. The property must satisfy the requirements of one of two "minimum set-aside" tests. |
| CHAPTER 2 | MINIMUM LOW-INCOME SET-ASIDE TEST<br><br>Applicable Law:<br><br>IRC § 42(g)(1) | The minimum low-income set-aside rules define not only how many units are to be set aside for IRC section 42 tenants, but also determine the income levels allowable for such tenants. The minimum set aside election is an irrevocable election made by the building owner on Part II of Form 8609. The elected set-aside requirements must be met no later than the close of the first year of the credit period and continue throughout the compliance period. |
| CHAPTER 2 | 20/50 TEST<br><br>Applicable Law:<br><br>IRC § 42(g)(1) | The 20/50 test is one of two minimum set-aside elections. For a project to qualify for a LIHC, at least 20 percent of the units must be occupied by tenants with incomes at or below 10 percent of the area median gross income. |
| CHAPTER 2 | 40/60 TEST<br><br>Applicable Law:<br><br>IRC § 42(g)(1) | The 40/60 test is one of two minimum set-aside elections. For a project to qualify for a LIHC, at least 40 percent of the units must be occupied by tenants with incomes at or below 60 percent of the area median gross income. |

| Chapter | Topic / Applicable Law | Description |
|---|---|---|
| CHAPTER 3 | ELIGIBLE BASIS<br><br>Applicable Law:<br><br>IRC § 42(d) | The eligible basis of a building is it's adjusted basis at the close of the first taxable year of the credit period. Depending on the type of low-income housing credit, the adjusted basis consists of expenditures relating to the acquisition, construction or rehabilitation of the building. No offset for depreciation is required when determining eligible basis. Eligible basis includes amenities to the extent that they are comparable between market rate and low-income units. |
| CHAPTER 3 | SUBSTANTIAL REHABILITATION<br><br>Applicable Law:<br><br>IRC § 42(e)(2)&(3)<br>IRC § 42(e)(3)(A)(I) & § 42(e)(3)(A)(ii)<br>IRC § 42(e)(4)A) | In addition to receiving an allocation, projects must meet a substantial rehabilitation test to qualify for the rehabilitation credit. The "substantial rehabilitation test" must be met as of the end of the first year of the low-income housing credit period, (10-year period). During any 24-month period the rehabilitation expenditures must exceed the greater of 10 percent of the adjusted basis as of the first day of that selected period, or an amount that, when qualified basis attributable to such amount, is divided by the low-income units in the building, is $3,000 or more. Prior to 1990, the per unit minimum was $2,000. |
| CHAPTER 4 | APPLICABLE FRACTION<br><br>Applicable Law:<br><br>IRC § 42(c)(1)(B), (C)&(D)<br>Rev. Rul. 91-38 | The applicable fraction of a low-income building is the lesser of: 1) the unit fraction, or 2) the floor space fraction. In determining this fraction, only those units that are qualifying low-income units, as provided for under section 42(I)(3), can be used. The applicable fraction is determined as of the last day of each taxable year. |
| CHAPTER 4 | QUALIFIED BASIS<br><br>Applicable Law:<br><br>IRC § 42(c)(1)(A)&(B)<br>IRC § 42(c)(1)(E)<br>Rev. Rul. 91-38<br>Treas. Reg. § 1.42-5 | The initial qualified basis of a low-income building is calculated by multiplying the eligible basis by the applicable fraction. The qualified basis is determined as of the last day of the taxable year the building is placed in service, or the subsequent year upon election. This qualified basis should remain constant throughout the compliance year. If it decreases, credit recapture under IRC section 42(j) may be applicable. The qualified basis includes any portion of a building that provides supportive services for the homeless, but only the lesser of: 1) the eligible basis attributable to such services, or 2) 20 percent of the qualified basis. |

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| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>4 | INCREASE IN QUALIFIED BASIS<br><br>Applicable Law:<br><br>IRC § 42(f)(3) | The Qualified Basis of a low-income building may increase after the initial credit year. The Increase may be the result of an increase in the occupancy of the low-income units. Credit from an increase is claimed over the entire 15-year compliance period, not just the 10-year credit period. Therefore, only 2/3's of the credit is allowable for each year. The combination of the initial credit and this increase in credit may not exceed the original allocation granted. |
| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>4 | LOW-INCOME UNIT<br><br>Applicable Law:<br><br>IRC § 42(I)(3)<br>IRC § 42(g)(2)<br>IRC § 42(d)(2)(D)(iii)<br>RRA of 1990<br>(Pub. Law 101-508 section 11407(b)(6))<br>OBRA 89<br>OBRA 93<br>Treas. Reg. § 1.42-5<br>Rev. Rul. 92-61<br>Section 52, 179, 267, 70 7 | A low-income unit is one that is both rent restricted and is occupied by income eligible tenants. In addition, the unit must be suitable for occupancy, not used on a transient basis, and can not be occupied by certain students, including those who are not eligible to file a joint return. |
| C<br>H<br>A<br>P<br>T<br>E<br>R<br>S<br><br>5<br>&<br>12 | ALLOCATION FROM STATE HOUSING CREDIT AGENCY<br><br>Applicable Law:<br><br>IRC § 42(h)(1)(A)<br>IRC § 42(h)(3)(A)<br>IRC § 42(h)(5)(A)<br>IRC § 42(m)(1)(A)<br>Temp-Reg.§1.42-1T(d)(8)(I)&(ii)<br>Treas. Reg. § 1.42-6 | For a building to qualify for a low-income housing tax credit, there must be an "Allocation" from a state housing credit agency. The allocation can be made by the state agency issuing a Form 8609 or a carryover allocation document to the owner. The bottom portion of the Form 8609 is also completed by the building owners to elect the start of the credit period, as well as the minimum set-aside. Note: Both the credit starting period, and the minimum set-aside of a project will be discussed as separate issues.<br>Also note that the Form 8609 is filed by the state housing credit agency with the IRS for the year that the allocation is made. |
| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>5 | CREDIT PERIOD AND COMPLIANCE PERIOD<br><br>Applicable Law:<br><br>IRC § 42(f) | The credit period extends over 10 taxable years commencing with the taxable year the building is placed in service, or at the election of taxpayer, the subsequent year. The elected minimum set-aside must be met by the end of the first taxable year in the credit period. The compliance period is 15 years beginning with*the first taxable year in the credit period. The project must continuously meet the allowable income limitations and rent restrictions for the whole compliance period. |

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| C H A P T E R 5 | AMOUNT OF THE CREDIT - APPLICABLE PERCENTAGE:<br><br>70% Present Value or<br>30% Present Value<br><br>Applicable Law:<br><br>IRC 42(a)(1)&(2)<br>IRC 42(b)(1)&(2)<br>IRC 42(d)(5)(A)<br>IRC 42(e)(2)(A)&(B)<br>IRC 42(f)(5)(B)<br>IRC 42(I)(2)(A)&(B)<br>IRC 42(I)(2)(C)&(D)<br>Reg 1.42-3<br>Reg. 1.42-8 | The amount of the credit attained for a project depends on the character of the expenditures incurred, as well as the financing used to pay for the project. The credit is generally the applicable percentage of the qualified basis of each qualified low-income building. The percentages are prescribed by the Secretary for a particular month which will yield over a 10-year period amounts of credit which have present values equal to either 70 percent or 30 percent of the "qualified basis" of the eligible building. Generally, the 70 percent credit is for rehabilitation work done to the building, for new construction and for the above costs in situations where all federal grants, tax-exempt financing, and federal subsidies have been removed. The 30 percent credit is for acquisition costs of a existing building to be rehabilitated, and also for new construction and rehabilitation costs where there is tax-exempt financing or a below-market loan, and the owner has opted to leave that financing in basis and take the lessor 30 percent credit. The actual credit percentage for either of the above present value amounts will depend on the month placed-in-service, or at the election of the taxpayer, the month in which they enter into a*binding agreement with the state. |
| C H A P T E R 5 | PRORATION OF TAX CREDIT<br><br>Applicable Law:<br><br>IRC § 42(f)(2) | In the first year of the credit period, an averaging convention is used to reflect only the months with low-income occupancy during the year. In calculating the first year credit, the sum of the applicable fractions as of the close of each month during the credit period is divided by 12 which determines the average applicable fraction to apply to the eligible basis in determining qualified basis. Any reduction in credit due to the first year computation is allowable in the 11th year. |
| C H A P T E R 5 | PLACED IN SERVICE: THE CORRECT TIMING FOR THE CREDIT TO BE TAKEN<br><br>Applicable Law:<br><br>IRC § 42(l)(1)(A)<br>IRC § 42(h)(1)(B)<br>Notice 88-116<br>IRC § 42(e)(4)(A)<br>IRC § 42(h)(1)(E)<br>IRC § 42(f)(1)<br>IRC § 42(f)(5) | The placed-in-service date for new or existing buildings is the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. Rehabilitation expenditures that are treated as a separate new building are placed-in-service at the close of any 24-month period, over which such expenditures are aggregated. An election is necessary if a taxpayer wants to begin claiming the credit in the year following the year the building was placed-in-service. Note: After 1989 the credit period for an existing building shall not begin before the 1st taxable year of the credit period for rehabilitation expenditures with respect to such building. |

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| CHAPTER 6 | FEDERALLY FINANCED GRANTS<br><br>Applicable Law:<br><br>IRC § 42(d)(5)(A) | A reduction to a building's eligible basis is required for projects that receive federal funds in the form of a grant. It does not matter if it was a direct or indirect grant. The reduction occurs no matter when during the compliance period the grant is received. If it is a federally funded loan without expectation of repayment, it should be considered a grant. The grant can be for the cost of acquisition, rehabilitation, or new construction, or for the operation of the low-income building. |
| CHAPTER 6 | FEDERAL FINANCING &<br>FEDERALLY SUBSIDIZED LOANS<br><br>Applicable Law:<br><br>IRC § 42(I)(1)&(2)<br>IRC § 103<br>IRC § 1274(d)(1)<br>IRC § 142(d)(6) | A federally subsidized building is a building using (directly or indirectly) the proceeds of an obligation where the interest is tax-exempt (under IRC section 103) or a loan that is federally funded and below market (AFR section 1274(d)(1)). An owner can make an election to either reduce eligible basis to the extent of the federal subsidy, and claim the 70 percent PVC, or retain the eligible basis and use the 30 percent PVC. There are exceptions for certain types of funding. The loan/obligation can occur prior to the building being placed-in-service. |
| CHAPTER 7 | CREDIT RECAPTURE<br>SURETY BONDS<br><br>Applicable Law:<br><br>IRC § 42(j) | The credit for low-income housing is allowed over a 10-year period known as the credit period, even though the projects must remain incompliance over a 15-year period known as the compliance period. If there is a disposition of the project or for some reason there is a decrease in the qualified basis, then recapture is warranted. Recapture can be avoided in the context of a disposition if a surety bond is posted. The surety bond is posted via a Form 8693, while if recapture applies the owner would use a Form 8611. |
| CHAPTER 8 | QUALIFIED NONPROFIT<br>ORGANIZATIONS<br><br>Applicable Law:<br><br>IRC § 42(h)(5)<br>IRC § 469(h) | Each state housing credit agency annually must set-aside 10 percent of their total credit ceiling for projects involving nonprofit participation. A qualified nonprofit organization must own an interest in the project (directly or through a partnership) and materially participate with the meaning of IRC section 469(h). To qualify for the 10 percent set-aside, the organization must be tax-exempt and described under IRC sections 501(c)(3) or 501(c)(4); the state must have made a determination that the nonprofit is not controlled or affiliated with a for-profit entity; one of the exempt purposes must be to foster low-income housing; qualified corporations (subsidiaries) used by the nonprofit for low-income projects must be 100% owned by one or more qualified nonprofit organization at all times. |

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| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>9 | EXTENDED USE COMMITMENT<br><br><br><br>Applicable Law:<br><br>IRC § 42(h)(6) | After 1989, the state housing credit agency and taxpayer must enter into an extended low-income housing commitment before the taxpayer can claim a credit. The commitment must be in effect on the first day of the compliance period and remain in effect on the later of the date specified in the agreement, or 15 years after the close of the compliance period. The extended use commitment will terminate if there is a legitimate foreclosure or if subsequent to the 14th year, the credit agency fails to respond to the taxpayer's written request to find a buyer to acquire and operate the building as a low-income building. The credit agency has one year to respond to this request. |
| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>11 | DEVELOPMENT COSTS<br>PROJECT SOFT COSTS<br>SHCA DISALLOWED COSTS<br><br><br>Applicable Law:<br><br>IRC § 42(m)<br>Various Court Cases Regarding the Tax Treatment of Soft Costs. | A material issue encountered in LIH credit cases has been the proper characterization and tax treatment of development fees and other soft costs. In many situations it has been determined that other aspects of an offering such as syndication or organization expenses have been improperly characterized and included in the eligible basis. Under IRC section 42(m) the states have the authority to limit costs, particularly those in the area of project development costs. This chapter addresses various scenarios, and also includes a sample report for addressing these type issues. |
| C<br>H<br>A<br>P<br>T<br>E<br>R<br><br>12 | CO-ADMINISTRATION OF THE LOW-INCOME TAX CREDIT<br><br>Monitoring of Compliance<br><br>Applicable Law:<br><br>IRC § 42(l)<br>IRC § 42(m)<br>IRC § 42(n)<br>Treas. Reg. § 1.42-5 | Under IRC section 42(l) both the owners of low-income housing projects and the state housing credit agencies have responsibilities in providing relevant information to the Service via Form 8609 and carryover allocation documents. IRC section 42(m) addresses the responsibilities of the state housing credit agencies, particularly the compliance monitoring aspects. Form 8823 notifies the Service of compliance violations. Forms 8609 and 8823 and carryover allocation documents also serve as valuable audit aids. |
| R<br>E<br>H<br>A<br>B<br><br>A<br>T<br>G | BASIS REDUCTION<br><br>If both the LIHC (IRC § 42) and RTC (IRC § 47) credits are taken, 100% basis reduction for RTC's are taken to to determine LIHC's qualified basis.<br><br>Applicable Law:<br><br>IRC § 42(d)(4)(A) | If the project combines the IRC section 47 Rehabilitation Credit with the Low-Income Housing Tax Credit (LIHC), the basis of the LIHC must be reduced by 100 percent of the expenditures relating to the Rehabilitation Credit before determining the qualified basis of the LIHC and the correct amount of depreciation. |

## Appendix D

### REFERENCE GUIDE

The following list, while not all-inclusive, is provided as an initial reference of the supporting authority for this area of tax law and is presented within the topical order to which it is relevant.

**QUALIFIED LOW-INCOME HOUSING PROJECT**

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| * Revenue Ruling 91-38 | LIHC Questions and Answers |
| * Revenue Ruling 94-57 | Changes in Area Median Gross Income |
| * Revenue Procedure 94-9 | Number of Bedroom Method Election |
| * Revenue Procedure 94-10 | Deep Rent Skewed Election |
| * Revenue Procedure 94-57 | Gross Rent Floor |
| * Notice 88-80 | Determination of Income |

**ELIGIBLE BASIS**

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| * Notice 88-116 | Construction, Reconstruction or Rehabilitation Costs and Placed In Service Definitions |

**QUALIFIED BASIS**

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| * Revenue Ruling 92-61 | Treatment of Resident Manager's Unit |

**CALCULATING THE LIHC**

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| * Revenue Ruling 92-79 | Extended-Use Commitment |

**RECAPTURE OF THE CREDIT**

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| * Revenue Ruling 90-60 | Satisfactory Bonds |
| * Revenue Ruling 99-1 | Bond Factor Amounts are published quarterly |
| * Announcement 94-130 | Additional Instructions for Form 8693 (Termination of Liability on a Bond) |

**QUALIFIED NONPROFIT ORGANIZATIONS**

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| * Revenue Procedure 96-32 | Safe Harbor Guidelines for Nonprofits |
| * U.S. Tax Court Case | ***Housing Pioneers, Inc. v. Commissioner*** |

**STATE ADMINISTRATION OF THE LOW-INCOME HOUSING CREDIT**

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| * Revenue Procedure 94-64 | Obtaining a Waiver of Annual Income Recertification |
| * Revenue Procedure 94-65 | Annual Income Certification Requirement |
| * Notice 88-91 | Building Identification Number |

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<u>**Appendix E**</u>

## FORMS USED IN CONNECTION WITH THE LOW-INCOME HOUSING CREDIT

### COMPREHENSIVE LIST

* **Form 8586** -- Low-Income Housing Credit
* **Form 8609** -- Low-Income Housing Credit Allocation Certification
* **Form 8609 Schedule A** -- Annual Statement
* **Form 8610** -- Annual Low-Income Housing Credit Agencies Report
* **Form 8611** -- Recapture of Low-Income Housing Credit
* **Form 8693** -- Low-Income Housing Credit Disposition Bond
* **Form 8703** -- Annual Certification of a Residential Rental Project
* **Form 8823** -- Low-Income Housing Credit Agencies Report of Noncompliance
* **Form 8038** -- Information Return for Tax-Exempt Private Activity Bonds
* **Form 8038-GC** -- Information Return for Small Tax-Exempt Government Bond Issues, Leases, and Installment Sales
* **Form 8038-T** -- Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate
* **Indenture of Restrictive Covenants**
* **Credit Carryover Allocation Agreement**
* **Election for Deep-Rent Skewing and Maximum Rent for Rent Restricted Units**
* **Waiver of Annual Recertifications for 100% Low-Income Projects**

**Form 8586 -- Low-Income Housing Credit**

Taxpayers use this form to claim the credit for low-income housing and compute the tax liability limitation. Form 8586, Form 8609, and Schedule A (Form 8609), are to be attached to the taxpayer's tax return, unless the credit is received from a flow-through entity, in which case only the Form 8586 is required.

Part I, Current Year Low-Income Housing Credit, allows for the reporting of the eligible and qualified basis of the building(s). Any decreases to qualified basis are also to be reported here. The current year credit, carried from Schedule A (Form 8609) is also recorded in this area. One of the key points, mechanically, of Part I is that it allows consideration to be given to the Passive Activities Restrictions and refers taxpayers to Form 8582 accordingly.

Part II, Tax Liability Limitation, ensures that the proper order of tax credits is considered. The low-income housing credit is included as a part of the general business credit. As the Code specifies, a pecking order for allowed credits, this part of the form ensures that the taxpayers follow this statutory order. Additionally, this part of the form provides consideration of the alternative minimum tax. The taxpayer is only allowed to use the credit to reduce a regular tax liability and this section ensures that any alternative minimum tax is not reduced by the credit.

**Form 8609 - Low-Income Housing Credit Allocation Certification**

Form 8609 is issued to the taxpayer/building owner for each building in a project in the year in which the building is placed in service or the subsequent year. The form reflects the date of the allocation and the maximum credit dollar amount allowable. This is determined by multiplying the maximum credit percentage allowable by the maximum qualified basis. The maximum credit percentage allowable is 70 percent present value credit for all new buildings and rehabilitation expenditures which are not federally subsidized and, if the building is federally subsidized, an election is made to reduce the eligible basis by the amount of federal subsidies. The 30 percent present value credit is allowed for existing buildings and all new buildings and rehabilitation expenditures where the election is not made to reduce the eligible basis by the amount of federal subsidies. The maximum qualified basis is the portion of the eligible basis which represent the low income units.

Part I, Allocation of Credit, of Form 8609 is completed and signed by an authorized official of the state housing credit agency. The Form 8609 is then sent to the Philadelphia Service Center with Form 8610 (see below) and all related attachments in the year in which an allocation is made. Part I also discloses the percentage of aggregate basis which is financed by tax-exempt bonds, whether the building is in a

qualified census tract or a difficult to develop area, and the date in which the building is placed in service.

Part II, First-Year Certification, is completed by the taxpayer, designating the first year of the credit period. A copy of the form is then signed and filed with Form 8609 -- Schedule A and Form 8586 in the year in which the credit is claimed. The original unsigned copy is held for filing with future year tax returns so each year of the 15-year compliance period, an original signature will appear on the form for the declaration under penalties of perjury. The Part II discloses certain irrevocable elections which must be made in the first year of the credit period. These include the elections to claim the credit in the year after the building is placed in service, the minimum set-aside requirements (20-50 and 40-60 tests), and the election not to treat a large partnership as the taxpayer.

If the above certification is not made by the taxpayer by the due date of the tax return for the first year of the credit period, no low-income housing credit is allowed for any taxable year before the certification is made. The Code also states that the Secretary may require taxpayers to annually submit information returns and incorporates a penalty under IRC section 6652(j), Failure to File Certification with Respect to Certain Residential Rental Projects, for failure to comply.

## Schedule A (Form 8609) -- Annual Statement

Schedule A (Form 8609) is completed by the taxpayer and filed annually with the taxpayer' s tax return and Forms 8609 and 8586 for each year during the 15-year compliance period. The schedule discloses increases or decreases in eligible basis, modified credit percentage, additions to qualified basis and other information as it pertains to a particular year.

## Form 8610 -- Annual Low-Income Housing Credit Agencies Report

Form 8610 is used by the Agencies to transmit all issued Forms 8609, allocating documents, binding agreements, and election statements to the Philadelphia Service Center. The form must be filed by February 28 of the year following the year in which the information on the form pertains. A penalty under IRC section 6652(j), Failure to File Certification with Respect to Certain Residential Rental Projects, of $100 per failure applies for each failure to file.

**Applicable Law:**

IRC section 42(l) -- Certifications and Reports to the Secretary
IRC section 42(m) -- Responsibilities of Housing Credit Agencies
Treas. Reg. section 1.42-5(a) -(h) -- Monitoring Compliance, Record keeping & Retention & Reviews
Treas. Reg. section 1.42-13(a) (proposed) -- Correction of Administrative Errors and Omissions
Treas. Reg. section 1.42-1T(d)(8) -- Housing Credit Allocations
Treas. Reg. section 1.42-1T(e) -- Limitation on Allocated Credit
Treas. Reg. section 1.42-1T(h) -- Filing of Forms and Special Rules

## Form 8611 -- Recapture of Low-Income Housing Credit

Form 8611 is used by the taxpayer if they must recapture the low-income housing credit due to a decrease in qualified basis or if they disposed of the building without posting satisfactory bond. Generally, the recapture is 1/3 or the accelerated portion of the credit. In addition to the recapture, the taxpayer must compute the interest using the overpayment rate for each prior tax year for which the credit is being recaptured. Interest is computed from the due date of the return for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

**Applicable Law:**

IRC section 42(j) -- Recapture of Credit

## Form 8693 -- Low-Income Housing Credit Disposition Bond

Form 8693 is used by a seller of a building or ownership interest in a building to post satisfactory bond to avoid the recapture provisions if it is reasonably expected that the building will continue to be operated as a qualified low income building for the remainder of the compliance period. The bond is forfeited proportionately as the qualified basis decreases. The seller must post satisfactory bond with one of the Bond Surety Companies listed in Circular 570. The bond must be maintained for at least 58 months after the end of the compliance period. Satisfactory bond factor amounts are announced periodically through Revenue Rulings.

**Applicable Law:**

IRC section 42(j)(6) - No Recapture Where Bond Posted
Rev. Rul. 90-60 -- Satisfactory Bond

Circular 570 -- Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies

**Form 8703 -- Annual Certification of a Residential Rental Project**

Form 8703 is used by an operator of a low-income project to provide annual information used to determine if a project continues to be a qualified project. If so, the interest paid on exempt facility bonds (if financed with such bonds) is not taxable to the recipient. A separate Form 8703 must be filed annually by March 31st for each project for which an election was made under IRC section 142(d). All Forms 8703 are filed with the Philadelphia Service Center. IRC section 6652(j), Failure to File Certification with Respect to Certain Residential Rental Projects, provides for a penalty of $100 for each failure to comply.

**Applicable Law:**

IRC section 142(d) -- Qualified Residential Rental Project

**Form 8823 -- Low Income Housing Credit Agencies Report of Noncompliance**

Form 8823 is used by the Agencies to notify the IRS of a building that is not in compliance with the low-income housing tax credit provisions. These forms are currently being filed at the Philadelphia Service Center and maintained on a low-income housing database.

**Applicable Law:**

IRC section 42(m) -- Responsibilities of Housing Credit Agencies
Treas. Reg. section 1.42-5(a) - (g) -- Monitoring Compliance

**Form 8038 -- Information Return for Tax Exempt Private Activity Bonds**

Form 8038 is used by issuers of tax-exempt private activity bonds to provide information regarding the issue. This form is used for all types of private activity bonds including exempt facility bonds (which would include tax-exempt bonds for low-income housing projects). The form is filed with the Philadelphia Service Center by the 15th day of the second month following the calendar quarter that contains the issue date. The issuer may be granted an extension of time to file. Although there are no provisions regarding penalties, failure to file a Form 8038 should result in the loss of tax-exempt status.

## Form 8038-G -- Information Return for Tax-Exempt Governmental Obligations

Form 8038-G is used by issuers of tax-exempt governmental obligations if the price of the issue is $100,000 or more and the obligations were issued after December 31, 1986, to provide information regarding the issue. The form is filed with the Philadelphia Service Center by the 15th day of the second month following the calendar quarter that contains the issue date. The issuer may be granted an extension of time to file. There are no provisions regarding penalties.

## Form 8038-GC -- Information Return for Small Tax-Exempt Government Bond Issues, Leases, and Installment Sales

Form 8038-GC is used by issuers of tax-exempt governmental obligations of less than $100,000 to provide information regarding the issue. The form is filed with the Philadelphia Service Center by the 15th day of the second month following the calendar quarter that contains the issue date. The issuer may be granted an extension of time to file. There are no provisions regarding penalties.

## Form 8038-T -- Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate

Form 8038-T is used to pay the arbitrage rebate to the United States or to pay the penalty in lieu of the arbitrage rebate. The form and installments are due 60 days after the end of every 5th bond year during the term of the issue, and are filed with the Philadelphia Service Center. The penalty for failure to file and pay on time is computed on the form.

**Applicable Law:**

IRC sections 141 through 159 -- Bonds

## Extended Low-Income Housing Commitment

This is a binding legal agreement between the taxpayer and the Agency where the taxpayer makes a commitment for 15 or more years for the low income housing project. The agreement must be in writing, binding under state law, specify the type of building (new, existing, rehabilitation expenses), states all representations, warranties, terms, etc., *** and is dated and signed by both the taxpayer and the Agency. There is also an agreement to extend the commitment between the taxpayer and the Agency recorded pursuant to state law as a restrictive covenant. The commitment extends the compliance period to 30 or more years.

**Applicable Law:**

IRC section 42(h)(6) -- Minimum Long-term Commitment to Low-Income Housing

## Credit Allocation Carryover Agreement

After the Agency reviews the taxpayer's application, an agreement for carryover allocation may be executed to either (1) reserve the credit amount to be allocated or (2) make a carryover allocation that is subject to certain terms and conditions. The taxpayer must provide the Agency with evidence that at the close of the allocation year the taxpayer's adjusted basis or carryover allocation basis in the building is more than 10 percent of the taxpayer's reasonably expected basis at the end of the second calendar year following the year the carryover allocation is made. The carryover allocation basis is the taxpayer's adjusted basis in land and depreciable real property for the entire project. This carryover allocation and supporting documentation should be filed with Form 8610 by the Agency for the year executed. The taxpayer must file the agreement with Form 8609 in the first year the credit is claimed.

Along with this agreement, the taxpayer can make an election as to the appropriate percentage month. This would be the month which the building is placed in service, or the month which the binding agreement is entered into. For 50 percent or more tax-exempt bond financed projects which affect the volume cap, the appropriate percentage month can be any one month in which the bonds were issued. The election can be made as part of the binding agreement, but is usually made in a separate document, the "Election of Low Income Housing Tax Credit Percentage," which references the binding agreement. This irrevocable election must be in writing, signed by the taxpayer, must refer to the binding agreement, and be notarized by the end of the 5th day following the end of the month in which the binding agreement is made. The taxpayer must give the notarized original election to the Agency and file a copy with the Form 8609 in the first tax year in which the credit is claimed. The Agency must file the original election with the Form 8610 for the year the allocation is made. The taxpayer and Agency must keep copies of all documents. See explanation of each individual form for time for filing.

**Applicable Law:**

Treas. Reg. section 1.42-6(a) - (e) -- Carryover Allocations
Treas. Reg. section 1.42-1T(d)(8) - Housing Credit Allocations
Treas. Reg. section 1.42-8(a) & (b) - Binding Agreement and Election of Appropriate Percent Month
Notice 89-1 -- Election of Appropriate Percent Month
IRC section 42(b)(2)(A) -- Appropriate Percent Month
IRC section 42(h)(1)(E) -- Exception for 10 Percent of Reasonably Expected Basis

## Election for Deep-Rent Skewing and Maximum Rent for Rent-Restricted Units

These elections are to be made under the Revenue Reconciliation Act of 1993. Revenue Procedures 94-9 and 94-10 explain the procedures which allow a building owner who received a credit allocation prior to 1990 to make these elections. The first election under Rev. Proc. 94-9 allows the building owner to determine the gross rent limitation for rent-restricted units under the number of bedroom method. The second election allows project owners to satisfy the 200-percent gross rent restriction for a deep rent skewed project. All written elections must have been sent by February 7, 1994, to the Philadelphia Service Center. A copy of the elections must also be sent to the state housing credit agency and also attached to the Form 8609 for the tax year of the election. The owner must also maintain a copy.

**Applicable Law:**

Rev. Proc. 94-9 and 94-10 -- Elections Regarding Rent Restricted Units
IRC section 42(g)(2)(C) -- Rent Restricted Units
IRC section 42(g)(4) -- Certain Rules Made Applicable
Treas. Reg. section 1.142(d)(4)(B)(iii) -- Tax Exempt Bonds

## Waiver of Annual Recertifications for 100-Percent Low Income Projects

On application by the taxpayer, the Secretary may waive the annual recertification of tenant income if the entire building is occupied by low income tenants and the building owner receives a report from the state to that effect. An owner can submit one waiver for all of the low income buildings in the project. The owner can waive the recertification by sending a written statement signed under penalty of perjury to the Philadelphia Service Center. In addition, a copy of the waiver must be sent to the state agency. The owner is not exempt from the other requirements of IRC section 42.

**Applicable Law:**

IRC section 42(g)(8)(B) -- Annual Recertification Waivers

# GLOSSARY

**15/40 TEST (See also Deep Rent Skewed Election)**

Requirement whereby 15 percent or more of the low-income units must be occupied by households with incomes of 40 percent or less of the area median gross income, adjusted for family size, and be rent-restricted to 30 percent of the applicable income level. This test is referred to as the "deep rent skewed" minimum set-aside election.

**20/50 TEST**

Requirement whereby 20 percent or more of the residential rental units are rent-restricted and occupied by households with incomes of 50 percent or less of the area median gross income, adjusted for family size. This test is referred to as one of the "minimum set-aside" requirements. Compliance with the minimum set-aside requirements must be maintained at all times during the 15-year compliance period. Failure to meet the elected test would disqualify a project from being eligible for the credit.

**25/60 TEST**

Requirement whereby 25 percent or more of the residential rental units are rent-restricted and occupied by households with incomes of 60 percent or less of the area median gross income, adjusted for family size. This test is available only to buildings located in New York City and is offered in lieu of the 40/60 test.

**40/60 TEST**

Requirement whereby 40 percent or more of the residential rental units are rent-restricted and occupied by households with incomes of 60 percent or less of the area median gross income, adjusted for family size. This test is referred to as one of the "minimum set-aside" requirements. Compliance with the minimum set-aside requirements must be maintained at all times during the 15-year compliance period. Failure to meet the elected test would disqualify a project from being eligible for the credit.

**30 PERCENT CREDIT**

This 30 percent present value credit applies to acquisitions of existing housing or for new construction/rehabilitations which are federally subsidized. The 30 percent credit will yield, over the 10-year credit period, a tax benefit equal to 30 percent of qualifying costs. On an annual basis, this present value computation approximates a 4-percent figure each year over the credit period to arrive at the 30-percent credit.

**70 PERCENT CREDIT**

This 70-percent present value credit applies to new construction and qualifying rehabilitations. The 70-percent credit will yield, over the 10-year credit period, a tax benefit equal to 70 percent of qualifying costs. On an annual basis, this present value computation approximates a 9-percent figure each year over the credit period to arrive at the 70-percent credit.

**ACCELERATED PORTION OF THE CREDIT**

In exchange for 10 years of tax credits, under the low-income housing credit program, a building owner agrees to comply with IRC section 42 for at least a 15-year period. This accelerates the tax benefits over a shorter term and lengthens compliance to 15 years. In each of the 10 years of the credit period, the building owner effectively receives an additional 1/3 of the credit which is accelerated from the 11th through 15th years. Thus, the credit for each year consists of both the "earned" portion (2/3) and the accelerated portion (1/3). It is the accelerated or unearned portion that must be recaptured as a result of decreases in qualified basis or disposition events.

**ALLOCATION**

A building must receive low-income credit authority from the credit agency in whose jurisdiction the qualifying low-income building is located.

**ALTERNATIVE MINIMUM TAX**

This tax, imposed under IRC section 55 (see also IRC sections 56 and 57) establishes a "minimum" tax liability for taxpayers participating in activities specified to yield a "tax preference". Taxpayers involved in LIHC activities cannot use the credit to reduce a taxpayer's tentative minimum tax.

**APPLICABLE FRACTION**

Used in the determination of qualified basis, the applicable fraction is the smaller of either the unit fraction or floor space fraction and represents the low-income portion of the building.

**APPLICABLE PERCENTAGE**

This is the credit percentage specific to a low-income housing project. Depending on the nature of the project, the applicable percentage may be either 4 percent or 90 percent (restated as approximating 30 percent and 70 percent in present value terms).

**AREA MEDIAN GROSS INCOME (AMGI)**

Term which represents the "midpoint" (that is, half are above and the other half are below) income level for a given area. These figures are published annually by HUD based on various population and earnings data. The AMGI figure, as adjusted for family size, is used in the determination of whether or not a household qualifies as "low-income" for purposes of the LIHC program.

**AT-RISK RULES**

These are rules provided by IRC sections 49(a) and 42(k), generally limiting an investor's ability to receive a tax benefit for which he has borne no economic risk and relates to the sources of financing. With respect to the low-income housing credit, the at-risk rule limits the inclusion into eligible basis of any property purchased with nonqualified nonrecourse financing, although an exception exists for "qualified commercial financing".

**AVERAGING RULE**

In the first year of the credit period, the allowable credit amount is determined using an averaging convention. This computation reflects the number of months in which the units comprising the qualified basis figure were occupied by low-income households. To the extent that the allowable credit for the first year is reduced by this averaging convention, the disallowed credit would be carried forward for use in the 11th taxable year.

**BARGAIN PURCHASE**

This term refers to the sale of a low-income project for an amount equal to the assumption of its liabilities. A charitable contribution is calculated based on the difference between the sales price and the project's fair market value. With regard to IRC section 42, a bargain purchase is usually structured between a partnership building owner and a non-profit organization at the end of the compliance period.

**BEDROOM ELECTION**

This election allows owners of low-income buildings with allocations before 1990 or on financed buildings placed in service before 1990 to determine the gross rent limitation for rent-restricted units under the number of bedrooms method. In this method, a set occupancy is assigned based on the number of bedrooms contained in the low-income unit. Previously, the actual number of occupants was used to determine the rent restriction. Refer to Rev. Proc. 94-9.

**BELOW MARKET LOANS**

This is a loan funded in whole or part with federal funds, if the loan is less than the applicable federal rate in effect under IRC section 1271(d)(4). There are six basic categories of below market federal loan programs: (1) federal tax-exempt interest loans, (2) IRC section 236 loans, (3) IRC section 515 loans, (4) IRC section 312 loans, (5) IRC section 221(d)(3) and (4) loans, and (6) flexible subsidy loans.

**BINDING COMMITMENT**

An agreement by the state agency to allocate the credit to the taxpayer at a future date. This agreement may include a reservation of credit or binding commitment to allocate credit in a future taxable year. A binding agreement can also be a carryover allocation under IRC section 42(h)(1)(E) or (F). (See Treas. Reg. section 1.42-6.).

**BUILDING IDENTIFICATION NUMBER**

This is the nine digit, alpha numeric designation assigned by the state housing credit agency to a low-income building. Essential to the monitoring process for IRC section 42, IRS Notice 88-91 provides information regarding building identification number requirements.

**CARRYBACK AND CARRYFORWARD CREDITS**

The low-income housing credit is subject to the IRC sections 38 and 39 rules of the general business credit, which limits the amount of income tax liability which can be reduced by this credit in a given year. The general rule for any unused credits arising in a taxable year beginning on or before December 31, 1997, is that they may be carried back to each of the 3 preceding taxable years and then carried forward to each of the 15 following taxable years. This rule is adjusted for the low-income housing credit so that no credit may be carried back to a taxable period prior to the creation of IRC section 42 (that is, taxable years prior to January 1, 1987). If the credit arises in a tax year beginning after December 31, 1997, the carryback and carryforward periods are, respectively, 1 year and 20 years. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 21 taxable ears to which such credit may be carried. The amount of the unused credit for the unused credit year shall be carried to each of the other 20 taxable years to the extent that such unused credit may not be taken into account under section 38(a) for a prior taxable year because of the limitations of subsection (b) and (c).

**CARRYOVER ALLOCATION**

Added by Congress in 1988, a carryover allocation allows the state to allocate credits to a project which has not yet been placed in service. Restrictions are included in this

agreement, stating that (1) 10 percent of the reasonably expected costs have been incurred by the end of the year in which the carryover allocation was granted and (2) the building must be placed in service generally no later than the end of the second calendar year following the year of such allocation. The state housing credit ceiling is reduced by the amount of any carryover allocations made during the year. Guidelines regarding information to be included in a carryover allocation document are provided in Treas. Reg. section 1.42-6(d)(2).

**C.D.B.G. (COMMUNITY DEVELOPMENT BLOCK GRANT)**

These grants are a type of federal subsidy commonly used in low-income housing credit projects. Loans from this program are not treated as a federal subsidy for purposes of determining the appropriate credit percentage, thus allowing these projects to qualify for the 9-percent credit.

**COMMUNITY REINVESTMENT ACT (CRA)**

This 1977 Act requires that financial institutions meet the credit needs of all members of their community, including the lower-income members. Many financial institutions will invest in low-income housing tax credit projects to help meet their responsibilities under the CRA.

**COMPLIANCE PERIOD**

This is the 15-year period over which a project must maintain compliance with IRC section 42. This period begins with the first taxable year of the credit period.

**CONSTITUTIONAL HOME RULE**

Special allocation rules apply to certain political subdivisions with "home rule" powers under a state constitution. The aggregate housing dollar amount for any constitutional home rule city for any calendar year shall be an amount which bears the same ratio to the state housing credit ceiling for such calendar year as the population of such city bears to the population of the entire state. See IRC sections 42(h)(3)(E) and 146(d)(3)(C).

**CREDIT PERIOD**

This is a 10-year period which generally begins in the year a property is placed in service. A taxpayer may instead elect to begin the credit period in the year following the one in which the building was placed in service. The LIHC is claimed annually for this 10-year period.

**DEEP RENT SKEWED ELECTION (SEE ALSO 15/40 TEST)**

A project may make this election when the minimum set-aside test of 15/40 is met, the rent is restricted to 30 percent of the applicable income limitations, and the rent for low-income units is not greater than 50 percent of rents charged to market tenants for comparable units.

**DIFFICULT DEVELOPMENT AREAS**

A "difficult development area" is one designated by the Secretary of Housing and Urban Development as an area which has high construction, land and utility costs relative to area median gross income. A building located in this area may be eligible for an increased credit by being granted up to a 30-percent increase in eligible basis for low-income housing credit projects (for a total eligible basis equaling up to 130 percent of eligible basis).

**DISPROPORTIONATE STANDARDS**

These standards describe a building consisting of both market rate and low-income tenants, and having an average cost per square foot attributed to the market rate units exceeding 15 percent of similar costs for low-income units. Once deemed to be disproportionate, the costs related to the market units would not be includible in the project's eligible basis. If the market unit costs do not exceed 15 percent, a building owner may exclude the excess of the market costs over the low-income costs (that is, include the comparable portion of the market costs into the eligible basis computation).

**ELIGIBLE BASIS**

Eligible basis consists of (1) the cost of new construction, (2) the cost of rehabilitation, or (3) the cost of acquisition of an existing building. Eligible basis includes only the adjusted basis of the building (including certain items of personal property and site improvements) and does not include the cost of land. Basis is generally determined at the time the building is placed in service.

**EQUITY**

Funds provided by investors in a project represent equity. The amount of this investment is contingent upon the value attributed to the tax benefits generated by ownership in the project. Represents one of the basic financing layers in a project.

**EQUITY GAP**

Equity gap is the term applied to the difference between the total costs required to develop a project and the financing provided by first mortgages and investor equity. Soft seconds and grants used to cover this difference are referred to as "gap financing."

**EXTENDED USE COMMITMENT**

Program requirement applicable to post-1989 years. The extended use period begins with the first day of the 15-year compliance period and ends 15 or more year after the close of the initial compliance period -- creating a 30 or more year period under which the building owner must be in compliance with IRC section 42.

**FEDERAL GRANTS**

Grants are funds which are provided to a project by the federal government and which do not require repayment. The eligible basis of a project is to be reduced by any federal grants, regardless of when made. Examples of federal grants include Community Development Block Grants, Urban Development Action Grants, and Rental Rehabilitation Grants.

**FARMERS HOME ADMINISTRATION (FmHA)**

See Rural Housing Service.

**FLOOR SPACE FRACTION**

The proportion of low-income related floor space to all residential rental floor space (whether occupied or not) in the building.

**FORECLOSURE**

Situation whereby a building owner defaults on a mortgage held against a project and legal possession of the property is assumed by the mortgage holder.

**FOUR PERCENT CREDIT**

See "30-Percent Credit."

**GENERAL BUSINESS CREDIT**

Federal tax credit offered under IRC section 38. Referred to as an "umbrella" credit, where several individual credits are provided for under this one general heading. In

addition to the rules specific to these individual credits, which includes the low-income housing tax credit, the rules relating to the general business credit also apply. These include tax liability limitations as well as carryback and carryforward restrictions.

**GENERAL PUBLIC USE**

The legislative history of IRC section 42 and Treas. Reg. section 1.42-9 provides that the residential rental units upon which a low-income housing credit is taken must be available for use by the general public. A residential rental unit is for use by the general public if the unit is rented in a manner consistent with housing policy governing nondiscrimination. HUD Handbook 4350.3 is the appropriate reference source.

**GROSS RENT LIMITATION**

Gross rent may not exceed 30 percent of the applicable qualifying income as adjusted for household size. Gross rent includes the cost of any utilities, except telephone. If utilities are paid directly by the tenant, the maximum rent must be reduced by the amount of the utility allowance. The gross rent limitation applies only to payments made directly by the tenant. Any rental assistance payments (such as [HUD] Section 8 payments) are not included in the gross rent limitation.

**HOME INVESTMENT PARTNERSHIPS ACT (THE HOME PROGRAM)**

The HOME Program, administered by HUD, provides grants to state and local governments for use in projects which increase home ownership and affordable housing opportunities for low and very low-income households. Any below-market loan funded under this program and meeting the special set-aside test of 40/50 is not a federal subsidy. Projects funded with these loans are eligible for the 70 percent present value credit.

**HOUSEHOLD INCOME LIMITATIONS**

One of the requirements of the minimum set-aside test, the income level of a qualifying unit is a set percentage of the Area Median Gross Income figure. In accordance with the minimum set-aside elections, the income level may be no greater than 50 percent or 60 percent of the respective area median gross income.

**INCOME CERTIFICATION**

All qualifying units must have adequate documentation to support the household income limitation at initial lease-up as well as annually throughout the compliance period. Treas. Reg. section 1.42-5(b) provides guidance on this compliance monitoring requirement.

**INTERMEDIATE CARE FACILITY**

Generally defined as a facility which provides frequent or continual nursing, medical or psychiatric care, these facilities do not qualify for the LIHC program.

**LOW-INCOME UNIT**

A low-income unit includes any unit in a qualified low-income building if the individuals occupying such unit meet the income limitations and if the unit meets the gross rent restrictions.

**McKINNEY ACT**

The Stewart B. McKinney Homeless Assistance Act provides definitions regarding "transitional housing," "homeless" individuals and related issues which must be reviewed to evaluate whether or not a building qualifies under the LIHC program under IRC section 42(i)(3)(B)(iii).

**MINIMUM SET-ASIDE TEST**

This is a requirement which must be met at all times during a project's 15-year compliance period. This test restricts rent and dictates which households qualify as low-income and how many units must be occupied by the qualifying households. The two general minimum set-aside tests are the 20/50 and the 40/60 tests. Refer to each for additional specifics.

**MIXED-INCOME PROJECTS**

Mixed-income projects are buildings with both low-income and market rate tenants.

**MULTIPLE BUILDING PROJECTS**

A project may consist of multiple buildings if such buildings are similarly constructed, located on the same tract of land, owned by the same party, and financed under a common plan of financing. These projects may meet the minimum set-aside by having each separate building meet the test within a year of their placed-in-service date or by an election to aggregate the buildings.

**NATIONAL POOL**

Unused state housing credit carryovers for any year are assigned to the Secretary of the Treasury and aggregated into a "national pool," from which credits are re-allocated among qualifying states during the next calendar year. This is an additional source of credits for the state housing credit agencies.

**NEXT AVAILABLE UNIT RULE**

The rule states that if a tenant's income in a low-income unit increases above 140 percent of the applicable income limitations (over-income unit), available units of comparable or smaller size must be rented to low-income tenants to continue treating the over-income unit as a low-income unit. See Treas. Reg. section 1.42-15.

**NINE PERCENT CREDIT**

See "70-Percent Credit".

**NONRECOURSE FINANCING**

For purposes of the low-income housing tax credit, nonrecourse financing generally means any amount for which the taxpayer is protected against loss through guarantee, stop-loss agreements, or other similar arrangements. A taxpayer's basis for purposes of calculating the credit must be reduced by the amount of the "nonqualified nonrecourse financing." Nonqualified nonrecourse financing is any nonrecourse financing which is not qualified commercial financing. See IRC sections 49(a) and 42(k) for the at-risk rules governing the low-income housing tax credit.

**OWNER CERTIFICATION**

Annually, a building owner must provide certification to the state housing credit agency that the low-income units in a project are occupied by qualifying households. Failure to provide such certification, and in a timely manner, will result in the filing of Form 8823 (Noncompliance Report) by the state housing credit agency. However, owners of buildings containing 100-percent low-income tenants may receive a waiver for this requirement. See Rev. Proc. 94-64, 1994-2 C.B. 797.

**PASSIVE LOSS LIMITATIONS**

Governed by IRC section 469, the designation of an activity as passive results in additional restrictions on currently allowable losses and credits. Unused credits and losses may be carried over indefinitely or until such property is disposed of in a fully taxable transaction to an unrelated party. The credit generated by IRC section 42 has relaxed passive activity rules applicable, although the deductions generated by these activities do not. (See Chapter 10 for a more in-depth discussion) .

**PERMANENT FILE**

A "permanent file" is a file consisting of workpapers, tax make-up sheets, source documents, and supporting schedules which would be required in an audit situation. Descriptions of accounting methods, policies, internal control systems, capital asset schedules, and other transaction records may be included.

**PLACED-IN-SERVICE**

"Placed-in service" is defined in IRS Notice 88-116, 1988-2 C.B. 449, as being the date on which the first unit in the building is first certified as being suitable for occupancy under state or local law. For rehabilitations which qualify for treatment as a separate new building, the placed in service date would occur at the end of the 24-month period over which such expenditures are aggregated.

**QUALIFIED BASIS**

This is the figure which, when multiplied by the applicable percentage, equals the low-income housing credit. Qualified basis equals product of the applicable fraction and the eligible basis.

LIHC = Qualified Basis x Applicable Percentage
Qualified Basis = Applicable Fraction x Eligible Basis

**QUALIFIED CENSUS TRACT**

A formal designation made by the Secretary of Housing and Urban Development, applying to a census tract where 50 percent or more of the households have an income which is less than 60 percent of the area median gross income.

**QUALIFIED LOW-INCOME BUILDING**

A building subject to the 15-year compliance period that meets the minimum set-aside and other requirements for all 15 years.

**QUALIFIED PROJECT**

A project that meets the minimum set-aside requirements and other requirements related to those units during the entire 15-year compliance period.

**RECAPTURE**

Recapture refers to an adjustment in which the accelerated portion of the credit, plus interest, is recovered as a result of reductions in qualified basis (including but not limited to the partial or full dispositions of the building or interest therein). If the qualified basis on which credit is taken decreases, recapture applies to that portion of the qualified basis that is no longer eligible for the credit. If a project ceases to meet the minimum set-aside requirement, the project no longer qualifies as a low-income housing project until the minimum set-aside is again met, and recapture is applied to all credits previously taken on the entire project.

**RELATED PARTY RULES**

For purposes of the at-risk rules, IRC section 465(b)(3)(C) provides that a person is related to any person if the related person bears a relationship to such person specified in IRC section 267(b) or IRC section 707(1)(b) or as defined in IRC sections 52(a) and (b). See IRC sections 49(a) and 42(k) for the specific requirements regarding related parties in the application of the at-risk rules and the low-income housing tax credit. See also IRC section 42(d)(2)(D)(iii)(II) for the related party rules concerning whether the placed-in-service rules of IRC section 42(d)(2)(B)(iii) (for the acquisition credit)have been met.

**RESERVATION OF CREDITS**

This is an agreement between a building owner and the state housing credit agency to set aside a specific amount of credits for a project to be used at a later date. Because this agreement does not constitute an allocation of credits, the state credit ceiling pool is not reduced.

**RESIDENT MANAGER UNIT**

The adjusted basis of a unit occupied by a full-time resident manager is included in the eligible basis of a qualified low-income building, but the unit is excluded from the applicable fraction for determining the building's qualified basis. See Rev. Rul. 92-61, 1992-2 C.B.7.

**RESTRICTIVE COVENANT**

A "restrictive covenant" is an agreement drafted to reflect the IRC section 42(h)(6) extended-use commitment made by the building owner to the LIHC program. The extended-use commitment period encompasses the 15-year compliance period and extends a minimum of 15 years past the end of the compliance period. The extended use agreement is recorded as a restrictive covenant and attaches to the property under state law.

**RIGHT OF FIRST REFUSAL**

A "right of first refusal" is an option offered to facilitate the transfer of a low-income property at the end of the compliance period, generally to a nonprofit sponsor of the project. The offer provides the nonprofit, tenants in cooperatives, a resident management corporation, or government agency, with the first opportunity to purchase the project after the compliance period (notwithstanding the extended-use commitment), generally for an amount equal to any outstanding investor indebtedness as well as any appropriate exit taxes.

**RURAL HOUSING SERVICE**

The Rural Housing Service, formerly known as the Farmers Home Administration, is an agency of the U.S. Department of Agriculture, which provides qualified public, nonprofit organizations, and public agencies with grant funds for programs to assist very-low and low-income homeowners repair and rehabilitate their homes in rural areas and to assist rental property owners and co-ops repair and rehabilitate their units if they agree to make such units available to low and very-low-income persons. Financial assistance provided by grantees may include loans, grants, interest reduction on commercial loans or other assistance.

**SCATTERED SITE PROJECT**

A project consisting of multiple buildings having similarly constructed housing units which are located on the same tract of land, are owned by the same person for Federal income tax purposes, and financed pursuant to a common plan of financing. If all units are 100-percent rent restricted, the buildings need not be on the same tract of land.

**SECTION 8 PROGRAM**

Refers to the rental assistance programs under Section 8 of the United States Housing Act of 1937 which assist low and very-low income families obtain decent housing in private accommodations.

**SECTION 515 PROGRAM**

Administered by the Rural Housing Services, the section 515 Rural Rental Housing Loan Program provides loans to finance rental and cooperatively-owned housing of modest design for very-low, low and moderate income families, the elderly, and the handicapped. Funds can be used to construct new housing or to purchase and/or rehabilitate existing structures for rental purposes.

**SINGLE ROOM OCCUPANCY (SRO) UNITS**

Residential rental units must generally contain complete living, sleeping, eating, cooking and sanitation facilities. IRC section 42 provides an exception to this definition which allows SRO units to qualify as residential rental units even if eating, cooking, and sanitation facilities are on a shared basis.

**SOFT SECOND FINANCING**

This term refers to a second layer of debt financing with very low or no current interest payments.

**STATE HOUSING CREDIT AGENCY**

An agency generally consisting of two separate divisions (allocation and compliance) that is a governmental unit within a state which allocates the low-income housing tax credit. The allocation division is responsible for scoring applications, making reservations and granting allocations. The compliance division reviews the annual income certifications and the compliance audits required under the Treas. Reg. section 1.42-5.

**STUDENT TENANTS**

Units occupied entirely by full time students will not be considered to qualify for the LIHC. Exceptions apply for students who are single parents of children which are also full time students, provided no one is claimed as a dependent of a third party. Married students who file a joint return are also exceptions, as are students enrolled in certain job training programs or those receiving assistance under Title IV of the Social Security Act.

**SUBSIDY LAYERING**

This relates to coordination of HUD programs with the LIHC program. Projects which avail themselves of HUD subsidies must notify HUD of their intentions to use the IRC section 42 tax credit. These projects are reviewed to ensure that they are not over-subsidized or appropriated funds which would negate the intent of the programs. HUD published administrative guidelines to facilitate these reviews, which are handled in some areas by the state housing credit agencies.

**SUBSTANTIAL REHABILITATION**

These are expenditures of a capital nature, which apply to or substantially benefit one or more of the low-income units, and also meet the greater of either 10 percent of the adjusted basis of the building or an average of $3,000 of qualified basis per low-income unit. These expenditures are tested over a 24-month period selected by the building owner.

**SYNDICATOR**

This is an agent involved in the sale of a project. Expenses related to the sale, (soft costs), are not depreciable and therefore not included in the project's eligible basis.

**TEN PERCENT TEST**

This test refers to a carryover allocation requirement, which states that 10 percent of the reasonably expected project costs must be incurred by the owner by the end of the calendar year in which the allocation was made in order for the allocation to be valid.

**TEN YEAR RULE**

This rule is a restriction on a building acquired by purchase. A building will not qualify for the acquisition credit unless the purchase is 10 or more years after the building had been previously placed in service or after the date of the most recent nonqualified substantial improvement. Exceptions are discussed in IRC section 42(d)(2)(D)(ii).

**TRANSITIONAL HOUSING**

A project designed to provide short-term housing and appropriate supportive services to homeless persons, including those persons with mental disabilities and those with children.

**UNIT FRACTION**

The proportion of low-income units to all residential rental units (whether occupied or not) in the building.

**UTILITY ALLOWANCE**

A portion of the gross rent figure represents utility expenses (other than telephone). In a situation where the tenant pays directly for utilities, the maximum rent charged must include the amount of the utility allowance.

**WAIVER OF TENANT INCOME RECERTIFICATION**

A request by a building owner to the Secretary of the Treasury to have the annual income certification for each low-income tenant in a qualified low-income building to the state housing agency waived. This applies to 100-percent low-income buildings only and does not release the building owners from the responsibility of having to satisfy the requirements of the monitoring procedure adopted by the state housing agency. See Rev. Proc. 94-64, 1994-2 C.B. 797.