LIHC Newsletter

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The LIHC Newsletter provides a forum for networking and sharing information about IRC 42, the Low-Income Housing Credit, and communicating technical knowledge and skills, guidance, and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The content of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

INSIDE THIS ISSUE:

Impact Fees & Dedicated Improvements: Audit Issues and Techniques

Impact Fees are one-time charges imposed by a state or local government against new development or expansion of existing development to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. Generally, impact fees are refundable (in full or in part) if the new or expanded development ultimately is not constructed as planned.

The question is, are impact fees includable in Eligible Basis? This issue was addressed in Rev. Rul. 2002-09; i.e., “Impact Fees" incurred in connection with the construction of a new residential rental building are capitalized costs allocable to the building under IRC §§ 263(a) and 263A. Therefore, the costs are included in Eligible Basis to the same extent they are allocable to the building under IRC §§ 263(a) and 263A.

Similarly, the cost of “dedicated improvements” is includible in Eligible Basis. The reasoning provided in PLR 200916007 should be applied:

1. The costs incurred by a taxpayer to construct the infrastructure improvements for a project are dedicated improvements for purposes of IRC §263(a) and Treas. Reg. §1.263(a)-4(d)(8)(iv) and, therefore, are not capitalizable as amounts paid to create an intangible under Treas. Reg. §1.263(a)-4(d)(8)(i).
2. The costs incurred by a taxpayer to construct the infrastructure improvements for a project are indirect costs, within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) for purposes of IRC §263A, and are capitalizable into the bases of the project's residential rental buildings, using a reasonable method of allocation under Treas. Reg. §1.263A-1(f) to allocate the costs among the residential rental buildings.
3. Assuming that project's residential rental buildings will be depreciated as residential rental property under IRC §168, the eligible basis of the project's residential rental buildings under IRC §42(d)(1) includes the cost of the infrastructure improvements.

<u>Audit Issues and Techniques</u>

As for all costs includable in Eligible Basis, there are criteria and substantiation issues to address during an audit.

Character

Is the cost, by definition an “impact fee” or “dedicated improvement?”

In Rev. Rul. 2002-09, the taxpayer was required by the county to pay impact fees for schools, law enforcement, and fire protection facilities to compensate the county for the financial impact of the taxpayer’s new buildings. The taxpayer paid the impact fees when the construction permit for the building was issued.

In PLR 200916007, the city required the taxpayer to construct streets and other infrastructure improvements to provide residents of the residential rental buildings access to the existing streets and in-

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Impact Fees and Dedicated Improvements…..

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frastructure; i.e., two-lane streets, curbs, sidewalks, storm water drainage, and domestic water in-flow. In addition, the taxpayer was required to purchase and install, at its own cost, the infrastructure needed by utility companies to install underground utilities, including utility steel casings within the streets through which the utilities run gas lines, electrical wiring, cable, and phone wires.

The taxpayer should provide documentation that the impact fee was imposed as a condition for constructing the low-income building, or that the taxpayer was required to provide specified dedicated improvements.

Dollar Value

As with all substantiation issues, the taxpayer must provide sufficient documentation of the dollar value of the cost incurred.

When Incurred

Generally, under IRC §42(d)(1), a cost must be incurred before the close of the first year of the credit period to be included in eligible basis.

Improvements Dedicated to Government Entity

If the taxpayer constructed dedicated improvements, the taxpayer must also demonstrate that:

1. ownership was transferred from the taxpayer to the government entity, and
2. the government entity assumed responsibility for maintaining the dedicated improvements.

Credit, Compliance & Extended Use Periods: Audit Significance

There are three time period unique to IRC §42; the credit, compliance and extended use periods. These periods are building-specific and should be identified as early as possible in the audit.

Credit Period

IRC §42(f)(1) defines the credit period, with respect to any *building*, as the 10-year period beginning with:

1. the taxable year in which the building is placed in service, or
2. at the election of the taxpayer, the succeeding taxable year.

Language immediately following IRC §42(f)(1) explains that:

- IRC §42(f)(1) only applies if the building is a qualified low-income building as of the close of the first year of such period, and
- The election to begin the credit period the taxable year succeeding the year the building is placed in service is irrevocable, once made.

If a building was acquired and then rehabilitated, there are two credit allocations and the taxpayer will file two Forms 8609-A with its tax return; one for the acquisition credit and another for the rehabilitation credit.

- Under IRC §42(f)(5), the credit period for the existing building (acquisition credit) cannot begin before the credit period for the rehabilitation credit.
- Under IRC §42(e)(4)(B), the applicable fraction for the substantial rehabilitation credit is the same as the applicable fraction for the acquisition credit.

What You Need to Know

Therefore, to determine a low-income building's credit period, an examiner needs to know when the building was placed in service and whether the taxpayer made the election to begin the credit period the succeeding year. Form 8609, Low-Income Housing Credit Allocation and Certification, documents the placed in service date on line 5 and the election on line 10a.

The "credit period" is important because, under IRC §42 (a), the credit is allowable only for taxable years in the credit period. From a taxpayer's perspective, the credit period represents 10-year stream of tax credits to off-set federal income tax liabilities.

There are two important caveats to this general rule.

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- *Special Rule for the First Year of Credit Period*

Regardless of when during the year a building is placed in service during the taxable year, the credit period begins on the first day of the taxable year. As a result, there is usually a gap in time at the beginning of the year when the building is not providing housing before it is placed in service. To account for this fact pattern, IRC §42(f)(2) provides a special "averaging" rule for computing the Applicable Fraction for the first year of the credit period. It is calculated as the sum of Applicable Fractions computed as of the close of each full month of the year that the building was in service, divided by 12. Any credit not allowed in the first year because of this rule is allowed in the 11th year, the first taxable year after the end of the credit period.

There are three common audit issues associated with this special rule:

1. The Applicable Fraction is determined as the smaller of the unit fraction or the floor space fraction (see IRC §42(c)(1)(B)). For the first year, computing the monthly fractions using both methods and comparing the two resulting first-year Applicable Fractions is recordkeeping intensive and a bit tedious since you need to know when each unit was first occupied by a qualifying low-income tenant. It is very tempting to "estimate" the applicable fraction based on the percentage of months that the building was placed in service.

   For example, a building was placed in service on March 15, 2012. Since the buildings was placed in service nine full months (April through December), a calendar-year taxpayer might incorrectly estimate the Applicable Fraction as 9/12 or 75%.

2. For a variety of reasons, a taxpayer may decide to defer the beginning of the credit period to the year following the year placed in service. In which case, a taxpayer may rationalize that since the building was placed in service the entire year, every unit was occupied by a qualified tenant as of the first day of the taxable year. Therefore, the Applicable Fraction is 100%, regardless of whether you use the unit fraction or the floor space fraction.

   For example, a building was placed in service on October 1, 2010. However, not all the amenities were completed by December 31, 2010. The taxpayer wanted to include the cost of the qualifying amenities in eligible basis, which is determined at the end of the first year of the credit period (see IRC §42(d)), so the taxpayer deferred the first year of the credit period to 2011. In October of 2012, when preparing the 2011 tax return, the calendar-year taxpayer incorrectly computed the allowable credit using an Applicable Fraction of 100% on Form 8609-A, line 2.

While the two issues described above are usually associated with the audit of the tax return for the first year of the credit period, there is a complementary issue when auditing the 11th year, i.e., the year after the end of the credit period.

3. The taxpayer can claim the portion of credit not allowable for the first year of the credit period because of the special rule. The credit claimed the first year and the 11th year should never add up to more than the maximum allowable credit identified on Form 8609 line 1b. An issue surfaces when the taxpayer claims credit less than the maximum allowable for the 11th year, but can't document how much credit was claimed the first year.

   No credit would be allowable in the 11th year unless the taxpayer can substantiate or reconstruct the allowable credit for the first year. For tax purposes, 10 years ago is almost ancient history, but Treas. Reg. §1.42-5(b)(2) requires taxpayers owning IRC §42 projects to retain the records for the first year of the credit period for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the building's 15-year compliance period (which will be discussed below).

> There are three critical time periods associated with the life cycle of an IRC §42 housing project; the 10-year **credit** period, the 15-year **compliance** period, and the +30-year **extended use** period.

Two other issues related to the credit period have also been observed during audits:

1. A taxpayer continues to claim the maximum allowable credit after the end of the credit period. I suppose there's a reason we have 10 fingers! No kidding, I am often counting the credit period out with my finger tips!

2. The taxpayer claims credit inconsistent with the election to begin credit period the first year after the building is placed in service.

   For example, a taxpayer places a building in service in 2002 and claimed credit, but elects to postpone the beginning of the credit period to the following year (2003) when completing Form 8609 Part II. The credit period is 2002 through 2011, with any credit not allowable in 2002 allowed in 2012. Based on the Form 8609 "paperwork," however, the credit period would be 2003 through 2012, and any credit not allowable in 2003 allowed in 2013. Relying on the

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Form 8609 information in 2012 and 2013, the taxpayer incorrectly claimed the credit an extra year. That is:

2002 – Credit computed using the special rule to account for when the units were placed in service and first occupied by qualifying tenants.

2003-2012 – Ten years that the taxpayer claimed the maximum allowable credit.

2013 – Credit not allowable in 2002 allowed.

- *Increase in Qualified Basis*

There are times when a building is a low-income building at the end of the first year of the credit period, but not all the residential units in the building are low-income units. If these units qualify as low-income units after the end of the first year of the credit period, then there is an increase in qualified basis.

Under IRC §42(f), the applicable percentage used to compute the credit associated with the "excess" qualified basis is 2/3 of the applicable percentage that would otherwise be used. The credit associated with increases in Qualified Basis is often referred to as the "2/3 credit."

- Under IRC §42(f)(3), there's a "special" rule to compute the applicable fraction for the first year the unit is a low-income unit similar to the rule under IRC §42(f)(2).
- The taxpayer can claim the 2/3 credit each year of the 15-year compliance period (after the first year) to the extent there is "excess" qualified basis.
- On Form 8609-A, the 2/3 credit is accounted for by reducing the allowable by the 1/3 that is not allowed. See Form 8609-A, lines 7 through 11.
- The 2/3 credit is not subject to recapture under IRC §42(j). See IRC §42(j)(4)(C). Any adjustment to the allowable credit made during an audit is first applied against the 2/3 credit.

Increases in Qualified Basis make computing the allowable credit on Form 8609-A a little convoluted and sometime taxpayers compute the allowable credit as:

$$\text{Qualified Basis}_{(\text{First Year})} \times \text{Applicable Percentage} = \text{“Full" Credit}$$

and

$$\text{Qualified Basis}_{(\text{Increase})} \times (2/3)\text{Applicable Percentage} = \text{“2/3" Credit}$$

The taxpayer adds the two together and "forces" the allowable credit on Form 8609-A, line 18, "taxpayer's credit." Claiming this "odd" credit amount must be explained during an audit.

<u>Compliance Period: IRC §42(i)(1)</u>

IRC §42(i)(1) defines the "compliance period" as the period of 15 taxable years beginning with the first taxable year of the 10-year credit period with respect to the low-income building. Once the credit period is identified, the compliance period can easily be computed.

The compliance period is important for the IRS, even though no credit (generally) is allowable during the last five years, because:

1. the taxpayer must file Form 8609-A to complete the IRC §42(l)(2) annual certification each year of the 15-year compliance period, and
2. the taxpayer continues to be subject to the IRC §42(j) credit recapture provisions, although the recapture rate decreases over the last five years.

<u>Extended Use Period: IRC §42(h)(6)(D)</u>

Under IRC §42(h)(6)(d), the extended use period begins on the first day of the building's compliance period and ends on the later of (1) the date specified in the extended use agreement, or (2) the date which is 15 years after the close of the compliance period.

The extended use period is associated with the "extended low-income housing commitment," also referred to as a "land use restrictive covenant" or "agreement." The agreement documents any requirements imposed by the state agency in addition to IRC §42 and is enforceable in state court by the state agency and any prospective, present, or former occupants of the building.

No credit is allowable for any taxable year unless the extended use agreement is recorded in land records.

<u>Common Errors</u>

To summarize, there are three critical time periods associated with the life cycle of an IRC §42 housing project.

- The 10-year credit period,
- The 15-year compliance period, and
- The +30-year extended use period.

Once the 10-year credit period is identified, the 15-year compliance period and +30-year extended use period can be identified. However, there are two easy-to-make and frequently encountered errors.

1. The 10-year credit period begins on the first day of the taxable year that the building was placed in service, or the following year if the taxpayer makes the election. The credit does NOT begin the day the building is placed in service.

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Administrative Procedures

Project/Tracking Codes:
All LIHC cases should include Project Code 0670 and Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designations.

Revenue Protection:

Form 5344, Examination Closing Record, requires entries if you are reducing the amount of credit to be carried forward to a tax year you are not going to audit. Enter the amount of credit carryforward to be disallowed for Item 46. Code "L" should be entered for Item 47. See IRC 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns:

If you believe it is appropriate to survey an LIHC tax return, please fax Form 1900 to Grace Robertson at (202) 283-2485 for signature approval.

TEFRA Requirements:

As IRC §42 project owners are almost always partnerships and are likely to be subject to TEFRA procedural requirements, please remember to document actions taken and decisions made by completing:

- Form 13813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualifications Checksheet
- Form 13827, Tax Matter Partner (TMP) Designation Checksheet

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For example, a calendar-year taxpayer places a low-income building in service on July 15th, 2013. The credit period begins on January 1, 2013, or at the taxpayer's election, on January 1, 2014.

2. When counting out the 10-year period, begin with the first year of the credit period. If the first year is 2013, then the credit period is 2013, 2014, 2015….2022. There is a tendency to start with 2014 because it marks the completion of a year, but it will add an extra year to the 10-year period.

Guide for Completing Form 8823

The "Guide" is available on the IRS website. There's a searchable html version and a downloadable pdf file. On the IRS website, www.irs.gov, enter "ATG" in the search engine. Select the first link on the list of results for "Audit Technique Guides." Then select "L" from the alphabet list and the Guide will be listed as "Low-Income Housing Credit-Guide for Completing Form 8823." Clicking on the title will lead you to the html version and the link to the right of the title will link you to the pdf file.

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♫ Grace Notes ♫

I love words, particularly words I can neither spell nor pronounce. And so much the better if a word gives Microsoft Word's spell check a tizzy. I just learned a new word, "syzygy," pronounced "siz-dzi." Syzygy refers to the straight-line alignment of three celestial bodies within a gravitational system, such as our solar system. For example, there's syzygy when the Earth, Moon, and Sun line up during a lunar eclipse. The gravitational effects of syzygies on planets are being studied. Did you know that in addition to affecting tides, the Sun-Earth-Moon syzgyy can cause moonquakes? But scientists have yet to find a relationship between syzygies and earthquakes, and don't believe there is one because the Earth is 82 times more massive than the Moon.

According to Wikipedia, syzygy is also "loosely" used to describe interesting configurations of planets in general. Since I can't remember the last time I had reason to speak of Sun-Earth-Moon alignments or even "interesting" configurations of planets (as if I'd notice), I propose we include an alternative use of the word "syzygy" to mean "the interesting alignment of circumstances." Next time my manager asks me, "How are things?" I'd really like to answer, "Great! Everything is syzygized." Unfortunately, I'm still not exactly sure how to pronounce "siz-dzi."

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