

# 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.*

## Eligible Basis:

### Construction Loans and Issuing Tax-Exempt Bonds

Eligible Basis is, by definition, the cost of residential rental property as defined in IRC §103 that is depreciable property under IRC §168. IRC §263A is also considered because an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer are capitalized to the property produced. IRC §263A(g)(1) defines “produce” as including constructing, building, installing, manufacturing, developing, or improving. Indirect costs subject to IRC §263A capitalization are defined in Treas. Reg. §1.263A-1(e)(3)(i) as “...all costs other than direct material costs and direct labor costs (in the case of property produced)...Indirect costs are properly allocable to property produced... when the costs directly benefit or are incurred by reason of the performance of production...”

#### Construction Loans

A taxpayer’s third-party costs and fees incurred in obtaining a construction loan are capitalized and amortized over the life of the loan and are not subject to IRC §168. Therefore, the cost is not includable in an IRC §42 building’s eligible basis. IRC §263A, however, requires the amortization deductions relating to the construction loan intangible be capitalized to the produced property during the construction period. The deductions must be reasonably allocated to all property produced. To the extent the amortization deductions are allocable under IRC §263A to the adjusted bases of IRC §168 property that qualifies as residential rental property under IRC §103 or IRC §168 property used in a common area or provided as a comparable amenity to all residential units in the building, the amortization deductions are includable in a low-income building’s eligible basis under IRC §42(d)(1).

#### Costs of Issuing Tax-Exempt Bonds: TAM 200043015

Like construction loans, the costs incurred to obtain tax-exempt bonds are capitalized and amortized over the life of the bond. But unlike construction loans, none of the cost of issuing tax-exempt bonds is includable in Eligible Basis. To summarize the explanation provided in TAM 200043015:

Congress determined that bond issuance costs, the components of which are identified in the legislative history to IRC §142, are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the offering. Characterizing a certain portion of bond issuance costs under IRC §263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Permitting such an IRC §263A characterization of bond issuance costs for purposes of IRC §42 would result in the disparate treatment of the term “residential rental property” between IRC §§ 42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42, that requires that residential rental property have the same meaning for purposes of both IRC §§ 42 and 142.

Accordingly, notwithstanding the general rule of IRC §263A, no portion of bond issuance costs (as these costs are described in the legislative history to IRC §142) are included in eligible basis for purposes of IRC §42(d)(1).

## Section 1602 Funds

The Section 1602 program is part of the American Recovery and Reinvestment Act of 2009. In 2009 and 2010, the housing agencies could exchange a portion of their 2009 credit ceiling (IRC §42 credit available for allocation) for an award of funds that could then be “subawarded” to developers for constructing and rehabilitating low-income rental housing. The IRS issued Notice 2010-18 to provide clarifications, two of which are relevant for auditing taxpayer receiving Section 1602 funds from a housing agency:

### Clarification #2: Income Tax Treatment of Subawards

Based on the legislative history of the Act, subawards made pursuant to section 1602(c) of the Act are excluded from the gross income of recipients and are exempt from taxation.

### Clarification #3: Basis Treatment of Subawards

IRC §42(i)(9)(B), as added by section 1404 of the Act, provides that the basis of a qualified building shall not be reduced by the amount

of any grant described in IRC §42(i)(9)(A). The legislative history to the Act provides that grants received under this provision (i.e., cash assistance received under section 1602 of the Act) do not reduce the tax basis of a qualified low-income building. By extension, subawards under section 1602(c) of the Act derived from cash assistance under that section that are used in a qualified low-income building are not federal grants for purposes of IRC §42(d)(5)(A) and do not otherwise reduce the depreciable or eligible basis of the building.

## IRC §42(g)(1): Minimum Set-Aside

The “Minimum Set-Aside” requirement reads:

(1) In general. The term “qualified low-income housing project” means any project for residential rental property if the project meets the requirements of subparagraph (A) or (B) whichever is elected by the taxpayer:

(A) 20-50 test. The project meets the requirements of this subparagraph if 20% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50% or less of area median gross income.

(B) 40-60 test. The project meets the requirements of this subparagraph if 40% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60% or less of area median gross income.

Any election under this paragraph, once made, shall be irrevocable. For purposes of this paragraph, any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes.

### Making the Election

The election is made on Form 8609, line 10c. The minimum set-aside is a project-based rule, so a taxpayer’s election to treat a building as part of a multiple building project is a significant consideration. This election is made on Form 8609, line 8b, with an attachment identifying the buildings to be included in the project.

Example 1: A taxpayer owns 10 low-income single-family homes, each of which received a \$10,000 credit allocation, for a total of \$100,000. The taxpayer elects to include them in one 10-building project. The taxpayer elects the 40-60 minimum set-aside for all 10 buildings; i.e., at least 4 of the 10 homes must be qualified low-income units for the taxpayer to claim any credit. For 2012, only three of the units were qualified low-income units. The taxpayer cannot claim *any* IRC §42 credit because the minimum set-aside was not met.

If 2012 is the first year of the credit period, then the taxpayer is prohibited from ever claiming the LIHC because the taxpayer failed to satisfy IRC §42(c)(2); i.e., the buildings are not “qualified low-income buildings.”

Example 2: A taxpayer owns 10 low-income single-family homes, each of which received a \$10,000 credit allocation, for a total of \$100,000. The taxpayer elects the 40-60 minimum set-aside for all 10 buildings but does *not* elect to include the buildings in a multi-building project. Each home is a separate project and the minimum set-aside test is applied to each home separately. For 2012, three of the homes units were qualified low-income units and the taxpayer can claim \$30,000 in credit.

### Minimum Set-Aside Defines “Low-Income”

The taxpayer’s election not only establishes the minimum number of low-income units that must be provided, but also identifies the income limit for *all* the low-income units in the project.

(Continued on page 3)

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Example 3: A taxpayer owns a single low-income building with 100 units, which received a \$100,000 credit allocation. The taxpayer intends to treat the building as 100% low-income and elects the 20-50 minimum set-aside; i.e., at least 20 of the 100 units must be qualified low-income units for the taxpayer to claim any credit. The taxpayer rented 21 units to households with income less than 50% of the area median gross income and rented the other 79 units to households with income less than 60%, but more than 50%, of the area median gross income. Only the 21 units rented to households with less than 50% of the area median gross income are qualified low-income unit. The taxpayer met the minimum set-aside, but can claim credit for only the 21 qualified units.

#### Minimum Set-Aside v. Applicable Fraction

The Minimum Set-Aside and the Applicable Fraction are two independent concepts. While the Minimum Set-Aside is the *minimum* number of low-income units within a “project” required to qualify for any credit, the Applicable Fraction is a measurement of the low-income portion of a low-income “building,” measured as the lesser of the percentage of floor space (of units) or the percentage of units.

Example 4: Same facts as Example 3. The building’s Eligible Basis is \$1,111,111 and the Applicable Percentage is 9.00%. How much credit can the taxpayer claim? Assuming all the units have the same floor space, the Applicable Fraction is 21/100 or .2100.

## Exception for Married Students

As explained in the legislative history, “In no case is a unit considered to be occupied by low-income individuals if all of the occupants of such unit are students (as determined under IRC §151(c)(4)), no one of whom is entitled to file a joint income tax return.”

While the rule itself is not explicitly included in IRC §42, exceptions for certain 100% full-time student households are specified in IRC §42(i)(3)(D), and includes an exception for full-times students if the students are married and file a joint return.

The Supreme Court recently ruled that a portion of the Defense of Marriage Act is unconstitutional and held that persons of the same sex who are legally married under State law may not be deprived of Federal benefits that are provided to married couples of the opposite sex.

So, how is the exception for married students applied? Registered domestic partners and same-sex partners who are legally married under state law cannot file federal tax returns as “married filing separately” or “married filing jointly” because federal law does not treat same sex partners as married for federal tax purposes. Therefore, the rule continues to be applied only for couples of the opposite sex. Please refer to the Guide for Completing Form 8823, Chapter 17, for additional guidance.

Also, the IRS and Treasury released their joint 2013-2014 priority guidance Plan (Doc 2013-19471) on August 9, 2013. The plan includes providing guidance on the Supreme Court’s decision that Section 3 of the Defense of Marriage Act was unconstitutional. The reference for the case is *United States v. Windsor, Sup. Ct. Dkt. No. 12-307 (2013) (Doc 2013-15479)*.

The allowable credit is computed as:

\$1,111,111	Eligible Basis
<u>x 0.2100</u>	Applicable Fraction
\$233,333	Qualified Basis
<u>x 0.0900</u>	Applicable Percentage
\$21,000	Allowable Credit

Can the Applicable Fraction be less than the minimum set-aside? Yes.

Example 5: A taxpayer owns three low-income buildings, each has 10 units and all the units in all three buildings have the same floor space. The taxpayer elects the 40-60 minimum set-aside and elects to include all three buildings in one multi-building project. The minimum set-aside is  $.40 \times 30 = 12$ ; i.e., at least 12 units in the three buildings must be qualified low-income unit to meet the minimum set-aside on a *project* basis.

The taxpayer rents 6 units in the first building, 4 units in the second building, and 2 units in the third building to qualified low-income households. Altogether, there are 12 qualified low-income units in the three-building project and the minimum set-aside requirement is satisfied. The Applicable Fractions for the three buildings are 60%, 40% and 20%, respectively.

## 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 Checklist
- Form 13828, Tax Matters Partner (TMP) Qualifications Checklist
- Form 13827, Tax Matter Partner (TMP) Designation Checklist

## Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace at [Grace.F.Robertson@irs.gov](mailto:Grace.F.Robertson@irs.gov). Also designate whether you would like to receive the Adobe pdf version or the Word document.

## 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](http://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.

## ♪ Grace Notes ♪

I'm at home today, quietly writing at the table by the window. Hannah (the big white cat) is contentedly sleeping in her favorite spot to the left of the computer... I know it's a favorite spot because she's always there when I work at home and she lays right where the computer's air vent is...a nice warm spot.

But I can't help notice that she's not really asleep. Her ears are twitching and her eyes are not entirely closed. She's looking out the window, so I look where she's looking and I can see a beautiful yellow and black butterfly gathering nectar from a Nasturtium. He moves from flower to flower, gathering nectar from some, quickly skipping over others... and then flitting away. He comes back and starts all over again five or six times before finally flying away. Hannah and I are mesmerized.

The entire flower bed is full of neon-yellow, golden yellow, bright orange, and variegated light and dark orange Nasturtiums all mixed up together. It would be difficult to tell you which one I like most, but it was easy to tell that the butterfly preferred the bright orange flower because he rested longest on those and liked the neon-yellow ones the least since he quickly skipped over those entirely. Perhaps it was the color, maybe the nectar...but he obviously cared and was deliberately choosing the bright orange blossoms.

We all care...the butterfly cares about the flowers, Hannah cares (and chooses carefully) where she naps, and I care about getting home safely from work, which can be a real conscious thought when I'm whizzing around the Washington beltway during rush hour. It's just a guess on my part, but since you're reading this newsletter, you probably care about IRC §42 for one reason or another.

The butterfly cares about survival, the cat cares about comfort, and I care about safety. I know a lot of people care quite passionately about IRC §42. Right now, I mostly care about finishing this newsletter within the time permitted and space allotted.

Grace Robertson

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PS: Curious about the yellow and black butterfly, I did a little Wikipedia research. Turns out he is an Eastern Tiger Swallowtail, a species common to the east coast. I know he is a "he" because of the markings; the "she" has blue markings around the edges of the wings. Hannah and I have seen "her," too, flitting around the pinkish Echinacea flowers in the back yard when we're watching the squirrels and chipmunks squabble over the peanuts left out for them all...apparently, squirrels really care about peanuts.