LIHC Newsletter

ISSUE #55

APRIL 2014

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:

New IRC §42 Mailbox	1
Foreclosures	1
PHA Utility Allowance Update	2
Noncompliance Correction Period: A Common Misunderstanding	3
IRC §42 Audit Technique Guide	3
♫ Grace Notes ♫	5

New IRC §42 Mailbox

Got a question about IRC §42? You can now email your question to the new IRS mailbox, sbse.lihc@irs.gov. "SBSE" is the acronym for "Small Business Self-Employed," the division within the IRS administering the IRC §42 program.

Foreclosures

Unfortunately, low-income housing projects fail and foreclosures happen.

Foreclosure Defined

A "foreclosure" is a legal procedure occurring when an owner defaults on a loan, and the lender takes legal action because the property was used as security for the loan. As a result, the property is sold to recover the debt. Foreclosure proceedings are governed by state law in the state where the property is located.

Alternatively, an owner may deed the property directly to the lender in a "transaction in lieu of foreclosure" in full or partial satisfaction of the mortgage debt.

Foreclosures do not include:

- Bankruptcy proceedings, although the property may ultimately be sold to pay the owner's debt.
- Selling a failing property to a third party who will assume the debt, with the lender's approval.

Law

IRC §42(h)(6) requires taxpayers to enter into an extended use agreement to provide low-income housing for a period not less than 30 years, beginning at the same time as the 10-year credit period. The agreement is made with the housing agency that allocated the credit and is recorded in the land records. The agreement is often referred to as a "land use restriction agreement" or "LURA." A building is not considered a qualified low-income building, and no credit is allowable, if an extended use agreement meeting all the requirements is not in place.

Generally, in the event of a foreclosures or transactions in lieu of foreclosure, the extended use agreement terminates as of the date the building is acquired by foreclosure (or instrument in lieu of foreclosure).

Effect on New Owner

Under IRC §42(d)(7)(A)(ii), a taxpayer acquiring an IRC §42 project during the 15-year compliance period can claim any credit that would have been allowable to the prior owner. In the event of a foreclosure or transaction in lieu of foreclosure, the lender or new owner may decide to operate the project in compliance with IRC §42. In which case, the lender or new owner will need to enter into a new extended use agreement with the allocating housing agency by the end of the taxable year for which the new owner intends to claim the credit.

(Continued on page 2)

PHA Utility Allowance Update

Gross rent, under IRC §42(g)(2)(B)(ii), includes a utility allowance to account for utilities paid by the tenant.

- ♦ Utilities do not include telephone, cable television, or Internet service.
- ♦ A separate estimate is computed for each utility.
- ♦ Different methods can be used to compute the individual utility allowances.
- ♦ The utility allowance is computed on a building-by-building basis.
- ♦ The maximum rent that may be paid by the tenant must be reduced by utility allowance(s).

Treas. Reg. §1.42-10 provides guidance for determining and applying utility allowances.

HUD Utility Schedule Model

One of the acceptable methods for calculating a utility allowance is the HUD Utility Schedule Model, which can be accessed on HUD's website.

The Utility Schedule Model uses codes assigned to the Public Housing Authorities (PHAs) to identify locations when calculating an allowance. HUD recently updated the webpage to include a listing of PHAs and the related code needed to calculate the utility allowance.

Updating Utility Allowances

- ∗ If the applicable utility allowance for units changes, the new utility allowance must be used to compute gross rents of the units due 90 days after the change (the 90-day period).
- ∗ A taxpayer using a utility company estimate, the HUD Utility Schedule Model, or an energy consumption model must submit copies of the utility estimates to the Agency that has jurisdiction over the building and make the estimates available to all tenants in the building at the beginning of the 90-day period before the utility allowances can be used in determining the gross rent of rent-restricted units. Any utility estimates obtained under the Agency estimate must also be made available to all tenants in the building at the beginning of the 90-day period.
- ∗ The taxpayer must pay for all costs incurred in obtaining the estimates and providing the estimates to the Agency and the tenants.
- ∗ The taxpayer is not required to review the utility allowances, or implement new utility allowances, until the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period, whichever is earlier.
- ∗ The building owner must review at least once during each calendar year the basis on which utility allowances have been established and must update the applicable utility allowance accordingly. The review must take into account any changes to the building such as any energy conservation measures that affect energy consumption and changes in utility rates.

Foreclosures

(Continued from page 1)

Otherwise, the new owner is under no obligation to continue operating the project in compliance with IRC §42, except for one provision. IRC §42(h)(6)(E)(ii) includes protections for tenants in the event of a foreclosure or transaction in lieu of foreclosure. For three years following the termination of the extended use agreement, the owner is not permitted to evict or terminate the tenancy (other than for good cause) of an existing tenant of any low-income unit, or increase the gross rent with respect to a low-income unit not otherwise permitted under IRC §42.

Effect on Former Owner

Foreclosures and transactions in lieu of foreclosure are treated as any other disposition. See CCA 201146016.

- The termination of the extended use agreement results in the disallowance of the credit for the year of disposition (unless the new owner enters into a new extended use agreement by the close of the year of disposition or IRC §42(h)(6)(j) otherwise applies), but does not automatically result in recapture under IRC §42(j).

(Continued on page 4)

Noncompliance Correction Period: A Common Misunderstanding

State housing agencies are required to review IRC §42 projects at least once every three years. As part of the review, the agencies physically inspect all the low-income building and, for at least 20% of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units. All observed noncompliance is reported to the IRS on Form 8823, Low-income Housing Credit Agencies Report of Noncompliance or Building Disposition, regardless of whether the noncompliance has been corrected.

Before sending the Forms 8823 to the IRS, however, the taxpayer is provided an opportunity to correct the noncompliance. As explained in Treas. Reg. §1.42-5(e)(4), the "correction" period is the period specified by the state agency during which the taxpayer must bring the project into compliance with IRC §42 requirements. The correction period is not to exceed 90 days from the date of the notice given to the taxpayer. An agency may extend the correction period to a total of six months, but only if the agency determines that there is good cause for granting the extension.

It is commonly believed (and argued by taxpayers during IRS audits) that noncompliance corrected within the correction period provided by the state agency has no tax consequences; i.e., no loss of credit or recapture under IRC §42(j). This is not true. The correction period is simply an administrative convenience allowing a taxpayer to correct noncompliance before submitting the Form 8823 to the IRS.

The tax consequences of noncompliance are not the same for all noncompliance issues and must be determined by applying the law to the particular circumstance of the noncompliance event.

IRC §42 Audit Technique Guide

Audit Techniques Guides (ATGs) help IRS examiners conducting audits by identifying issues and accounting methods unique to specific industries. While ATGs are designed to provide guidance for IRS employees, they're also useful to taxpayers and tax professionals who prepare returns.

A new ATG has been drafted for IRC §42, the Low-Income Housing Credit, and was released for public comment in December of 2013. Comments were due March 28, 2014.

The draft IRC §42 ATG has also been reviewed within the IRS by Revenue Agents. You might say the ATG has been "road tested" and the tires kicked. After considering all the feedback, the draft ATG will be revised. The completed ATG will then be made available on the IRS website.

IRC §42 ATG v. Form 8823 Guide

◊ The IRC §42 ATG does not replace the Form 8823 Guide, which was written to assist state housing agencies evaluate taxpayer compliance with IRC §42 requirements and report noncompliance to the IRS. The Form 8823 Guide is considered an ATG for IRS administrative purposes and is available to the public as well as state housing agencies.

◊ The two documents are complementary. Combined, they provide a reasonably complete discussion of IRC §42.

◊ The Form 8823 Guide is referenced in the IRC §42 ATG rather than duplicating information.

Other ATGs

For more information about ATGs, visit the IRS website, where there's a link to a very short video. Other ATGs that might be helpful include:

Conservation Easements

Construction Industry

Rehabilitation Tax Credit

Foreclosures

(Continued from page 2)

- The former owner is subject to recapture upon disposition unless IRC §42(j)(6) applies; i.e., there is no recapture on disposition of building if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the building's remaining compliance period, including entering into an extended use agreement for the remainder of the building's entire +30-year extended use period.

State Agency Responsibilities

State housing agencies should:

1. Report the disposition to the IRS on Form 8823, line 13a, and check the "foreclosure" box. If the building will no longer participate in the program, check the box for line 11p.

   If available, include the foreclosure documentation as an attachment. Check the box for line 12 on Form 8823.

   If the new owner has entered into a new extended use agreement and is continuing to operate the building in compliance with IRC §42, include an attachment to affirm for the IRS that the building is participating in the program.

2. Make sure the tenants are aware of their rights; i.e., the three-year tenant protections can be enforced by tenants.

Planned Foreclosures

Under IRC §42(h)(6)(E)(i)(I), the extended use agreement terminates on the date the building is acquired by foreclosure or instrument in lieu of foreclosure *unless the Secretary determines* that such acquisition is part of an arrangement with the taxpayer a purpose of which is to terminate such period.

A state housing agency that becomes aware of a situation that it believes constitutes a "planned" foreclosure can provide a letter detailing the characteristics of the transaction to James Holmes in the IRS Office of Chief Counsel, Passthroughs & Special Industries, Branch 5.

IRS Audits

The scope of an IRS audit is not limited to the IRC §42 issues. The IRS also considers the foreclosure itself and whether the taxpayer properly reported the gain (or loss) upon disposition and any income from cancellation of the debt.

Whose flag is this? Answer at the end of the newsletter after ♫Grace Notes♫.

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.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just send an email to sbse.lihc@irs.gov. Please specify 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, 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 ♫

Its April Fools' Day today and time to execute a well-planned "prank" on a friend… all in good fun, of course. Ever wonder why we engage in this delightful ritual?

From 1568 until 1648, the Dutch were at war with the Spanish…and yes, that's 80 years of warring. The king of Spain gained control of the southern part of the country, what we now know as Belgium, and then his soldiers marched north to conquer the rest of the stubborn Netherlanders.

The nobles of Holland, led by Prince William of Orange (known as William the Silent and grandfather of the William of Orange that would become king of England), did their very best to free the cities occupied by the Spanish. The Prince and his sons dedicated their lives to liberating the Netherlands from the Spanish rule. Not to be redundant, but this war went on for 80 years.

A small town in the south called Brielle, close to the sea and rivers, was an important stronghold for Spain. From here, the Spanish could control the flow of weapons and supplies to the soldiers further north. Liberating this town was imperative to breaking the Spanish hold on the Netherlands. So, freedom fighters, called Sea Pirates, decided to liberate Brielle.

The pirates smuggled soldiers into the city by hiding them in the bottoms of two flat bottom barges loaded with vegetables, fruits, wine, and beer on top. The barges entered the city using one of the many canals. As planned, the barges arrived in the market place so late in the afternoon that it was too late to unload them before dark, so they were tied to the dock until morning. During the evening, while still hidden in the barges, one of the pirates began coughing. Not wanting to endanger the operation, he allowed himself to be strangled to death. By midnight the Spanish guards were all asleep, except for a few guards, and they had enjoyed the beer and wine confiscated from one of the barges a bit too much.

In the middle of the night of April 1, 1572, the pirates crept off the barges and the weak Spanish garrison was thrown out. Brielle was liberated and the Netherlanders celebrated breaking the Spanish stronghold on the north. It was a pretty good joke, too, because "Brielle" means spectacles in Dutch and the Spanish had lost their spectacles and were blindly wandering around without control of Brielle.

Other cities were liberated and joined William of Orange, and the Spanish finally responded by sending more soldiers to the north to suppress the rebellion. Cities withstood sieges and starvations, dams were broken to flood the land, and the sea pirates came to their rescue. The world marveled at the courage of the small Dutch towns in watery Holland who dared to resist the Spanish, whose realm was worldwide.

The strategy was successful and the Spanish never again succeeded in subjecting Holland and the Netherlanders to their rule. The Dutch remember the pun each year on the April 1st anniversary by playing tricks and silly jokes on each other.

And the Dutch people carried on the tradition when they immigrated to other countries. I should know. I'm the daughter of a Dutch immigrant who will tell you herself that she left everything behind in one free country to be an American, no other free county would do.

Grace Robertson
Phone: (240) 613-6671
Fax: 877-477-9143
Grace.F.Robertson@irs.gov

The Eighty Years War is a complicated subject. For more information you might want to read A Short History of the Netherlands by Allert de Lange, or, for shorter but not necessarily short or complete articles, see Wikipedia: April Fools' Day, William the Silent, and the Capture of Brielle.

The Netherlands…more information is available on Wikipedia.