// Low Income Housing Credit Newsletter

Internal Revenue Service

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The purpose of this newsletter is to provide a forum for networking and sharing information among LIHC program coordinators and examiners. It is a means by which to communicate technical information, issues developed through examination activity, industry trends and any other pertinent information which surfaces from time to time. Articles and ideas for future articles are most welcome!!

Reviewing Tenant Files: State Agency Requirements

Under Treas. Reg. 1.42-5, state housing agencies are responsible for periodically reviewing tenant files. The files must be reviewed at least once every three years and the files for at least 20% of the units in the project (which may be multiple buildings) must be reviewed.

The purpose of the review is to determine whether the household occupying the unit is income-qualified; i.e., the household's income does not exceed the limit. The dollar limit on income is determined based on (1) the number of people in the household, (2) the Area Median Gross Income determined by HUD for the location of the building and (3) the taxpayer's minimum set-aside election.

Defining Income

Income for purposes of determining a household's income is not "Taxable Income" as reported on a tax return. Tenant income is *calculated* in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937, not in accordance with the determination of gross income for federal income tax liabilities. HUD's Handbook 4350.3, chapter 5, is the reference for determining the treatment of income for Section 8 purposes. (For *IRS employees*, Handbook 4350.3, chapter 5 is available on the Examination Specialization & Technical Guidance webpage at **http://sbse.web.irs.gov/TG/TGIndustryIssues.htm#LowIncome**.)

To determine whether a household is income-eligible, the owner must estimate the amount of income the household will receive during the next 12 months. Generally, annualizing the household's current income is a reasonable method for anticipating future earning. In addition, owners must account for any anticipated changes. Examples within the handbook clearly indicate that "anticipated changes" are those events where the source of the anticipated funds is identifiable, as well as an approximate amount of income.

Similar to IRC §61, income for Section 8 purposes includes everything not specifically excluded by regulation.

Documenting Income

The HUD handbook also outlines standards for collecting evidence and documenting the tenant's file. Most state agencies have adopted these standards for IRC §42 properties and owners are required to meet the standards as set forth by the states. However, the IRS standard, as stated in Treas. Reg. 1.42-5(b)(vii) is very broadly stated:

> Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verification of income from third parties such as employers or state agencies paying unemployment compensation).

Evaluating Income Certification

When evaluating tenant files, state agencies are determining whether the households were income-qualified at the time of move-in or last annual income recertification.

- Have all the potential sources of income been accounted for?
- Are the methods for estimating income reasonable based on the facts?

- Was the correct income limit used?
- Was the computation correct?
- Is the evidence sufficient?
- Does the information make sense?

Basically, does the certification and documentation support the conclusion that the household is income-qualified?

Once the review of the sampled tenant files is complete, the state agency evaluates whether the sample should be expanded to include more files. Was the same mistake made over and over again (systemic) or was there a significant number of different mistakes (extensive)?

The owner is then presented with the state agency's finding and provided a period of time to correct any items of noncompliance.

Reporting Noncompliance

Once the correction period (generally 90 days) has expired, the state agency is required to report any findings of noncompliance to the IRS, regardless of whether the taxpayer corrected the noncompliance. Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, is used for this purpose. The form includes a list of common noncompliance issues, as well as an "other" category for issues not specifically identified.

The completed forms are submitted (with supporting documentation) to the LIHC Compliance Unit, where they are processed. Taxpayers receive a contact letter to provide notification that the IRS has received a Form 8823. The Forms 8823 are also evaluated for audit potential.

Auditing Tenant Income Issues: IRS Procedures

Kent Rinehart, Program Analyst

By the time a case reaches a revenue agent, the case will quite probably include a significant amount of case-building information, including Forms 8823 and supporting documents submitted by the state agency. For tenant income issues, the state agencies often include a summary, unit-by-unit, of the noncompliance items and associated dates.

At a minimum, and regardless of whether noncompliance has been reported by the state agency, the following audit steps should be completed.

Interview the Taxpayer

The focus of the interview should be on the taxpayer's internal controls intended to ensure that households are properly qualified. While the TMP or general partner may be able to provide only a high-level overview of the procedures, the information will be valuable when touring the property and working with the site manager.

- Does the taxpayer manage the property, or is an *independent* management company responsible for day-to-day operations? If a management company operates the property, what kind of oversight does the taxpayer provide? Identify the individual who actually manages the property. Who do they report to? What is the chain of command from this point to the owner (or to the person you are interviewing)?
- How are potential tenants identified?
- What are the procedures for income-qualifying potential tenants and making sure the requirements are met?
- How does the taxpayer identify and monitor changes in household size? What procedures are in place to do this? How diligent is the taxpayer in making sure that the actual size of the household matches tenant information in the file.

The rules for LIHC properties are detailed and complex.

- Ask what procedures and internal controls are in place to ensure that the property stays in compliance.
- Has an internal audit been conducted? If so, ask to see the report.
- Has the investment group (limited partners) conducted an independent review or audit? If so, ask to see the report.

- Have the site management employees received training? What type of training have they received? Is their work reviewed?
- What happens when noncompliance is identified, other than by the state housing agency during their review? Have the interviewee give you an example of such noncompliance that they have identified and corrected.
- How and where are the tenant files, as well as books and records maintained?

Evaluate Procedures for Qualifying Households

Review the property manager's procedures for qualifying new tenants. Does the owner have written procedures for the manager to follow? Determine how the property manager conducts interviews, contacts third parties for verification, and maintains the files. Ask how the property manager handles certain scenarios; e.g., the total anticipated income for the upcoming year is less than what it will cost to reside at the property or a one-person household requests a three bedroom unit. If the property is near a college or university, how is student status confirmed? How does the property manager know when it is time for the annual recertification?

Evaluate Internal Controls

Consider the *property manager's* internal controls. All tenants (18 years or older) should be asked the same questions and all the files should have the same documentation. Some basic questions include:

- Does the manager use a standardized income certification document?
- Is a management company involved? If so, what do they do? Is the management company related to the general partner (this is a common practice for LIHC properties)?
- Who reviews the property manager's work?

Review Tenant Files

Although the state agency may have conducted a thorough review of a sample population of tenant files, examiners should conduct an independent inspection of the records. Two issues need to be considered; (1) whether the household's income has been correctly computed, and whether the correct income limit (based on the AMGI and the taxpayer's minimum set-aside) has been applied.

Testing Income

Under IRC §42, the tenant is to provide the owner with information about the household and the total anticipated income they expect to receive during the next twelve months. Income includes, but is not limited to, earned and *unearned* income from household members age 18 and older, unearned income of minor children, and income from assets.

One quick audit technique is comparing the information in the tenant file with the income reported on the tenant's tax return. You can identify the tenant's wages, interest, social security, annuities, alimony, and other taxable sources. Generally, if the taxable income is more than the LIHC income limit, there's a potential problem.

The tenant file should include a list of all sources of nontaxable income. Nontaxable income includes, but is not limited to, deferred compensation payments, employer non-accountable allowances or reimbursements, nontaxable social security payments, insurance annuities, nontaxable retirement fund distributions, disability or death benefits paid, welfare assistance payments, child support, and regular contributions and gifts from person(s) not residing in the unit.

Together, the income per tax return and the nontaxable income per tenant files will provide an estimate of the tenant's total anticipated gross income for each year. Generally, if the tenant's gross income on the tax return and nontaxable income added together is about the same as the anticipated gross income shown on the tenant certification, there is no issue. On the other hand, if there is a discrepancy, further analysis will be needed to determine whether the tenant is qualified.

Testing Income Limits (Household Size)

Since the income limit is dependent on the size of the household, the next step is to determine whether the tenant's file identifies all the members

of the household. Indicators of potential problems include:

- One name on a lease for a unit with multiple bedrooms,
- The tenant's income (as reported in the file) is not sufficient to pay the rent and a reasonable estimate of living expenses,
- Rent payments from more than one person,
- Separate leases for amenities, such as garage space. You may find different names for rental of garage space than names on the rent roles.

Request a listing of all the tax returns filed from the LIHC project's address using IDRS commands. If there are more names than the taxpayer provided, you probably have unrecorded household members.

Analysis

Analyzing all this information is not an exact science. Evaluate the property manager's diligence and efforts to identify qualified tenants and satisfy yourself that you've accounted for all tenants for each unit of the property.

Basically, you are looking for what doesn't make sense. It is important for you to question certain things that are inconsistent with tight budgets. For example:

- Why would one tenant want to rent a three-bedroom apartment?
- How can this tenant pay for expenses when total income is less than half of what it costs to live in the unit?
- Why are there two separate rent payments being recorded each month for a unit with only one individual listed as the tenant?
- Why does this one tenant need two parking spaces?

If the facts don't add up, chances are there is an unrecorded tenant.

Auditing Tenant Income Issues: A Tax-Exempt Bond Case Study

Robert T. Main, TEB Agent

Local housing authorities or government entities promote the development of low-income housing in their communities by issuing tax-exempt bonds and loaning the proceeds to developers to build low-income housing projects. These developers can save millions of dollars in interest expense by using this tax-exempt debt. The low-income credits are an additional economic incentive.

To be a "qualified" low-income facility and qualify for the low-income credits, the owner must comply with the record keeping and record retention provisions used to determine tenant income under Treas. Reg. §1.42-5(b)(vii). Failure to comply with this regulation could put the tax-exempt bond in jeopardy.

Qualified low-income housing projects must comply with the minimum set-aside test (20-50 or 40-60), as elected by the taxpayer. In both tests, the first number describes the percentage of the rental units that must be occupied by low-income tenants. The second number represents the percentage of the area median gross income (AMGI) for the location where the housing is built, and determines the income limit The same tests are used for IRC §42 properties (IRC §42(g)(1)) and IRC §142 tax-exempt bond properties (IRC §142(d)(1)) These tests are used to determine whether the project qualifies as low-income housing and, if financed with bonds, whether the bonds are tax-exempt.

Income-Qualified Tenants

In a recently closed tax exempt bond case, it was necessary for me to determine whether new tenants were income-qualified using the AMGI for the area. This was a mixed-use property, so I wanted to make sure the owner was complying with the Next Available Unit Rule under IRC §142(d)(3)(B) by renting vacant units to income-qualified tenants. This rule is intended to ensure that as households' incomes increase above 140% of the income limit, these "over-income" households are replaced by households with qualifying income. Remember, for purposes of

the tax-exempt bond, only the minimum number of low-income units must be maintained.

First, I accessed internal sources using social security numbers for the tenants living in the housing. (See IRM Exhibit 4.10.4-2, Internal Sources of Information.)

Second, I determined the household's income by adding the W-2 wages, net schedule C income, interest, dividends, and periodic payments of the tenant(s) for each low-income designated unit.

Then, after adjusting for family size, I compared the income limit to my determination of gross income for tax purposes. If the tenant(s) gross earnings for tax purposes exceeded the HUD limits, I knew it was probably a nonqualifying low-income unit.

Outcome

The disqualified units will affect the Applicable Fraction and the amount of LIHC will be reduced. If the number of qualifying units drops below the owner's elected 20% or 40% minimum in any year after the first year of the credit period, the entire credit is disallowed for that year. If a project fails the minimum set-aside requirement for the first year of the credit period, the owner is prohibited from ever claiming the LIHC. Disallowance of credits may also cause a failure in the tax-exempt bond financing for the low-income project.

If the tax-exempt bonds are determined to be taxable bonds, what is the downside to the owner of the facility? The owner could end up paying the tax exposure of all the bondholders. Tax exposure consists of the bond issuer and conduit borrower (usually the developer) entering into a closing agreement with the IRS (TE/GE Tax Exempt Bonds Divisions [TEB]) to capture 29% of the interest paid to bondholders going back three years and going forward for as long as the bonds are on the market. The owner's interest deduction paid on the loan could also be denied under IRC §150(b)(2)(B) for all open statute years.

Issues Related to Tax Exempt Bonds

An owner who uses tax-exempt bonds to finance his low income facility could have income tax problems even if he meets the LIHC requirements under both IRC §§ 42 and 142.

- Take a look at the depreciation schedule of the facility. Did the owner use accelerated depreciation on the portion of the facility purchased using tax-exempt bond proceeds? If the owner used anything other that straight-line depreciation under IRC §168(g)(1)(C), there's an income tax adjustment for an improper depreciation deduction. (No referral to TEB is necessary for this adjustment.)

Referrals to Tax Exempt Bonds (TEB)

You've just completed a Low-Income Housing Credit (LIHC) examination and determined that there is a serious issue with nonqualifying households or the owner's records are insufficient or nonexistent. As a result, you have adjustments eliminating some or all the low-income housing credits. Is your examination complete?

One important aspect of your examination should include a determination of how the low-income facility was financed and whether tax-exempt bonds were involved in this financing.

- Form 8609, line 4, identifies the percentage of aggregate basis (land and building) that is financed with tax-exempt bonds. Also, buildings financed with tax-exempt bonds are limited to the 30% present value credit, which is reflected on Form 8609, line 2.
- Ask the owner in your initial interview if the low-income facility was financed with tax-exempt debt.
- Request a copy of Form 8038, which is an information return for Tax-Exempt Private Activity Bond Issues.
- Review deductions on the income tax return for costs of bond issuance or expense reimbursements from bond proceeds.

Owners claiming low-income credits on the residential rental units, but have poor records of qualifying tenant incomes, face substantial financial penalties when tax-exempt bonds are part of the financing. Local housing authorities and local governments want low-income

housing to be occupied by households who need the benefits. They are not pleased when their efforts are circumvented by owners who allow tenants with higher incomes to occupy the units and limit the availability of affordable housing for those who truly need the housing.

If tax-exempt bonds were used in financing of the building or rehabilitation of a low-income housing facility, and you have adjustments because units were occupied by nonqualifying tenants, consider a referral to TE/GE Tax Exempt Bonds Division, Acting Compliance Program Manager, Steven A. Chamberlin, (636) 940-6466.

Tenant Income Issues: A Tax Court Case

A recently decided Tax Court case, Bentley Court II L.P., T.C. Memo 2006-113, involved a determination that an apartment complex did not qualify for the credit because the households were not income-qualified.

Facts

The taxpayer received an allocation of credit and constructed the housing during 1990 and 1991. The taxpayer claimed IRC §42 credits for six years, 1990-1995, as follows:

Year	Credits
1990	$28,508
1991	$699,780
1992	$859,543
1993	$918,155
1994	$926,819
1995	$927,606

The tax returns for 1993, 1994, and 1995 were audited. The revenue agent determined that the taxpayer had falsified documents, including changing income amounts and indicating that certain tenants were not students when, in fact, they were. A review of the tenant files by the state agency revealed that 90% of the tenants in the apartment complex were students.

The revenue agent concluded that the apartment complex did not qualify for the LIHC because the households occupying the units were not qualified and disallowed the entire credit for all three years under audit. In addition, the revenue agent applied the recapture rules under IRC §42(j) to recapture 1/3 of the credit claimed in 1990, 1991 and 1992; $9,493, $233,027 and $286,228 respectively.

Outcome

Although the taxpayer originally alleged errors in the IRS' determination, the taxpayer eventually conceded all the low-income housing credit for 1993, 1994, and 1995 during settlement negotiations.

The general partner was sentenced to 30 months in prison based on his guilty pleas to 1 of 22 counts of obstructing and impeding the administration of the internal revenue law "by losing and concealing tenant files… [two tenants] of Bentley Court Apartments, which tenant files were to be examined by the Internal Revenue Service as part of an audit of the partnership…" The remaining 21 counts were similar and related to the one described and concerned allegations that the general partner willfully made false reports of occupancy beginning in late 1992 through mid-1997. The 21 related counts were dropped.

The taxpayer did not concede the recapture of one third of the credits claimed in 1990, 1991, and 1992.

Issue Before the Court

The sole issue before the Court in Bentley Court II was whether the taxpayer, under IRC §42(j) must recapture in 1993, $528,747 in low-income housing credits claimed in prior years.

IRC §42(j)(1) states that if, as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the taxpayer's tax …for the taxable year shall be increased by the credit recapture amount.

Qualified Basis is computed as:

Eligible Basis x Applicable Fraction

The taxpayer argued that not only was it *not* entitled to the credits for 1993, 1994, and 1995, but that the same fact pattern existed in earlier years. Therefore, even though the tax years were barred from examination by the expiration of the statute of limitation, the actually Qualified Basis in those years is also zero. Because there is no difference in the Qualified Basis between 1992 and 1993, the credit recapture rules cannot be applied. Bentley Court argued that the government was overreaching or maneuvering by determining deficiencies in open year and using the recapture provisions to circumvent the closure of years in which a deficiency would or should have been determined.

The government responded that since the Qualified Basis, as determined in the audit, was less than the Qualified Basis of $11,537,221 reported on the taxpayer's 1992 return, the recapture rules under IRC §42(j) are applicable. The government argued that:

- Bentley Court offered no evidence to show that the apartment complex was not a qualified low-income building during 1990, 1991 and 1992 tax years;
- Bentley Court is bound by a *duty of consistency* not to take inconsistent positions; contending now that it failed to qualify or that qualified basis was zero for 1990, 1991 and 1992, when the taxpayer had previously claimed the credit and reported on the tax return that a qualified basis existed for those same years.

The Duty of Consistency Doctrine

The Duty of Consistency doctrine is intended to prevent a taxpayer from taking a position in a earlier year and a contrary position in a later year after the limitations period has run on the first year. As noted in Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974), a duty of consistency arises where:

1. the taxpayer has made a representation or reported an item for tax purposes in one year,
2. the Commissioner [IRS] has acquiesced in or relied on that fact for that year, and
3. the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial year.

The government argued that the facts of the case show that all three of the criteria had been met and that Bentley Court should be held to a duty of consistency.

Bentley Court contended that the duty of consistency is inapplicable, or if it is, it should be applied to estop the government from recapturing the credit because (1) Bentley Court report low-income credits in 1990 to 1995, and the government "disallowed" those credits in all year by criminally prosecuting the general partner; (2) because of the indictments against the general partner, respondent did not acquiesce to the credits claimed for 1990, 1992, and 1992; and (3) Bentley Court was compelled to change its initial representation or claim of credits due to the criminal prosecution of the general partner.

In an alternative position, Bentley Court argued that the Duty of Consistency doctrine is limited to cases involving a mistake of fact, not a mistake of law; i.e., the general partner did not understanding which types of students could qualify as low-income individuals.

The Tax Court's Decision

The Tax Court upheld the government's position. In framing its decision, the Court addressed the three criteria presented in Beltzer.

1. The taxpayer claimed credits and reported Qualified Basis on its 1990, 1991, and 1992 tax returns.
2. The government acquiesced to and relied upon the taxpayer's representation by "accepting" the 1990, 1991 and 1992 tax returns as filed. The indictment and criminal proceeding against the general partner started after the normal 3-year statutes of limitation had expired for the taxpayer's 1990, 1991 and 1992 tax returns.

Further, the audit did not extend back prior to the 1993 year. Therefore, it appears that the government (during the audit) did not gain access to facts that would have put the government on notice that the credit claimed for 1992 was erroneous.

3. Bentley Court first represented that it qualified for the credit for the years 1990, 1991, and 1992. The taxpayer, now that the statutes of limitation have closed for those years, is claiming that the previously reported year-end qualified bases were actually zero.

As for the taxpayer's argument that the general partner made a "mistake of law", the Court stated it had no basis and was not worthy of further consideration; i.e., that "it is obvious…that the criminal matter had to do with misrepresentations and/or concealment of facts on Bentley Court's behalf by [the general partner]."

Lessons Learned

The Tax Court has confirmed that IRC §42 is "detailed and complex". Yes, the judge actually included the statement in his opinion.

As is often the case, attempts at concealment just make matters worse. In this case, the general partner served 30 months in jail. All taxpayers are subject to the recordkeeping requirements outlined in Treas. Reg. §1.6001.

- Reg. 1.6001-1(a): In general, any person subject to income tax "shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax…"

- Reg, 1.6001-1(e): "The books and records …shall be kept at all times available for inspection by authorized internal revenue officers and employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

Specific to owners of LIHC properties, Reg. 1.42-5(b) requires owners of LIHC properties to retain records that show that the taxpayer was in compliance with IRC §42. The requirements are presented as a list of nine items. The records must be retained for at least six years after the due date (with extensions) for filing the federal income tax return for that year. However, the records for the first year of the credit period must be maintained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the *last* year of the [15-year] compliance period – that's approximately 21 years! Under Rev. Rul. 2004-82, an electronic storage system can be used as long as it satisfies the requirements of *Rev. Proc. 97-22.* However, the taxpayer must also satisfy any additional recordkeeping and record retention requirements required by the state agency.

This case also definitively determines that an adjustment to either the Eligible Basis or the Applicable Fraction as the result of an IRS audit will trigger the application of the recapture provisions. It has long been contemplated that, because the Qualified Basis in the year before the year under audit is actually the same as the corrected Qualified Basis for the year under audit, the recapture rules are not applicable.

For example, a taxpayer overstates the Eligible Basis for the first year of the credit period and every year thereafter. As a result of an audit in one of the later years, the revenue agent identifies the overstatement and reduces the Eligible Basis for that year. Instead of looking to the *actual* Eligible Basis in the prior year, we would, under the Duty of Consistency Doctrine, look to the Eligible Basis reported on the taxpayer's tax return for the prior year.

Clarifications

When filing Form 8823, line 5, *Total credit allocated to this BIN*, should reflect the total amount of credit allocated to the building. This is computed by adding the amounts of credit allocated to that BIN on all Forms 8609, line 1b. Do not include Forms 8609 for which the compliance period has expired. Remember that a separate Form 8823 must be filed for each BIN.

The new Form 8823 now includes a box to identify when an amended form is being filed. An amended Form 8823 should be filed with the IRS only if it is necessary to correct an error on a Form 8823 that was previously filed with the Service. For example, the wrong category is selected or an address is incorrect. A copy of the amended Form 8823 should be sent to the owner concurrent to filing the form with the IRS.

Subscribing to the LIHC Newsletter

The LIHC Newsletter is distributed through e-mail, free of charge. If you would like to subscribe, just contact Grace Robertson at **Grace.F.Robertson@irs.gov**.

Administrative Reminders

All LIHC cases should include Project Code 670 and ERCS tracking code 9812. If you expand an audit to include additional years or related taxpayer, please make sure the additional returns also carry the LIHC project code and tracking code designation.

Surveying LIHC Tax Returns

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

♫Grace Notes♫

The Low Income Housing Credit Program was enacted by Congress as part of the Tax Act of 1986 with the expressed purpose of increasing the availability of affordable housing to households with the greatest need. As the industry celebrates the low-income housing credit's 20th anniversary, attention is again focused on efforts to ensure that qualified households have safe, secure, and affordable housing opportunities.

For example, I recently attended a conference with representatives of all the state housing agencies to discuss current LIHC developments and issues. The number one topic for discussion was tenant income certifications, with enough related issues to make me dizzy.

If Kent's article on audit procedures for auditing tenant income sounds vaguely familiar, you are probably a long-term subscriber to the newsletter. It's an edited version of an article originally appearing in the December 2002 edition, but is as relevant today as it was when he wrote it. This time, however, it follows how the state reviews tenant files and is then followed by a case study in which these techniques were used.

I don't often have the opportunity to analyze a Tax Court case involving IRC §42, but isn't it nice that the recently decided Bentley Court case is right on point?

Sometimes, newsletters write themselves.

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