

Low Income Housing Credit Newsletter

Internal Revenue Service

Issue No. 22

September 2006

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!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

IRC §42: the Low-Income Housing Credit in Summary

by Grace Robertson, LIHC Program Analyst

I was recently asked if I could *please* summarize IRC §42 in 1,581 words or less. So here's a condensed, high-level explanation. In the absence of details, I've included references.

Intent

The credit was intended to provide an incentive for taxpayers to invest in affordable housing; i.e., the credit is a dollar-for-dollar reduction of the income tax liability.

Administration

IRC §42 is co-administered by the Internal Revenue Service and state housing agencies. The states receive a specific amount of credit each year (based on population). They determine which housing projects will receive credits, and how much. They are also responsible for monitoring the properties to ensure that the taxpayer remains compliant throughout the life of the project. Noncompliance is reported to the IRS. [IRC §42(m) and Regulation 1.42-5]

Commitment

The taxpayer agrees to provide affordable housing for at least thirty years.

- In exchange for the investment in affordable housing, the taxpayer will receive tax credits for each of ten years, which is known as the credit period. [IRC §42(f)(1)]
- To keep the credit, the taxpayer must provide affordable housing for fifteen years,

which is known as the compliance period. [IRC §42(i)(1)]

- After IRS jurisdiction ends, the taxpayer must continue to provide affordable housing under the terms of the extended use agreement, which is referred to as the extended use period. The agreement is a contract entered into by the taxpayer and the state agency, recorded in the land records, and enforceable under state law. The state agency has sole jurisdiction. [IRC §42(h)(6)]

All three time periods begin on the same day; i.e., the first day of the tax year in which the buildings are placed in service, or if the taxpayer elects, the following year.

Types of Housing

The credit supports a variety of housing opportunities. The taxpayer can build new housing, or acquire and rehabilitate existing housing. The housing can be apartments, single-family housing, single-occupancy rooms, or even transitional housing for the homeless. The property may be mixed affordable and market rate rental units or a portion of the property may be for commercial use. However, the housing was intended for use on a nontransient basis, so the credit cannot be used, for example, to build hotels, hospitals, or nursing homes.

Financing

In combination with investment generating the Low-Income Housing credit, the taxpayer may also qualify for the Rehabilitation credit under IRC §47, but not the New Markets credit under IRC §45D. The project may also qualify for tax-exempt bonds under IRC §146, in which case

the taxpayer is also subject to the rules under IRC §142(d). The taxpayer may also use other federally-sourced loans and grants.

Credit Amount

The amount of credit the taxpayer can claim each year is determined as:

$$\frac{\text{Eligible Basis} \times \text{Applicable Fraction}}{\text{Qualified Basis}}$$

$$\frac{\text{Qualified Basis} \times \text{Applicable Percentage}}{\text{Credit Amount}}$$

Eligible Basis – IRC §§42(d) and 42(e)

The Eligible Basis is the total of allowable costs associated with the depreciable residential rental property. If the building is located in a high cost area, the Eligible Basis may be increased to 130% of the actual costs. Common errors include:

- The cost cannot be documented,
- The cost was not incurred before the end of the first year of the credit period,
- The cost is associated with the land or a land improvement,
- The cost is not allocated between the land, land improvements, and depreciable residential rental property.
- The cost is associated with a commercial use, or
- The cost was financed with a federal grant.

Applicable Fraction – IRC §§42(c) & 42(f)

The Applicable Fraction is the portion of rental units that are qualified low-income units; determined as the lesser of square footage or number of units. To qualify under IRC §42(i)(3), the unit must be:

- Occupied by a qualifying household; i.e., the household has income less than a predetermined limit based on the number of individuals in the household, the taxpayer's election of a minimum set-aside, and the

area's median gross income. Income is determined using HUD's rules for Section 8 housing, not taxable income under the Internal Revenue Code. [IRC §§ 42(g)(4) and 142(d)(2)(B)]

If any member of the household is a student, the unit is qualified only if an exception under IRC §42(i)(3)(D) is met. The most common errors include:

1. Failure to compute the Applicable Fraction for the first year of the credit period using the "averaging" formula under IRC §42(f)(2).
2. Failure to account for units first occupied by qualifying tenants after the end of the first year of the credit period under IRC §42(f)(3).
3. Failure to document, or adequately document, that the household has qualifying income. [Regulation 1.42-5(b)(2)]

- The housing must be suitable for occupancy. Consideration is given to the site, building exterior, building systems, dwelling units, and common areas. All areas and components of the housing must be free of health and safety hazards. One of the most common problems is the inability to address routine maintenance and "wear and tear" over time. [IRC § 42(i)(3)(B) and instructions for Form 8823]
- The rent must be restricted. The rent cannot exceed 30 percent of the imputed income limit. Problems include failure to include a utility allowance, or including unallowable fees in addition to the monthly rent; i.e., the fees are a condition of occupancy or nonrefundable. [IRC § 42(g)(2)]

Applicable Percentage – IRC §42(b)

The amount of credit, over the ten-year credit period, is equal to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing. The discount factor is known as the Applicable Percentage and is based on interest rates. The Applicable

Percentage is fixed as of the month the building is placed in service, or at the taxpayer's election, as of the month the taxpayer and state agency enter into a binding agreement regarding the building. The Applicable Percentage is published each month in the Internal Revenue Bulletin. Note, however, that state agencies have the authority to limit the amount of credit the taxpayer is allocated under IRC §42(m)(2). If the state agency decides to allocate less than the maximum allowable under IRC §42, the Applicable Percentage will be adjusted.

The Applicable Percentage is seldom an audit issue unless:

- the taxpayer financed the building(s) with federally-sourced subsidies [IRC §42(i)(2)],
- The taxpayer did not use the Applicable Percentage identified by the state agency on Form 8609, line 2.

Global Issues

The taxpayer is also subject to the following rules which may impact compliance on a unit-by-unit basis, at the building level, or the entire project.

- Minimum Set-Aside – the housing project will not qualify for any credit unless it includes a minimum number of qualified low-income rental units. [IRC §42(g)(1)]
- Available Unit Rule – If the income of an existing tenant rises above a specific limit, the next available comparable unit in the building must be rented to an income-qualified tenant. [IRC §42(g)(2)(D) and Regulation 1.42-15]
- Vacant Unit Rule – If a low-income unit becomes vacant, the taxpayer must make reasonable attempts to rent the unit before renting any units to tenants who are not income-qualified. [Regulation 1.42-5(c)(1)(ix)]
- General Public Use – the rental units must be available for use by the general public. In addition, units must be rented in a manner

consistent with the Fair Housing Act; i.e., a determination that the taxpayer violated the Fair Housing Act may result in the loss of credit. [Regulation 1.42-9]

- Material Participation of Qualified Nonprofit Organizations – If the taxpayer received an allocation under IRC §42(h)(6), the qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period.
- Extended Use Agreement – No credit is allowable for a taxable year unless such an agreement is in effect as of the last day of such taxable year. [IRC §42(h)(6)]
- Certifications and Annual Reports – Under IRC §42(l), a taxpayer completes a one-time certification and provides the IRS with annual reports:
 1. Certification with respect to the 1st year of the credit period, which is a one-time filing of Form 8609. Part I is completed by the state agency and Part II is completed by the taxpayer.
 2. The taxpayer files Form 8609-A with the tax return for each year of the 15-year compliance period to complete the annual report.
- The taxpayer is required to certify at least annually to the state agency that the project met all the requirements. [Regulation 1.42-5(c)]
- Inspections by State Agency – tenant records and the property are subject to physical inspection by the state agency. [Regulation 1.42-5(c)(2)]

Credit Disallowance and Recapture

The credit may be disallowed (in part or in whole) based on the results of an audit. Not only is the credit disallowed in the year under audit, but if the Qualified Basis (Eligible Basis x Applicable Fraction) is less than the Qualified Basis at the close of the preceding year, then the

taxpayer is subject to the credit recapture provisions. [IRC §42(j)]

The recapture amount is computed as a portion of the credit allowable in prior years plus interest beginning on the due date for filing the return for the prior taxable year involved.

No credit is allowable for the year in which a taxpayer disposes of a building (or interest therein). The recapture provisions are also applicable unless, under IRC §42(j)(6), it is reasonably expected that the new owner will continue to operate the building as a qualified low-income building for the remainder of the 15-year compliance period *and* the taxpayer timely furnishes the IRS a bond for a satisfactory amount and for the required time period. [See Form 8693 and instructions]

Conclusion

In the Bentley Court case, the judge said that IRC §42 is detailed and complex. I agree, and even though this summary isn't exactly "brief", it is 1,580 words! Hope it helps.

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 202-283-2240, for signature approval.

♪ Grace Notes ♪

New Year's Eve, as the clock strikes twelve, we traditionally bid a fond farewell (or good riddance) to the ending year and usher a new year in with high expectations and a list of resolutions to accomplish. If you work for the Federal government, which has a fiscal year ending September 30th, the whole month is a time of reckoning!

And, as we complete another year, I would like to sum it all up by thanking all of you who have so steadfastly and enthusiastically engaged in the administration of IRC §42,

**Thank You
And
Happy New (Fiscal) Year!**

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