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

LIHC Partnership Returns & the Examination of Income

The examination of income is a required issue for all tax returns selected for audit and while LIHC partnerships are usually audited for specific IRC §42 issues, examiners must still complete the minimum income probes. While there is no required order in which these audit procedures and techniques for business returns must be performed, they are presented here as outlined in IRM 4.10.4.3.4.

Financial Status Analysis (IRM 4.10.4.3.3.1)

But first, while not required for partnership returns, a quick Financial Status Analysis (FSA) based on the rental schedule included with the return can be insightful. The FSA is really an evaluation of cash flows to estimate whether the taxpayer has sufficient funds to cover the known expenses. If possible, a three year analysis should be completed. The key questions are:

1. Is the rental activity generating a loss; i.e., there are more deductible expenses than income?

2. If generating a loss, is it a "tax" loss caused by depreciation or another noncash expense?

Note that a true negative cash flow can be anticipated because the rent for low-income units is restricted. In fact, under Reg. 1.42-4, the IRC §183 "hobby loss" rules do not apply to qualified low-income buildings for which the IRC §42 credit is allowable.

If the loss represents a true imbalance of cash flows, i.e., more expenses paid than income reported, then the examiner needs to determine the source of funds used to pay the bills and debt.

Balance Sheet Analysis

Analyzing accounts that have significantly changed and/or activity in the account may help explain how the taxpayer balances the cash flows. For example:

1. Increase in capital accounts,
2. Decrease in cash reserves or other assets,
3. Accrual of short term liabilities,
4. Postponement of existing debt, and
5. Increased or new debt.

For LIHC purposes, it is most important to consider the postponement of debt and increased debt. Key questions include:

1. If the terms of existing debt are so favorable that the taxpayer can postpone payment, then is it true debt? Is the debt owed to a related third party? Is the debt amount fixed? Are the interest rate and repayment periods fixed? Has the taxpayer made payments in the past? Can it be anticipated that the taxpayer will ever be able to repay the debt? Is the only payment on debt anticipated to be the proceeds from the building (when sold)?

2. Does the debt represent a developer's fee? If the payment is conditioned upon the on-going compliance of the LIHC project, then the fee is a management fee that should be expensed in the current period.

More than likely the debt described above supports costs included in the Eligible Basis used to compute the LIHC amount. If debt is not true debt, or is determined to be a current period cost, then the Eligible Basis will be affected.

Also consider whether the debt is really a disguised federal grant; i.e., there is no expectation of repayment. If the debt is really a federal grant, the Eligible Basis must be reduced by the amount of the grant that is federally funded and used to construct or operate an LIHC building. See IRC §42(d)(5)(A). Note: Eligible Basis is not reduced if the proceeds of a federal grant are used as a rental assistance payment under Section 8 of the United States Housing Act of 1937 or any comparable rental assistance program.

Is debt federally sourced? If so, what are the terms? Federal subsidies include direct and indirect loans which are from a federal source and bear a below-market interest rate; i.e., less than the applicable Federal rate in effect under IRC §1274(d)(1) as of the date on which the loan is made. Under IRC §42(b)(2)(B)(ii), the Applicable Percentage is 30% of the qualified basis of qualified new buildings that are federally subsidized, resulting in an Applicable Percentage approximating 4% for each year in the 10-year credit period.

<u>Reconcile Schedule M-1, M-2</u>

For Schedule M-1, remember that entries are not part of the taxpayer's double-entry accounting system. Normal account controls do not exist and errors can be frequent. Look for items that are deducted from the books and then erroneously deducted again on the Schedule M-1, transpositions of numbers, and expenses on the books but not on the tax return.

For Schedule M-2, changes in capital accounts can indicate whether monies have been distributed to a partner and where those funds originated

<u>Required Filing Checks</u>

The partnership return and the partners' tax returns are considered related because the returns are for entities over which a partner (most likely the general partner) will have control and could possibly manipulate to divert funds or camouflage transactions. In addition to determining whether the partnership and related partners are filing returns, the analysis should include:

1. A review of the partnership agreement. This document will provide information regarding the rights, obligations and powers of the managing partner.

2. Since the general partner is frequently the entity that developed the property, review the terms of the development contract (fee) and any contracts for on-going management of the project.

3. Identify transactions between the taxpayer and any individual or group of partners. Loans to the partnership and the source of the funds loaned should be evaluated.

<u>Interview the Taxpayer</u>

Interviewing the taxpayer is one of the most important audit techniques an examiner can use to gather information. This section focuses on interviewing the taxpayer about income from the operation of a LIHC project. Please refer to LIHC Newsletter #12 for more information about interviewing the owner of an LIHC project.

Rents

The maximum rent that can be charged for an LIHC unit is based on location, the location's median gross income, and the number of bedrooms in the unit. Ask the owner how many units are in the project, what the vacancy rate is, and what the turnover rate is for both low-income and market rate units. Also ask how many bedrooms each low-income and market rate unit has. From this information, the maximum rental income can be estimated. See IRC §42(g)(2) for details

However, there are adjustments to the rent limit, which need to be addressed during the interview:

1. Has the taxpayer received payments under Section 8 of the United States Housing Act of

1937? The gross rent limit applies only to payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through Section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, are not included in gross rent

2. Do tenants pay their own utilities? The gross rent must include an allowance for the cost of any utilities, other than telephone and cable, paid directly by the tenant.

3. Do tenant pay fees for supportive services? After 1989, gross rent does not include any fee for a supportive service paid to the owner by any governmental program or tax-exempt organization if the amounts paid for rent and assistance are not separable. Supportive services are discussed in Reg. §1.42-11.

4. Is rent based on Section 515 of the Housing Act of 1949? Beginning in 1991, gross rent does not include any Section 515 rental payment to the extent the owner pays an equivalent amount to the USDA Rural Housing Service. See IRC §42 (g)(2)(B)(iv).

Other Income Producing Activities

1. Are tenants paying any fees in addition to rent, and if so, what are the fees for?
2. Is the taxpayer receiving any rent subsidies from any federal, state, local or private source?
3. Is the property being used for a commercial purpose that generates income?

Other Sources of Funds

1. Did the taxpayer receive any federal grants or federal subsidies during the tax year under audit?
2. Have investors made additional contributions?
3. Did the taxpayer receive any loan proceeds during the tax year under audit?

Tour the Business Site

For purposes of the minimum income probes, touring the LIHC property site serves three fundamental purposes:

Taxpayer's Business Practices

Examiners can gain familiarity with the taxpayer's business practices. This is particularly important if a management company provides day-to-day oversight of the property. Observe the taxpayer's internal controls: how is rent collected, recorded and deposited? Trace the transactions through the books and records to evaluate the reliability of the taxpayer's recordkeeping; i.e., do the books and records reflect actual operation?

Also ask about other common rental fees and payments. The treatment of these additional fees as either included in gross rent, or as a fee in addition to gross rent, will determine whether the LIHC unit is correctly rent-restricted. If not properly rent restricted, the unit is not included in the numerator when computing the Applicable Fraction.

Any charges to low-income tenants for services that are not optional generally must be included in gross rent. (See Reg. §1.42-11). No separate fees should be charged for tenant facilities (i.e., pools, parking, recreational facilities) if the costs of the facilities are included in eligible basis.

Identify Potential Sources of Income

In addition to the rent collected from households occupying the LIHC units, consider other sources that are not tenant-specific, such as vending machines in a laundry room. Also look for commercial uses of the property, such as a radio or cell phone tower.

Confirm the Existence of Assets

It may seem obvious considering the frequent reviews and inspections by the state agencies, but make sure the property actually exists and is currently suitable for occupancy. A detailed explanation of the physical standards is included in the instructions to Form 8823.

Evaluate Internal Controls

Internal controls are the taxpayer's policies and procedures used to identify, measure, and safeguard business operations and avoid material misstatements of financial information. As with all taxpayers, the evaluation must include gaining an understanding of the taxpayer's business practices and control features. Specific to the LIHC, examiners should determine how the taxpayer ensures that the LIHC units are occupied by qualified low-income households, the rents for LIHC units are correctly limited, and the units are physically maintained in a manner suitable for occupancy.

1. Separation of duties: who determines that households are income-qualified? What policies are in place to ensure that the housing is available to the general public? How are prospective tenants identified? Who collects rents? Who makes deposits? Who reconciles the bank accounts?

2. Who maintains the financial records? Equally important, who has custody of the tenant files?

3. Adequate supervision of employees: Is there an on-site property manager? Who decides when physical maintenance is needed?

4. Management oversight and review: Because of the complex compliance requirements and potentially significant financial loss should noncompliance occur, it is quite likely that the limited partners (investors) will have some mechanism for ensuring that their investment is not at risk. Ask the taxpayer if there have been any independent or internal audits. A review of the results can be helpful to identify issues and set both the scope and depth of the IRS audit.

<u>Test Gross Receipts</u>

Use judgment to determine the depth of the reconciliation of income per the books and records to the income reported on the tax return. Base the conclusion on the reliability of the internal controls

1. Ask the taxpayer how income was computed and duplicate the taxpayer's steps.

2. Reconcile the bank records. If loan proceeds or other non-rent deposits are identified, ask for verification of the source; e.g., loan documents.

3. Confirm that income from all assets observed during the tour of the business in included in income.

4. Trace specific transactions. Do the books account for each month that each unit was occupied? For tenants that pay by cash, how is cash handled and how timely is cash deposited?

5. Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income. Test weaknesses to determine whether income was actually diverted.

<u>Business Ratio Analysis</u>

The initial reconciliation of income per the books and records to the tax return provides an understanding of *how* the taxpayer determined gross receipts. The books and records can also be used to evaluate the accuracy and reasonableness of the reported amount of income by analyzing ratios.

Horizontal Analysis

The tax return under audit should be compared to the prior and subsequent year returns. Look for changes in key ratios or absolute numeric entries. Changes over time can be identified and may result in the identification of large, unusual, or questionable items that would not otherwise be apparent. For example, a significant decrease in the depreciation expense may indicate that an asset is no longer in service. If the cost of the asset was included in the Eligible Basis, the impact on the credit needs to be considered.

Vertical Analysis

The tax return should be analyzed to identify differences between this taxpayer's business and the industry's standards for the year under audit. The purpose is to evaluate the reasonableness of the gross rents and new profit reported on the tax return.

This is a great audit technique, but realistically, where would you easily find statistics specific to LIHC properties?

An alternative is needed and (thank goodness) there is an easy substitute. Under IRC §42(m), the following information is available from the state agency that allocated the credit:

1. A comprehensive market study of the housing needs of low-income individuals in the area to be served by the project. (IRC §42(m)(1)(A)(iii))

2. Sources and uses of funds, as well as the total financing planned for the project. (IRC §42(m)(2)(B)(i))

3. Developmental and operational costs of the project. (IRC §42(m)(2)(B)(iv))

The information listed above can help determine whether the property is performing as anticipated. Significant deviation of actual costs and rental income from the anticipated amounts should be explained. Please refer to Newsletter #7 for more information about state agencies and how to contact them.

Conclusion

An examination of income is conducted to determine whether taxable income has been accurately reported on the tax return. While a return may be selected specifically for an LIHC issue, the examination of income remains an audit requirement. Completion of the examination of income will also provide needed information for determining whether the owner is in compliance with the requirements of IRC §42 and if the credit was correctly computed.

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 taxpayers, please make sure the additional returns also carry the LIHC project code and tracking code designation. 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♫

I really enjoy living on the east coast. Having grown up in the Salt Lake valley, basically a desert and dry bed of the really big ancient Lake Bonneville, I truly appreciate the multitudes of green trees in the spring…the glades of sun-dappled green trees in the summer…and the brilliant splendor of flaming reds and oranges and yellows during the autumn months. I even (mostly) enjoy raking up the leaves, which is what I found myself doing most of Thanksgiving weekend.

So there I was, raking up a pile of leaves under the Oak tree, when a flurry of wind came rushing through, creating a little momentary tornado with me in the middle. It was an odd feeling and certainly a unique perspective as the leaves fluttered around me. The leaves were as individually shaped as snowflakes!

Later, dragging bags of leaves to the sidewalk, I noticed an oddly shaped leaf stuck to the brick façade of my house. My first thought was that the leaf was snagged in a cobweb. But when I looked closer, I discovered that it was really a brown Preying Mantis sunning on the warm bricks. "Cool", I thought, "I didn't know these beautiful creatures actually change colors so they can continue blending with the foliage!" (If your brother is an entomologist, all bugs are beautiful creatures.)

While we have always focused directly on LIHC issues, the feature article this month is also written from a new point of view. What if I changed the perspective and looked at how I would complete the mandatory examination of income for a LIHC tax return…and, since this is the LIHC Newsletter, how would the examination of income interrelate with the audit of the credit?

Looking at something from a different perspective brings understanding and appreciation. It's fun!

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