Low-Income Housing Credit 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 contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

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Auditing Partners

Since most IRC §42 projects are owned by partnerships, it only stands to reason that the IRC §42 credit might surface as an issue when a partner's tax return is independently audited. The audit techniques required as part of the Required Filing Checks under IRM 4.10.5.4, for related returns when auditing a partner's return and possible resulting issues are discussed in this article.

Required Filing Checks for Related Tax Returns

Required filing checks are analytical audit techniques used to determine whether taxpayers are in compliance with all federal tax return filing requirements and whether the taxpayer's filed tax returns reflect the substantially correct tax liability. Completion of the Required Filing Checks is an important tool for increasing taxpayer compliance because the analysis is an opportunity to inspect more tax returns in greater detail and in context relative to the taxpayer's span of control. When warranted, the examination can be expanded to include related tax returns.

Identifying Partners

Taxpayers who are partners are relatively easy to identify since, at a minimum, the tax return will includes items such as income (or loss) and the IRC §42 credit flowing through from the partnership. Keep in mind that a partner can be another partnership, was well as a taxpaying entity such as an individual or corporation.

Related Entity Defined

Related returns are tax returns that have a relationship to the return. Returns are considered related if:

1. Adjustments made to one return require corresponding adjustments to the other return to ensure consistent treatment (see IRC §1313(c) and IRC §267), or
2. Returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage transactions (see IRC §267(b)).

Partner is a Partnership or Other Flow-Through Entity

If the investor files a partnership return, it is likely that the partnership has invested in multiple IRC §42 projects. The investments may be made directly as a partner in the partnership owning the IRC §42 project, or through tiers of flow-through entities.

1. Reconcile the amount of credit identified on Schedule K to the K-1s received from the partnerships through which the credit is flowing.
2. Determine whether the partnerships in which the taxpayer is a partner have filed their tax returns.
3. Using the research tools listed in IRM 4.10.5.4.1, confirm that the amount of credit claimed by the partnership when filing its tax return is consistent with the amount included on the Schedule k-1 provided to the partner. For example:

   - The taxpayer owns a 10% interest in a partnership claiming a $100,000 credit. The taxpayer claims a $10,000 credit.
   - The taxpayer owns a 10% interest in a partnership and claims a $10,000 credit based on the Schedule k-1 provided by the partnership. However, due to noncompliance issues, the partnership claimed zero credit when filing the partnership's tax return several months after distributing Schedules K-1 to its partners.

   If the related partnership has not filed a tax return, then all tax attributes, including the IRC §42 credit, income or loss, and deductions reported on the Schedule K-1 should be removed from the taxpayer's return.

4. Review the taxpayer's portfolio of investments in IRC §42 projects and determine whether the taxpayer has disposed of any investments. Ensure that the gain or loss has been correctly reported and consider whether the taxpayer is subject to the IRC §42(j) recapture provisions.

Partner is a Corporations

Complete the same analyses as for partnerships. In addition, reconcile the amount of credit claimed or carried forward into the tax year with the ordering rules in IRC §38(d) and carryforward/carryback rules in IRC §39.

Partner is an Individual

Complete the same analysis as for corporations, and in addition, apply the passive activity rules under IRC §469.

Conclusion

To summarize, the four basic issues to review are:

1. Does the credit claimed by the taxpayer reconcile to the Schedule k-1 provided by the partnership in which the taxpayer is a partner?

2. Did the related partnership file a tax return?

3. Is the credit claimed by the partnership consistent with the amount included on the Schedule k-1 provided to the partner?

4. If there was a disposition of a partnership interest, did the taxpayer report the gain/loss? Is the taxpayer subject to recapture?

Editor's Note #1: This article is a reprint and update of an article titled "Auditing Related Investor Returns" presented in Newsletter #20, issued in April of 2006.

Editor's Note #2: This article is based on information included in IRM 4.10.4.5, Required Filing Checks, which was recently updated.

Disallowing & Recapturing Credit: What's the Difference?

The terms "disallowing" and "recapturing" are so intrinsic to IRS jargon that it's easy to forget how the vernacular originated.

Disallowing Credit

IRC §38(a) reads, "…There shall be *allowed* as a credit against the tax imposed….for the taxable year an amount equal to the sum of the business credit carryforwards…the amount of the current year business credit, plus the business credit carrybacks…." The IRC §42 credit is included as part of the general business credit in IRC §38(b)(5). Therefore, if, as a result of an examination, the credit is determined not to be allowable, then (obviously) the credit is "disallowed" and voila, "disallowing" is what the examiner does! Disallowing, then, refers to decreasing the allowable credit for the year under examination.

Recapturing Credit

The term "recapturing," has a very specific meaning under IRC §42. Since the owner of an IRC §42 project claims the credit each year for 10 years (the credit period), but agrees to provide low-income housing for 15 year (the compliance period), the owner is claiming credit in advance of providing the associated services. Effectively, a portion of the credit claimed for each year in the credit period is associated with providing low-income housing in the last five years of the compliance period. Under IRC §42(j)(3) this portion of credit claimed in advance of providing the housing is called the "accelerated" credit.

The accelerated portion claimed in prior years is subject to recapture in all subsequent years of the compliance period if, at the close of the taxable year, the low-income building's qualified basis is less than the qualified basis at the end of the preceding taxable year, as reported on the taxpayer's tax return for the prior year. (See Newsletter #21 for discussion of the Duty of Consistency Doctrine.) A decrease in qualified basis is often referred to as a "recapture event." There will be a recapture event anytime an adjustment made to decrease either the Eligible Basis or the Applicable Fraction; i.e., qualified basis = eligible basis x applicable fraction.

The credit recapture amount is defined in IRC §42(j)(2) as the aggregate of the accelerated portion of the credit claimed in each prior year plus interest at the overpayment rate beginning on the due date for filing the tax return on which the credit was claimed. For audit purposes, the interest computation period ends on the date the tax return being audited was due. The percentage of credit subject to recapture decreases of time; .333 for years 2-11, .267 for year 12, .200 in year 13, .133 in year 14, and .067 for year 15. The percentage decreases during the last years because the taxpayer has been providing low-income housing for tax years after the credit period. However, the period of time over which interest is calculated is increasing.

Cautions

IRC §42(j)(4) includes special rules that also need to be considered. While not elaborated here, keep in mind that:

1. There is a tax benefit rule to account for carryforwards and carrybacks of credit by taxpayers actually using the credit to reduce their tax liability.

2. The recapture rules do not apply to credit based on additions to qualified basis under IRC §42(f)(3), as reflected on Form 8609-A line 7.

3. The recapture amount is not treated as a tax for determining any amount of credit.

4. No recapture is required if the reduction in qualified basis results from a casualty loss, but only if the loss is restored by reconstruction or replacement within a reasonable period.

5. Under certain circumstances, the recapture amount can be assessed at the partnership level.

6. The disposition of a low-income building (or interest therein) after July 30th, 2008, is not a recapture event if it is reasonably expected that the building will continue to be operated as a qualified IRC §42 project. However, the taxpayer remains subject to recapture if there is a recapture event after the disposition.

Significance

1. If there is an adjustment to the allowable credit for the current year, consider whether the adjustment has triggered the recapture provisions under IRC §42.

2. If the recapture provisions are triggered, the accelerated portion of the disallowed credit claimed in each prior year is recaptured.

3. There will be two adjustments on the audit report, one for the disallowed credit and one for the recapture amount.

4. Generally, the adjustment for the recapture amount is made only for the year that the recapture event occurred. Credit is not allowable for the year of the recapture event and, if the noncompliance continues in subsequent years, no credit would be allowable.

Evaluating Audit Risks

When evaluating audit risks for possible disallowance of credit in the current year, also consider the significance of recapturing credit originally claimed in prior years. Further, if the adjustment results in a permanent reduction in credit for the remaining years of the credit period, the evaluation should include consideration of revenue protection for tax years subsequent to the year audited.

Large Partnerships: How Large is Large?

A large partnership is a partnership with 35 or more *direct* partners. A large partnership is treated as the taxpayer to whom the credit is allowable for purposes of applying the credit recapture rules *at the partnership level*. As a result, the tax benefit rule under IRC §42(j)(4)(A) does not apply and the increase in tax because of the recapture amount is allocated among the partners in the same manner as the partnership's taxable income for the year is allocated among the partners. However, under IRC §42(j)(5)(C), a large partnership can elect not to be treated as a large partnership on Form 8609, line 10b. The election is irrevocable.

Administrative Reminders

Expanding Audits, Project/Tracking Code: All LIHC cases should include Project Code 0670 and ERCS 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 designation.

Form 5344, Revenue Protection: The Examination Closing Record, Form 5344, 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 IRM 4.4.12.4.58 for an example.

Surveying LIHC Tax Returns: If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

TEFRA Requirements: As LIHC property 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 12813, TEFRA Procedures
- Form 13814, TEFRA Linkage Package Checksheet
- Form 13828, Tax Matters Partner (TMP) Qualification Checksheet
- Form 13827, Tax Matters Partner (TMP) Designation Checksheet

More information is available on the TEFRA website, along with a list of TEFRA Coordinators who can help walk you through the procedures.

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**.

♫*Grace Notes*♫

Just for good measure. You know what I mean. You're 10 minutes late for work, so you stay 15 minutes late just for good measure. You fill your car's gas tank and when it's full and automatically stops, you give one last squeeze on the nozzle just for good measure. You're buying material off a bolt and the clerk measures an extra six inches because the edge is crooked just for good measure. You buy a dozen cookies at the spiffy French bakery and, to your delight, they gave you a baker's dozen just for good measure.

September is the end of the IRS' fiscal year, and as the newsletter is intended to be a quarterly newsletter, I counted to make sure….October and December of 2009, April and August of 2010…yep, four within the year…and one for good measure.

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