

Low-Income Housing Credit Newsletter

Internal Revenue Service

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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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Editor's Explanation: To qualify as a low-income unit, a residential rental unit must meet three requirements: (1) the unit must be occupied by an income-qualified household, (2) the rent must be restricted, and (3) the unit must be suitable for occupancy. This edition of the LIHC Newsletter is dedicated to a discussion of the last of these three criteria.

Suitable for Occupancy: Law

Under IRC §42(i)(3)(B)(ii), a low-income unit must be suitable for occupancy under regulations prescribed by the Secretary taking into account local health, safety, and building codes.

Annual Certification to State Agency

Under Treas. Reg. 1.42-5(c)(1)(vi), a taxpayer must certify annually to the state agency that, for the preceding 12-month period:

1. the buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes (or other habitability standards), and
2. the state or local government unit responsible for making local health, safety, or building code inspections did not issue a violation report for any building or low-income unit in the project. If a violation report or notice was issued by the governmental unit, the owner must attach a statement summarizing the violation report or notice or a copy of the violation report or notice to the annual

certification submitted to the state agency and explain whether the violation has been corrected.

Record Retention

Under Treas. Reg. 1.42-5((b)(3), a taxpayer must retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit for the state agency's inspection. Retention of the original violation reports or notices is not required once the state agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

Casualty Losses

The determination that a unit is unsuitable for occupancy is based on its physical condition, without regard for the cause of the noncompliance. However, there are relief measures in place when the damage is the result of a casualty event. While no credit is allowable, IRC §42(j)(6)(E) provides relief from the credit recapture provisions; i.e., the recapture provisions are not applied when there is a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period. In CCA 200134006, Chief Counsel clarified that a period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties.

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after July 2, 2007, then Rev. Proc. 2007-54 provides the additional relief for damaged projects. Similar relief provisions are provided in Rev. Proc. 95-28 for locations declared major disaster areas before July 2, 2007.

Suitable for Occupancy: State Agency Inspections

State agencies are required to physically inspect IRC §42 projects throughout the entire 15-year compliance period. The inspections are based on a sample of at least 20% of the low-income units in the project. Under Treas. Reg. 1.42-5(c)(2)(ii), the inspections are conducted:

1. by the end of the second calendar year following the year the last building in the project is placed in service, and
2. at least once every 3 years thereafter.

The state agency can choose the standard used for conducting inspections and determining compliance. The state agency can choose either:

1. local health, safety, and building codes (or other habitability standards), or
2. the uniform physical condition standards for public housing established by HUD. If the state agency uses HUD's physical condition standards to conduct inspections, HUD's standards do not supersede or preempt local health, safety, and building codes. A low-income housing project under IRC §42 must continue to satisfy the local health, safety and building codes.

The state agency must also review any local health, safety, or building code violations reports or notices retained by the taxpayer.

Suitable for Occupancy: HUD's Uniform Physical Condition Standards

HUD's Uniform Physical Condition Standards (UPCS) require housing to be decent, safe, sanitary and in good repair. The major areas of consideration include:

1. **Site:** The site components such as fencing and retaining walls, grounds, lighting, mailboxes/project signs, parking lots and driveways, play areas and equipment, refuse disposal, roads, storm drainage, and walkways must be free of health and safety hazards and in good repair. The site must not be subject to material adverse conditions, such as abandoned vehicles, dangerous walks or steps, poor drainage, septic tank back-ups, sewer hazards, excess accumulations of trash, vermin or rodent infestation, or fire hazards.
2. **Building Exterior:** Each building on the site must be structurally sound, secure, habitable, and in good repair. Each building's doors, fire escapes, foundations, lighting, roofs, walls, and windows, where applicable, must be free of health and safety hazards, operable, and in good repair.
3. **Building Systems:** Each building's domestic water, electrical systems, elevators, emergency power, fire protection, HVAC, and sanitary system must be free from health and safety hazards, functionally adequate, operable and in good repair.
4. **Dwelling Units:** Each dwelling unit within a building must be structurally sound, habitable, and in good repair. The dwelling unit must be free from health and safety hazards, functionally adequate, operable and in good repair. This includes all areas and aspects of the

dwelling unit; i.e., bathroom, call-for-aid (if applicable), ceiling, doors, electrical systems, floors, hot water heater, HVAC, kitchen, lighting, outlets/switches, patio/porch/balcony, smoke detectors, stairs, walls and windows.

Where applicable, the dwelling unit must have hot and cold running water, including an adequate source of potable water. If the unit includes its own sanitary facility, it must be in proper operating condition, usable in privacy and adequate for personal hygiene and the disposal of human waste. The unit must include at least one battery-operated or hard-wired smoke detector in proper working condition on each level of the unit.

5. **Common Areas:** The common areas must be structurally sound, secure, and functionally adequate for the purposes intended. The basement/garage/carport, restrooms, closets, utility, mechanical, community rooms, day care, halls and corridors, stairs, kitchens, laundry rooms, office, porch, patio, balcony and trash collection areas, if applicable, must be free from health and safety hazards, operable, and in good repair. All common area ceilings, doors, floors, HVAC, lighting, outlets/switches, smoke detectors, stairs, walls, and windows, to the extent applicable, must be free of health and safety hazards, operable, and in good repair.
6. **Health and Safety Concerns:** All areas and components of the housing must be free of health and safety hazards. These areas include, but are not limited to, air quality, electrical hazards, elevators, emergency/fire exits, flammable materials, garbage and debris, handrail hazards, infestation and lead based paint. For example, buildings must have fire exits that are not blocked and have hand rails that are not damaged, loose, missing portions, or otherwise unusable. The housing must have no evidence of infestation by rats, mice, vermin, or garbage and debris. The housing must have no evidence of electrical hazards, natural hazards, or fire hazards. The dwelling units and common areas must have proper ventilation and be free of mold as well as odor (e.g., propane, natural, sewer or methane gas) or other observable deficiencies. The housing must comply with all requirements related to the evaluation and reduction of lead-based paint hazards and have available proper certifications of such.

Dictionary of Deficiencies

To ensure consistent evaluation of the property's physical condition, the UPCS are supplemented by the Dictionary of Deficiencies, which uses the same major sections as the UPCS and identifying specific components and non-compliance issue ranked by severity (level 1, 2 or 3).

Suitable for Occupancy: IRS Provides Additional Guidance

CCA 201042045, released October 22, 2010, provides explanations for two issues related to evaluating the physical condition of IRC §42 projects.

Unit-by-Unit or Building Determinations

The first question addressed the issue of whether the suitable for occupancy requirement of IRC §42(i)(3)(B) must be determined on a unit-by-unit basis, or could the condition of the exterior components of the building (e.g., wall, roof, etc.) be so poor as to lead to a determination that all the units in a building were not suitable for occupancy?

Chief Counsel responded that the suitable for occupancy requirement does not have to be determined on a unit-by-unit basis if the facts exist that the condition of the exterior components of the building (e.g., wall, roof, etc.) are so poor as to lead to a factual determination that all the units in a building are not suitable for occupancy. For example, if an earthquake created large fissures in the foundation and exterior walls of a building then the building could be determined not suitable for occupancy for safety reasons without having to check each unit.

Inspection Standards

Chief Counsel was also asked to explain the relationship between HUD's uniform physical condition standards (UPCS) and the "local health, safety and buildings codes" as described in Treas. Reg. §1.42-5 (d).

Chief Counsel responded that:

1. Under Treas. Reg. §1.42-5(d)(2), an Agency may use the HUD uniform physical condition standard to perform an on-site inspection to satisfy the Agency's inspection responsibility.
2. A violation of the HUD physical condition standard alone is sufficient for a violation of IRC §42(i)(3)(B).
3. "...a taxpayer, in response to the IRS finding a violation, may raise an affirmative defense by proving that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result where as the HUD standard does not reach a taxpayer favorable result. Under these circumstances, the local law would control as respects the violation itself."

Suitable for Occupancy: Audit Techniques

Audit Technique #1: Interview Questions

The taxpayer should be interviewed and asked to explain what internal controls are in place to ensure that the units are

suitable for occupancy. What procedures are in place to maintain the project, identify physical deficiencies, and correct problems on an on-going basis? Does the taxpayer follow a routine maintenance schedule? Does the taxpayer regularly inspect the units?

If the IRC §42 project is operated by an independent property manager, what oversight does the taxpayer provide to ensure that the manager maintains the project in compliance? Does the taxpayer conduct internal audits or personally visit the project?

Audit Technique #2: Annual Certification to State Agency

The taxpayer's annual certification to the state agency should be reviewed. If the taxpayer cannot provide the certification, request the documentation from the state agency. Although self-prepared, the certification may be the only evidence of compliance prepared concurrent to the events.

Audit Technique #3: Vacant Units

Vacant units must also be suitable for occupancy. While a reasonable period to clean a unit and repair any damages caused by a prior tenant is acceptable, vacant units that are not move-in ready are not suitable for occupancy.

1. Ask the taxpayer to explain the policies and procedures in place to prepare a vacated unit for a new tenant and how long it usually takes. For example, if the vacancy rate is high, a taxpayer may not be willing to expend the funds until a new tenant has been identified.
2. Review the tenant rent roles to identify rental units that are vacated during the year and estimate the average time between tenants.
3. Identify rental units that are vacant for unusually long periods of time. Ask the taxpayer to document that the units were prepared for occupancy. For example, the taxpayer may show receipts for cleaning expenses or repairs.

Audit Technique #4: Tour the Project Site

The IRC §42 project should be toured to ensure the housing exists, includes the assets described in the records, and is suitable for occupancy. The tour is an opportunity to observe the project's current physical condition and the taxpayer's on-going efforts to physically maintain the housing.

Audit Technique #5: State Agency Inspections

If the state agency inspected the IRC §42 project during the year under audit, the documentation of their inspection can be used as evidence that the project was maintained in a manner suitable for occupancy. If the state agency reported to the IRS on Form 8823 that the buildings were not suitable for occupancy during the year under audit, then the state agency should be able to provide reports (including descriptions), correspondence with the taxpayer or property manager, and in some cases, photographs. Ask the taxpayer

whether the noncompliance has been corrected and to provide documentation evidencing exactly when the project was restored to compliance.

Audit Technique #6: Other Documentation of Compliance

While it is not possible to physically observe the project as it was maintained during the taxable year under audit, documentary evidence of compliance from other sources should be reviewed if available.

1. Ask the owner whether any state or local government conducted an inspection, and if so, if any violations were noted. Copies of the reports should be secured and reviewed to determine if any noted violations were corrected. Alternatively, state and local governments may be contacted directly to determine whether inspections occurred and whether violations were identified.
2. Determine whether the project was physically inspected for another purpose and secure any findings. For example, regular inspections will be conducted if the taxpayer is participating in HUD's housing programs or a commercial lender may conduct inspections to ensure that the assets securing the debt maintain their value.

Suitable for Occupancy: Adjusting the Applicable Fraction

Under IRC §42(c)(1)(B), the Applicable Fraction is the smaller of the unit fraction or the floor space fraction. IRC §42(c)(1)(C) defines "unit fraction" as the fraction, the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units in such building. IRC §42(c)(1)(D) defines "floor space fraction" as the fraction, the numerator of which is the total floor space of the low-income units in such building, and the denominator of which is the total floor space of the residential rental units.

Under IRC §42(c)(1)(A), the applicable fraction is determined on the last day of the taxable year. Low-income units that are not suitable for occupancy at the end of the taxable year are not qualified low-income units and will reduce the Applicable Fraction used to compute the allowable IRC §42 credit for the taxable year.

Example

Suppose a taxpayer owns a 100% low-income building with 10 residential units. As part of an IRS audit, an examiner determined that 3 of the 10 units were not suitable for occupancy at the end of the taxable year under audit. Using the Unit Fraction method, the Applicable Fraction is $(10-3)/10 = .7000$.

The examiner must also compute the fraction using the Floor Space Fraction method. The 100% low-income building consists of 5 units with 1,000 square feet and 5 units with

1,200 square feet, for a total of 11,000 square feet. All three of the units determined to be unsuitable for occupancy were units with 1,200 square feet. The Applicable Fraction using the Floor Space Method is computed as:

$$\frac{(2)(1,200) + (5)(1,000)}{11,000} = .6700$$

The corrected Applicable Fraction is the smaller of the two fractions, or .6700.

Audit Adjustments

Suppose the allowable IRC §42 credit is \$75,000, and that on Form 8609-A filed with the tax return, the taxpayer computed the credit as:

Eligible Basis:	\$833,333
Applicable Fraction:	x 1.00
Qualified Basis:	\$833,333
Applicable Percentage:	x 0.0900
Allowable Credit:	\$75,000

When the Applicable Fraction is reduced to .6700, the allowable credit is $\$833,333 \times .6700 \times 0.0900 = \$50,250$.

The adjustment to the allowable credit is $\$75,000 - \$50,250 = \$24,750$. Since the adjustment resulted in a reduction of the Qualified Basis, the IRC §42(j) recapture provisions are also applied.

Suppose the year under audit is 2008, and is the 6th year of the 15-year compliance period. The recapture rate is .333. The recapture amount from each prior year is $.333 \times \$24,750$, which equals \$8,241, plus interest from the due date of the return on which the credit was claimed to the due date of the return on which the recapture is being made. For the example here, the total recapture amount (credit and interest) is \$50,461 for tax years 2003-2007.

Helpful Hint

The computation of the allowable credit can be quite complex, unlike the simple computation presented in the example. The easiest method is to follow the format presented on Form 8609-A filed with the tax return.

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 202-283-2485, 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

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♪ Grace Notes ♪

Wouldn't you know? I'm at the office and helping an agent with the computation of an adjustment to Eligible Basis. Unlike nice examples with numbers that are easy to work in your head, I am working with real costs and need my calculator. I reach in my bag for my little HP and...what! It isn't there. Where did I leave it? Oh, it's probably at home on my desk where I was balancing my checking account. Well, not really a problem, I can still add, subtract, multiple and even divide numbers all by myself, right? Okay...how do you set up a long division problem on paper again? Only an almost unnoticeable hesitation as I reached for paper and pen...well, better use a pencil. Can't find one! Then, I needed to multiply one big number by a three digit fraction...how do you move that decimal point again? I haven't not used a calculator for a serious "got-to-be-right" math problem for a very long time!

In the back of my head I can hear my high school math teacher, "...You can't depend on calculators...You have to think for yourself," while sadly shaking his head in disappointment. Obviously, he wasn't about to let us use our spiffy hand-sized calculators. Instead, he taught us how to use a slide ruler...which, even way back in the 1970's when I was in high school, already seemed like... shall we say...a useless exercise?

But it got me to thinking...who do we have to thank for the slide ruler? And by the way...who figured out computer chips? I mean, how does electricity flowing through a bunch of silicon add up numbers, do google searches, identify "questionable" grammar with squiggly green lines, and, just for fun, provide me with 228 fonts to choose from (yes, I counted and that includes the wing-

dings), and who can decide? Whoever thought anyone *needed* 228 choices?

So, I get home from work and being a little concerned about my not-so-cheap HP, I look for it on my desk and it isn't there. I search a bit more diligently...under several stacks of paper...still can't find it. Did I use it at work, then leave it somewhere on the desk rather than putting it back in my bag...must be...and if you ever saw my office, you'd understand why I'm pretty sure it has to be there. But nope; I looked the next morning and it was not to be found. So, where is it....after more focused searching at home, I still couldn't find it!

So, I applied the "eventually" theory: you know, "eventually" it will turn up. And eventually it did...I was sorting through a stack of Christmas CD's by the stereo...and there it was, stuck right in the middle of the stack...I have absolutely no idea how it got there!

But in case you are curious (I was), the slide rule was invented by William Oughtred in 1625 and continued to be used until the first handheld calculator was produced in 1972 by...you guessed it...Hewlett Packard. I still have my first little calculator and I just love 1970's design with the black finish and silver highlights. But I'm digressing. Think about it. In 1972, when I learned to use a slide rule, I could have time traveled back to any point in time after 1625 (a 347 year span) and would have seen everyone using the same exact tool I was using...I'd fit right in! But if today's high school senior went back to 1971...right before the calculator went on the market...could they multiply \$10,957,782 by .0948 without a calculator? Could they even begin to use a slide rule? What about telephones? Would they know to look for a pay phone? Would they know what it would have looked like? Would they know to listen for the dial tone before dialing? Cell phones were not much more than an itsy-bitsy intriguing concept being imprinted on a Star Trek fan's head while watching Captain Kirk stuck on a planet "communicating" with Spock on board the Enterprise ----nothing more than a clever literary device at the time. By the way, have you noticed how your cell phone loses its signal at the most inconvenient moments...just like Captain Kirk's communicator at the most critical point in the plot?

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