

# THE LOW-INCOME HOUSING TAX CREDIT

Steven L. Paul

2017 Edition



**Klein Hornig** LLP

COUNSELORS AT LAW

Boston . Washington . [www.kleinhornig.com](http://www.kleinhornig.com)

Klein Hornig LLP provides tax and syndication expertise to developers and syndicators of, and investors in, affordable housing projects utilizing the low-income housing tax credit. Services offered by the Firm include tax and structuring advice, preparation of offering materials, partnership agreements and other syndication documents, rendering of tax opinions and, when appropriate, obtaining IRS private letter rulings. The Firm regularly works on projects sponsored by nonprofit organizations. Our experience includes projects for families, mixed-income projects, including large-scale 80-20 projects, projects for the elderly, including congregate care and assisted-living facilities, single-room occupancy projects for homeless individuals or individuals with substance abuse problems, projects for tenants with special needs, HOPE VI projects, mixed-use projects and projects eligible for both the low-income housing and rehabilitation tax credits.



Steven Paul joined the Firm as a partner in March of 2015. Before joining the firm, Steve was a partner and, for many years, served as the Chair of the Tax, Benefits and Compensation Department of Boston's Palmer & Dodge LLP and its successors, Edwards Angell Palmer & Dodge LLP, Edwards Wildman Palmer LLP and Locke Lord LLP. He is a former Chair of the Committee on Real Estate of the American Bar Association Section of Taxation. Mr. Paul has twice been appointed Visiting Lecturer in real estate taxation and finance at Yale Law School, where his course featured low-income housing syndications. He has also taught at the Boston University Law School Graduate Tax Program and served as Chair of the Federal Tax Committee of the Boston Bar Association and vice-chair of the Tax Section of the Massachusetts Bar Association. He served as Attorney-Advisor and Assistant Branch Chief in the Interpretative Division, Office of Chief Counsel, Internal Revenue Service. Mr. Paul received his B.A. from the University of Pennsylvania in 1970, his J.D. from Boston College Law School in 1973, and his L.L.M. in Taxation from Georgetown University Law Center in 1976.

The assistance of Katie G. Day, Emily J. Blumberg, Rebecca Melaas and Sara Silverstein in the updating of this outline is gratefully acknowledged.

Katie joined Klein Hornig in May 2015, focusing her practice on federal and state income taxation of corporate, flow-through, and tax-exempt entities, as well as individuals. Katie represents developers, syndicators and investors in federal and state tax credit transactions, including historic, new markets and low-income housing tax credits. Katie also has extensive experience representing non-profit organizations and is well-versed in the



law of tax-exempt organizations, including the rules governing private foundations, various federal and state reporting requirements, and the tax on unrelated business income. Prior to joining Klein Hornig, Katie worked for Edwards Wildman Palmer LLP as a member of the firm's Tax, Benefits & Compensation Department. Katie received her B.A. from The College of William & Mary in 2003, her J.D. from Boston College Law School in 2006 and her L.L.M. in Taxation at Boston University in 2014. Katie was promoted to partner in December 2016.

Emily Blumberg focuses her practice on a wide range of affordable housing and community development issues, including public housing/mixed-finance development, Low-Income Housing Tax Credits, HUD regulatory matters, and nonprofit organizations. She draws on her recent experience as a Polikoff-Gautreaux Fellow at Business and Professional People for the Public Interest (BPI) in Chicago, where she used legal, policy, and legislative advocacy to revitalize public housing and preserve affordable housing. Prior to joining BPI, Emily clerked for Justice Denise R. Johnson of the Vermont Supreme Court. Emily received her B.A. from Harvard College in 2004 and her J.D. from Harvard Law School in 2010.



Rebecca Melaas joined Klein Hornig in January 2016, focusing her practice on federal and state income taxation of corporate, flow-through and tax-exempt entities and individuals. She also has experience in transactions using federal and state tax credits and incentives, including low-income housing and new markets tax credits. Rebecca has also represented a number of non-profit organizations in obtaining tax-exempt status and addressing on-going compliance issues, including various federal and state reporting requirements and the tax on unrelated business income. Before joining Klein Hornig, Rebecca worked for Locke Lord LLP (formerly Edwards Wildman Palmer LLP) as a member of the firm's Tax, Benefits & Compensation Department. Rebecca received her B.A. from Bates College in 2008 and her J.D. from Boston College Law School

in 2011.



Sara Silverstein joined Klein Hornig in November 2015, focusing her practice on affordable housing and community development with a particular emphasis on federal and state tax credit transactions, including historic, new markets, and low-income housing tax credits. She advises for-profit and nonprofit clients on a variety of development and financing issues, including corporate structuring and investments, purchase and sale agreements, real estate financing, and tax credits. Prior to joining Klein Hornig, Sara worked for King & Spalding, where she gained significant experience advising clients on a wide range of complex state and federal

tax matters. She structured and reviewed transactional agreements, researched and drafted memoranda relating to complex tax matters, and counseled nonprofit entities on issues that uniquely affect tax-exempt organizations. Sara also served as a law clerk for the Honorable Marian Blank Horn on the United States Court of Federal Claims. Sara earned her B.A. from the University of Pennsylvania in 2008 and her J.D. from New York University School of Law in 2011.

October 10, 2017



## HIGHLIGHTS OF 2017 EDITION

On June 14, 2017, the IRS and Treasury Department published proposed regulations regarding the new centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA). The BBA was enacted into law on November 2, 2015, repealing TEFRA's unified partnership audit and litigation rules and replacing them with a new centralized regime. Pub. L. No. 114-74. Under the new partnership audit rules, adjustments to items of income, gain, loss, deduction, or credit of a partnership are determined, and tax attributes attributable thereto are assessed and collected, at the partnership level. The new rules provide an opportunity to elect out of partnership-level tax and flow through any adjustment to the partners. The election must be made within 45 days of the final determination. Many investors are requiring that any elections under the new rules, including the election to flow through an adjustment to the partners, be made only with the consent of the investor. One way to address this from the Sponsor's perspective is to include language in the partnership agreement to the effect that if the partnership bears the burden of an adjustment, each of the partners will be required to make a capital contribution to the partnership equal to its proportionate share of such adjustment, provided that the general partner remains responsible for any items for which it is already obligated under the partnership agreement, e.g., recapture, disallowance, adjusters, etc. These rules go into effect for partnership taxable years beginning after December 31, 2017, and they mark a drastic change in the way partnerships are audited.

The proposed regulations provide procedures for partnerships to elect out of the new regime and to elect to pass through adjustments to the partners, guidance regarding filing administrative adjustment requests and determinations of amounts owed, and definitions and rules governing the existence and activity of the partnership representative. The proposed regulations affect partnerships for taxable years beginning after December 31, 2017 and any other partnerships that elect its application for taxable years beginning between November 2, 2015 and January 1, 2018. Comments were requested and a hearing was scheduled for September 18, 2017. Under the new rules, all partnership and partner adjustments related to an audit are made in the year in which the audit takes place (the "adjustment year"). Consequently, the persons who are partners in the adjustment year may bear the economic burden of an assessment of tax due even if they were not the same persons who were partners during the year under audit, i.e., current partners may bear the economic burden of an assessment rather than former partners who benefitted from the underpayment in earlier years.

Legislation of major significance was reintroduced over the past year as well. The Affordable Housing Credit Improvement Act of 2017, S. 548, 115th Congress (2017) reiterates the proposals previously set forth in the Affordable Housing Credit Improvement Act of 2016, S. 2962, 114th Congress (2016) and S. 3237, 114<sup>th</sup> Congress (2016). The 2017 bill contains the same three provisions in S. 2962 and S. 3237 (i.e., (i) a 50% increase in per-capita and small state minimum allocations, phased in over 5 years, (ii) a new income-averaging election, which would allow properties to reserve at least 40% of the apartments in a development for renters at an average of



60% of area median gross income (AMGI) as long as no renter is more than 80% of AMGI at initial occupancy, and (iii) a permanent minimum 4% rate for LIHTCs used to finance the acquisition of property or generated by tax-exempt bonds). In addition to these provisions, the 2017 bill includes four other major improvements. The 2017 bill provides state housing finance agencies with the authority that Treasury currently possesses to make a determination that a planned foreclosure is an “arrangement” intended to terminate the extended use period, adds a provision that repeals the cap on qualified census tracts and difficult to develop areas so that a greater number of areas may receive these designations, entitling projects located in such areas to receive a basis boost, requires the Secretary of the Treasury to issue guidance prohibiting states’ QAPs from including local approval or local contribution requirements, and provides criteria for states to consider when determining whether projects contribute to a concerted community revitalization plan.

Over the past year there has been tremendous speculation regarding major tax reform and the lowering of tax rates for both individuals and corporations; however, to date, little has actually taken place. Tax reform and the passage of relevant tax extenders remain uncertain. The equity markets appear to have settled on the assumption of a 25% tax rate. Most investors are moving away from upward adjusters if the tax rate remains at 35% or drops but stays at above 25%.



## TABLE OF CONTENTS

|             |   |    |
|-------------|---|----|
| <b>I.</b>   | <b>TIMING AND AMOUNT OF CREDIT</b> .....                              | 1  |
| <b>A.</b>   | Ten Year Period. ....   | 1  |
| <b>B.</b>   | Amount of Credit. ....  | 6  |
| <b>C.</b>   | Determination of Applicable Percentage. ....                          | 12 |
| <b>D.</b>   | Compliance Period.....  | 17 |
| <b>II.</b>  | <b>ELIGIBLE BASIS/QUALIFIED BASIS</b> .....                           | 17 |
| <b>A.</b>   | New Buildings and Substantial Rehabilitations.....                    | 17 |
| <b>B.</b>   | Existing Buildings.....   | 19 |
| <b>C.</b>   | Special Rules for Calculating Eligible Basis. ....                    | 23 |
| <b>D.</b>   | Property Purchased During Construction. ....                          | 31 |
| <b>III.</b> | <b>DEFINITION OF “QUALIFIED LOW-INCOME BUILDING”</b> .....            | 32 |
| <b>A.</b>   | Must be subject to the Modified Accelerated Cost Recovery System..... | 32 |
| <b>B.</b>   | Must be part of “Qualified Low-Income Housing Project”.....           | 32 |
| <b>C.</b>   | Multiple Buildings. ....  | 44 |
| <b>D.</b>   | Definition of Low-Income Units. ....                                  | 46 |
| <b>E.</b>   | Extended Use Requirements. ....                                       | 50 |
| <b>IV.</b>  | <b>ALLOCATION OF CREDIT</b> .....                                     | 57 |
| <b>A.</b>   | Allocation Required. ....   | 57 |
| <b>B.</b>   | Timing and Duration of Allocation.....                                | 57 |
| <b>C.</b>   | Determination of State Ceilings.....                                  | 61 |
| <b>D.</b>   | Allocation Procedures: Qualified Allocation Plans. ....               | 63 |
| <b>E.</b>   | Compliance Monitoring. ....   | 66 |
| <b>F.</b>   | Set-Aside for Non-profit Organizations.....                           | 69 |
| <b>G.</b>   | Special Rules.....  | 75 |
| <b>H.</b>   | Bond Financed Projects. ....  | 76 |
| <b>I.</b>   | Correction of Administrative Errors. ....                             | 79 |
| <b>V.</b>   | <b>RECAPTURE OF CREDIT</b> .....                                      | 81 |
| <b>A.</b>   | Recapture Events During Compliance Period. ....                       | 81 |
| <b>B.</b>   | Amount Subject to Recapture. ....                                     | 85 |
| <b>C.</b>   | Large Partnerships. ....  | 86 |
| <b>VI.</b>  | <b>LIMITATIONS ON CREDIT</b> .....                                    | 86 |

## TABLE OF CONTENTS

|              |   |           |
|--------------|---|-----------|
| A.           | Regular Section 38 Rules Apply.....   | 86        |
| B.           | Section 183 and Similar Limitations Do Not Apply.....   | 86        |
| C.           | Application of At Risk Rules.....   | 88        |
| D.           | Application of Passive Activity Rules.....  | 89        |
| <b>VII.</b>  | <b>MASSACHUSETTS LOW-INCOME HOUSING TAX CREDIT .....</b>  | <b>89</b> |
| A.           | Timing and Amount of Credit.....  | 90        |
| B.           | Allocation of Credit.....   | 91        |
| C.           | Recapture of Credit.....  | 93        |
| <b>VIII.</b> | <b>COLLATERAL TAX ISSUES .....</b>  | <b>94</b> |
| A.           | Partnership Allocations.....  | 94        |
| B.           | Deferred Development Fees.....  | 96        |
| C.           | Partnership Anti-Abuse Regulations.....   | 96        |
| D.           | Economic Substance.....   | 97        |
| E.           | Federal Tax Treatment of State Tax Credits.....   | 99        |
| F.           | Imputed Interest.....   | 103       |
| G.           | Property Taxes and Related Issues.....  | 104       |
| H.           | Tax-Exempt-Use Property.....  | 105       |
| I.           | Reportable Transactions: Disclosure Requirements and Excise Taxes.....  | 107       |
| J.           | Electronic Filing and Form 8609.....  | 108       |
| K.           | Hurricane and Other Disaster-Related Relief.....  | 108       |
| L.           | Form 8823, Low-Income Housing Credit Agencies Report of<br>Noncompliance or Building Disposition, and Updated §42 Audit<br>Technique Guide..... | 111       |
| M.           | Legislative Updates.....  | 113       |
| N.           | GAO Report.....   | 116       |



## I. TIMING AND AMOUNT OF CREDIT

### A. Ten Year Period.

The low-income housing tax credit is claimed annually over a ten-year period (the “Credit Period”) which begins when a building is placed in service or, at the irrevocable election of the taxpayer, in the succeeding taxable year. Internal Revenue Code of 1986, as amended (“Code”) §§42(a) and (f)(1). Buildings in the same project may have different Credit Periods.

1. The first-year credit is reduced to reflect the number of months of qualified occupancy (determined as of the last day of each month) during the first year. Note that although first-year occupancy is determined at the end of each month, a unit must be in service for the full month to qualify for credits. Code §42(f)(2)(A)(i); Rev. Rul. 2004-82, 2004-2 C.B. 350.
2. Any unused portion of first-year credit is allowed in the 11th year. Code §42(f)(2)(B).
3. The Credit Period for costs of acquiring an existing building generally does not begin until the building has been substantially rehabilitated. Code §42(f)(5). For projects consisting of the acquisition of an occupied building and a substantial rehabilitation of the building, the taxpayer may claim first-year credits for both rehabilitation and acquisition costs based on the number of full months of occupancy of the acquired building during the year the rehabilitation expenditures are placed in service, provided the tenants are certified as qualified tenants within a reasonable period following the acquisition of the building. Code §42(e)(4)(B); PLR 200044020 (August 3, 2000). Comment: Absent an election to defer the start of the Credit Period (see A.5., infra), this rule may result in a loss of credits for investors admitted after acquisition but prior to completion of the rehabilitation when all events occur in the same year.

Example: A fully occupied building is purchased by a limited partnership on January 20, tenants are certified by March 1, an investor limited partner is admitted on May 1 and rehabilitation of the building is completed in December, all in the same year. Eleven months of credits on both acquisition and rehabilitation costs are available that year, from February through December, with one month of credits deferred until the eleventh year. Credits for three months, February through April, will not be available to the investor unless the Partnership elects to commence the Credit Period the following year. Query: If certification of tenants is not completed until May 1, might the Credit Period start then so that the February through April Credits are deferred to year eleven, rather than being lost to the investor entirely?

4. Although Code §42(f)(1) refers to ten “taxable years,” IRS views the Credit Period as covering 120 months so that credit is prorated for short taxable years. Rev. Rul. 91-38, 1991-2 C.B. 3, Questions 2 and 3.
5. Comment: Election to defer Credit Period may be useful:
  - a. to avoid “wasting” of credits prior to syndication (see A.3, supra);
  - b. to maximize Eligible Basis (defined in II.A.1., infra), which includes costs incurred through the end of the first year of the Credit Period; see II.A., infra;
  - c. to avoid reduction of credits to 2/3 of applicable percentage for units first occupied by eligible tenants after year of placement in service, see C.4., infra.
  - d. Note: The IRS may grant a reasonable extension of time to the taxpayer to make (or correct) the election if the taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government. See PLR 201616007 (January 13, 2016); PLR 201552012 (September 16, 2015); PLR 201518011 (January 12, 2015); PLR 201505037 (October 23, 2014); PLR 201444013 (July 29, 2014); PLR 201431001 (April 3, 2014); PLR 201436046 (February 20, 2014); PLR 201338010 (September 20, 2013); PLR 201218006 (May 4, 2012); PLR 201223005 (June 6, 2012).
  - e. Split-Year Allocations. In some states (e.g., Massachusetts), split-year allocations (e.g., credits awarded to a project from two separate annual credit ceilings (e.g., 2017 and 2018)) are increasingly common and can be problematic, particularly for single building projects. First, under the first year convention, a project owner may only claim a portion of the annual allocation for the first year in the Credit Period based on the number of months of qualified occupancy during such year. Code §42(h)(7)(C). For example, assume a project comprised of a single building receives a binding forward commitment in 2016, the year the project is placed in service, for \$500,000 of 2017 and \$500,000 of 2018 Credits. As a threshold matter, the project needs to elect to defer the start of the credit period until 2017. This is true even though the project is not eligible to claim credits in 2016. See PLR 201518011. If the project is placed in service on July 1, 2017 and fully leased up on or before July 31, 2017, the project owner would be entitled to claim \$250,000 of Credits (not \$500,000) in 2017 under the first-year convention. Note that if the entire \$1 million allocation had come from the State’s 2017 annual credit ceiling, the project owner would be entitled to claim



\$500,000 of Credits in 2017 based on 6 months of qualified occupancy. In addition, because a building has a single credit period of 120 months, a building with a split-year allocation that does not (or in the example above is not able to defer the start of the Credit Period until 2018 since the building is placed in service in 2016), would lose a portion of the last year of Credits from the 2018 allocation (credits for July through December of 2027 in the example above). When a project includes multiple buildings, this can be avoided by allocating one year of Credits (i.e., 2017 Credits) to certain buildings (Buildings 1 and 2) and the other year (i.e, 2018 Credits) to the balance of the buildings (Buildings 3 and 4) so that no single building has a split-year allocation. Alternatively, in the example above, the project owner could avoid the potential wasting of Credits by delaying placement in service of the building until 2017 and electing to defer the Credit Period until 2018.

- f.** New or existing buildings are placed in service when they are ready and available for their specifically assigned functions, i.e., the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. Advance Notice 88-116. A temporary or conditional certificate of occupancy may provide adequate documentation of a building's placed in service date, provided that the local jurisdiction issuing the temporary certificate of occupancy requires that the building be habitable at the time the temporary certificate of occupancy is issued. PLR 9243032 (July 24, 1992); CCA 200137044, Question 1 (June 28, 2001).
- g.** Rehabilitation expenditures are generally treated as placed in service at the close of any 24-month period over which such expenditures are aggregated for purposes of determining whether they are "substantial" (including a period that ends less than 24 months after commencement of the rehabilitation), apparently without regard to the readiness or availability of the building. Code §42(e)(4)(A); Advance Notice 88-116; Rev. Rul. 91-38, Question 6. If, however, the rehabilitation is completed and the minimum expenditures requirement of Code §42(e)(3)(A) is met in less than a 24-month period, the taxpayer may elect to place the rehabilitation expenditures in service at the close of that shorter period of time. PLR 200044020 (August 3, 2000).
- h.** Actual occupancy by low-income tenants is not required for placement in service. Advance Notice 88-116, but see II.A.2., infra, concerning "Qualified Basis" computation.



- i.** If the rehabilitation is also a certified historic rehabilitation, the placed-in-service date for purposes of the rehabilitation tax credit is based on substantial completion of the rehabilitation and, therefore, may differ from the placed-in-service date for purposes of the low-income housing tax credit. PLR 200605004 (February 3, 2006); PLR 8934048 (May 30, 1989). The 2006 ruling concluded that placement-in-service under Code §42(e)(4) could occur in the year after placement-in-service for purposes of the historic rehabilitation tax credit, enabling the project owner to obtain additional low-income housing tax credit allocation in the later year.
- j.** First-Year Credits in Re-Syndication of an Existing Low-Income Housing Project.

  - (i)** A low-income unit occupied by an over-income tenant at the time of acquisition continues to qualify as a low-income unit. The MSSP Training Guide provides that “Households determined to be income-qualified for purposes of [Section 42 of the Internal Revenue Code of 1986, as amended] during the 15-year compliance period are concurrently income-qualified households for purposes of the +30-year extended use agreement. As a result, any household determined to be income qualified at the time of move-in for purpose[s] of the extended use agreement is a qualified low-income household for any subsequent allocation of [Section] 42 credit.” MSSP Training Guide, Guide for Completing Form 8823, Chapter 4, Category 11 a Household Income Above Income Limit upon Initial Occupancy. If the unit was determined to be an over-income unit under Section 42(g)(2)(D) of the Code at the time of the household’s last recertification, then the owner of the project is subject to the so-called “available unit rule” (unless the project is a 100% low-income housing tax credit project, in which case the available unit rule does not apply). Accordingly, a low-income unit occupied by an over-income tenant at the time of acquisition continues to qualify as a low-income unit provided the available unit rule, if applicable, is satisfied.
  - (ii)** In the case of a mixed-income project, an over-income unit does not cease to qualify as a low-income unit if the over-income tenants are temporarily relocated during the rehabilitation provided the over-income tenants return to their original unit or occupy a unit in the same building following the rehabilitation. The MSSP Training Guide provides that when a household moves to a different unit



within the same building, the newly occupied unit adopts the status of the vacated unit. Thus, if a current household, whose income exceeds the applicable income limitation moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit and the vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident. However, if an over-income tenant moves to a low-income unit in a different building, the newly occupied unit will not qualify as a low-income unit unless the project is 100% LIHTC. The vacated unit is treated as a vacant unit. Tenants in a 100% LIHTC project can transfer between buildings even if they are over-income. Since annual certifications are no longer required for projects that are 100% affordable, the IRS does not require owners to determine if a tenant's income is less than 140% of the income limit before allowing a tenant to transfer between buildings in a 100% LIHTC project. See MSSP Training Guide, Guide For Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, Tenant Moves to Another Low-Income Unit, Example 2. The MSSP Training Guide does not explicitly address how these rules apply in the context of a temporary relocation of over-income tenants during the rehabilitation of an existing LIHTC project as part of an acquisition/rehabilitation or a rehabilitation by the current owner of the project. However, Example 1 under "Previously Income-Qualified Households" is instructive. In the example, owner ("O"), who previously received Section 42 credits to construct new low-income housing, applies for and receives an allocation of low-income housing tax credits in 2007 to rehabilitate the existing low-income buildings following the expiration of the 15-year compliance period with respect to the original syndication on December 31, 2005. The rehabilitation is completed and O starts claiming credits in 2009. On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit in the Project ("Unit A"). John and Mary timely complete their income recertification each year 2005 through 2008. Unit A has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period. Unit A is a low-income unit on January 1, 2009 when O begins claiming the credit. If Unit A was determined to be an over-income unit at the time of the household's last recertification in January of 2008, then



O is subject to the available unit rule, if applicable. Although not explicitly stated, John and Mary are presumably temporarily relocated since Unit A is taken out of service during rehabilitation. It logically follows that if John and Mary were over-income at the time of their most recent recertification, Unit A will continue to qualify as a low-income unit following the rehabilitation and re-occupancy by John and Mary following their temporary relocation provided the available unit rule, if applicable, is satisfied.

**B. Amount of Credit.**

1. For new buildings not receiving other federal subsidy, an annual amount over the Credit Period intended to have a present value equal to 70% of Qualified Basis (defined in II.A.2., *infra*) (the “70% Present Value Credit”). On an annual basis, the 70% Present Value Credit has represented 7-9% of Qualified Basis.
  - a. Rehabilitation expenditures are treated as “new buildings” provided that they are allocable to or substantially benefit one or more low-income units and the amount of such expenditures incurred within any 24-month period equals the greater of 20% of the adjusted basis of the building or an amount sufficient to cause the “Qualified Basis” resulting from such expenditures to equal or exceed \$6,000 per low-income unit, adjusted from 2008 for inflation (\$6,700 per low-income unit for expenditures treated as placed in service during calendar year 2017). Code §42(e), as amended by the Housing and Economic Recovery Act of 2008 (“HERA”). Rev. Proc. 2016-55. Expenditures for common areas may provide the requisite substantial benefit. PLR 9338013 (June 23, 1993).
  - b. Rehabilitation expenditures on buildings acquired from governmental entities need only be \$6,000 (adjusted for inflation) per low-income unit to qualify as a “new building.” Code §42(e)(3)(B).
  - c. The IRS has ruled that when a developer of a condominium project in which the units had been developed and held for sale sells condominium units to an unrelated partnership which intends to hold the units as low-income housing, the units are “new buildings” in the hands of the partnership, provided that no depreciation had been claimed by the developer with respect to the units. PLRs 9101006 (Jan. 4, 1991) and 9120021 (Feb. 19, 1991).



2. An annual amount over the Credit Period intended to have a present value equal to 30% of Qualified Basis (the “30% Present Value Credit”), or approximately 3-4% annually, for
  - a. new buildings receiving other federal subsidy; or
  - b. existing buildings.
3. Definition of “other federal subsidy”. Code §42(i)(2).
  - a. For this purpose, pursuant to HERA, “federal subsidy” means only tax-exempt financing the proceeds of which can or will be used (directly or indirectly) with respect to the building or the operation thereof. Below-market federal loans will not cause a building placed in service after July 30, 2008 to be treated as federally subsidized. Federal grants have never been treated as “Federal subsidy”.
  - b. If a building owner elects to reduce Eligible Basis (defined in Section II, infra) by an amount equal to the amount of “federal subsidy”, the building will not be treated as receiving federal subsidy. Code §42(i)(2)(B). The election must be made on Form 8609 for the taxable year in which the building is placed in service. Treas. Reg. §301.9100-7T(b). The IRS may grant a reasonable extension of time to the taxpayer to make the election if the taxpayer acted reasonably and in good faith. See PLR 201606026 (November 2, 2015); PLR 200726020 (June 29, 2007); PLR 200725021 (June 22, 2007). PLR 200725020 (June 29, 2007).
    - (i) The amount of Eligible Basis reduction is reflected on the Form 8609 for each building.
    - (ii) While allocation of federal subsidy among multiple buildings may permissibly be based on costs, to date there is no definitive guidance discussing whether other methods of allocation would be permitted, whether allocations should be made separately to acquisition and rehabilitation costs which are treated as separate buildings, or the impact of basis reductions for Code §47 credits.
  - c. Tax-exempt construction financing is not considered federal subsidy if such financing is repaid prior to placement in service. Code §42(i)(2)(C). Conversely, retirement of tax-exempt financing immediately after placement in service should not prevent a project from qualifying for the 30% Present Value Credit without an allocation of credits, provided that at least 50%





of the basis of the land and buildings in the project was financed with such financing. See IV.H.1., *infra*.

- d. Federal grants are not a federal subsidy for this purpose but Eligible Basis cannot include any costs financed with the proceeds of any federally funded grant. Code §42(d)(5)(A), as amended by HERA. The basis reduction rule applies to federally funded grants received before or during the Compliance Period (defined in D., *infra*). However, no basis reduction is required for federally funded grants to enable the property to be rented to low-income tenants received during the Compliance Period if those grants do not otherwise increase the Eligible Basis in the building.
- e. Comment: After HERA, the so-called “IRP Decoupling” program pursuant to which HUD continues Section 236 interest subsidy payments following repayment of a Section 236 loan and such payments are applied to reduce the effective interest rate on a new loan should not be included in the definition of “federal subsidy” and would seem to be compatible with both the 70% and 30% Present Value Credit. In addition, to the extent that these payments fund deductible interest expense (and not capitalized construction-period interest), they should not be treated as the type of federal grants that reduce Eligible Basis.
- f. If a city or a project sponsor receives a federal grant and then lends the grant funds at the applicable federal rate for use in a project, the loan proceeds do not constitute either a grant or a below-market federal loan. See PLR 8813024 (Dec. 30, 1987) and former Code §42(i)(2)(D). Cf. TAM 200523023 (June 10, 2005) (general partner’s loan of federal grant funds at a below-market rate treated as a below-market federal loan). Note: Loans from project sponsors which are treated as related persons with respect to the project ownership entity may raise additional issues. See. IX.A.3, *infra*.
- g. Credits are allowed for buildings receiving Section 8 moderate rehabilitation assistance under Section 8(e)(2) of the United States Housing Act of 1937 including assistance received under the McKinney Homeless Assistance Act as in effect on October 26, 1990, provided the buildings are placed in service after July 30, 2008. Code §42(c)(2), as amended by HERA. Buildings placed in service before that date which receive rental assistance payments pursuant to the renewal of Section 8 Housing Assistance Payment contracts under §524 of the Multifamily Assisted Housing Reform and Affordability Act of 1997 are ineligible to receive credits if the original contract was authorized





under the Section 8 moderate rehabilitation assistance program. PLR 200044013 (July 31, 2000).

- h.** The fact that rehabilitation expenditures are made with respect to an existing building previously financed with tax-exempt bonds will not cause the rehabilitation expenditures to be treated as “federally subsidized,” provided that no “material modification” is made to the tax-exempt financing. See Treas. Reg. 1.1001-3 for rules regarding material modifications. Thus, those rehabilitation expenditures may qualify for the 70% Present Value Credit. See H. Rep. No. 99-841, 99th Cong. 2d Sess. II-89 (1986). Based on this legislative history, the IRS has ruled that the purchase of existing buildings subject to tax-exempt bonds did not taint either rehabilitation expenditures on those buildings or newly constructed buildings on land that secured the bonds. PLR 9601005 (Sept. 26, 1995).
- (i)** The IRS has refused to extend the foregoing legislative history to permit the proceeds of tax-exempt bonds used to acquire and rehabilitate a multiple building project to be allocated exclusively to certain buildings in the project, and, thus, to avoid the federal subsidy taint for the other buildings, especially when all the buildings collateralize the bonds. TAM 9528002 (March 20, 1995). Similarly, the IRS has taken the position that when the rehabilitation and acquisition of a building are financed by the issuance of tax-exempt bonds and taxable bonds, both of which close on the same date and use the same bank trustee, allocating the proceeds of the tax-exempt bonds solely to the acquisition costs of the building will not enable the rehabilitation costs of the building to avoid the federal subsidy taint. If, however, the acquisition and rehabilitation financings are independent transactions, the taint of the tax-exempt financing will not extend to the rehabilitation expenditures. PLR 200035016 (May 30, 2000).
- (ii)** See also, PLR 9001046 (Oct. 11, 1989), revoked by PLR 9011017 (Dec. 18, 1989) in which the IRS appeared to approve and then reject a tracing of federal subsidy proceeds.
- (iii)** See Paul, Of (Low-Income) Housing Bondage: Will Cross-Collateralization Cause Federal Subsidy Taint? 14 Real Estate Tax Digest 39 (Feb. 1996).



(iv) Query: If a modification triggers COD income that causes the face amount of tax-exempt bonds to exceed their imputed principal amount, is the amount of federal subsidy equal to the original amount of bond proceeds, the new imputed principal amount or, perhaps, the imputed principal amount plus OID scheduled to accrue during the 15-year Compliance Period?

i. In Rev. Rul. 96-35, 1996-2 C.B. 4, the IRS ruled that below-market federal loans and federal grants made prior to July 30, 2008 did not require a reduction in Eligible Basis when the loans and grants were made by the Federal Emergency Management Agency (“FEMA”) to restore qualified low-income buildings that had been partially destroyed by a hurricane. Because the FEMA funds merely helped to restore the buildings to their pre-casualty condition, they did not pose the type of “double dipping” concerns to which the federal subsidy and federal grant rules are addressed. See also PLR 9611010 (Dec. 7, 1995).

j. In instances in which a project’s development will require credits in excess of the available amount of competitively-awarded 9% low-income housing tax credits, a project may in certain circumstances utilize 9% credits for a portion of the structure and non-competitive, bond-financed 4% credits for the rest. This may be done by utilizing a condominium structure and dividing a building into two condominiums, which are treated as separate buildings for tax purposes. Notice 88-91, 1988-2 C.B. 414. A new building can qualify for 9% credits if it is not “federally subsidized.” If a new building is federally subsidized it can only qualify for 4% credits. Code Section 42(b)(1)(A), (B). A new building is treated as federally subsidized if there are tax-exempt bonds outstanding, the proceeds of which “... are or were used (directly or indirectly) with respect to such building or the operation thereof.” Code Section 42(i)(2)(A). In order to use both credits within a single structure, the 9% unit must avoid the “taint” of bond financing while the 4% unit is considered bond-financed and eligible for 4% credits. Cross collateralization causes all buildings to be considered federally subsidized. TAM 9253002 (March 29, 1995). If there are “independent financings”, the taint can be avoided. PLR 200035016 (May 30, 2000).

(i) In an acquisition/rehabilitation transaction, a building can be divided into two condominiums from the start. The 4% unit can be purchased and rehabilitated with bond proceeds while the 9% unit does not receive any direct or indirect bond financing. The two units would be separately owned by distinct entities, although the sponsor and equity



investor may be the same for both projects, and there may be two separate construction contracts, with a cost-sharing agreement entered into in order to fund work performed on the condominium common areas. Bond proceeds would be spent solely on the acquisition and rehabilitation of the 4% unit and a proportionate share of common area rehabilitation expenses equal to the unit owner's percentage interest in the condominium.

- (ii)** In the case of new construction, the condominiums may not be able to be established until construction is at least partially completed. In Massachusetts, for example, a condominium cannot be declared without identifying walls. In such an instance, the land could be purchased by the entity that will ultimately own the 9% unit, initial construction of the entire development could be financed without the use of tax-exempt financing, and once walls are in place, two separate condominium units could be created. The 4% unit could then be conveyed to a separate owner that would fund its purchase of the unit using tax-exempt financing, causing it to be considered bond-financed and eligible for 4% credits, while the 9% unit avoids the “taint” of bond financing and remains eligible for 9% credits. A building can be partially or entirely built without bond proceeds and still meet the 50% test and qualify for 4% credits so long as a sufficient amount of bond proceeds are spent to finish the building or to repay construction financing. See PLR 201049018 (December 10, 2010); PLR 199912023 (December 22, 1998); PLR 9816018 (January 14, 1998). All of the bonds would be required to remain outstanding through the end of the first year of the 4% unit's credit period. See, e.g. PLR 9853036 (October 1, 1998).
- (iii)** An alternative structure in the case of new construction is for tax-exempt bond proceeds to be drawn to fund the initial construction, and then a portion of the bonds corresponding to the 9% unit redeemed with the proceeds of the sale of the 9% unit. This approach relies on an exception to the “federally subsidized” definition which states that tax-exempt bonds used to provide construction financing for a new building will not cause that building to be federally subsidized if: (i) the bonds identified the building for which they would be used and (ii) the bonds are redeemed before the building is placed in service. Code Section 42(i)(2)(C). At the closing of the transaction, the 4% owner would own the site and borrow tax-exempt bond



proceeds to help finance initial construction of the entire structure. One tranche, or series, of the bonds would be identified specifically to be used for the 9% unit and used to fund a corresponding element of the loan to the 4% owner (the “9% unit tranche”). When the 9% unit was conveyed to the 9% owner, the 4% owner would use the sale proceeds to repay and redeem the 9% unit tranche. This would occur before the 9% unit is placed in service, so the 9% unit would qualify for 9% credits under the special rule for subsidized construction financing cited above. The remaining elements of the 4% owner’s bond loan would continue to finance the 4% unit at least until the 4% unit is placed in service, so that loan could be used to satisfy the 50% test for the 4% unit. Once the units were separated, the 9% Unit would no longer serve as collateral for the bonds and the two units would continue under separate plans of finance. Although this approach would allow tax-exempt financing to be utilized during construction, it is unclear that bond issuers would allow the use of volume cap for these purposes, when no credits would be generated as a result of the bonds.

- k. In Rev. Rul. 96-35, 1996-2 C.B. 4, the IRS ruled that below-market federal loans and federal grants made prior to July 30, 2008 did not require a reduction in Eligible Basis when the loans and grants were made by the Federal Emergency Management Agency (“FEMA”) to restore qualified low-income buildings that had been partially destroyed by a hurricane. Because the FEMA funds merely helped to restore the buildings to their pre-casualty condition, they did not pose the type of “double dipping” concerns to which the federal subsidy and federal grant rules are addressed. See also PLR 9611010 (Dec. 7, 1995).

### C. Determination of Applicable Percentage.

- 1. The annual credits are expressed as a percentage of Qualified Basis, referred to as the “applicable percentage,” that over a 10-year period has a present value equal to 70% or 30% of Qualified Basis, as the case may be. Applicable percentages are announced monthly in the same revenue rulings that announce “applicable federal rates.” For any new building placed in service after July 30, 2008 and receiving an allocation before January 1, 2015 that is not federally subsidized, the applicable percentage for 70% Present Value Credits will be the greater of the published monthly rate or 9%. Code §42(b)(2). For new buildings receiving an allocation after January 1, 2015, the applicable percentage is also the greater of the published monthly rate or 9%, as established by the PATH Act, discussed in paragraph (b) below.



- a. Note: The extension of the temporary minimum low-income housing tax credit rate for non-federally subsidized buildings for allocations made before January 1, 2015 was passed as part of the Tax Increase Prevention Act of 2014, H.R. 5571, 113 P.L. 295 (2014). This law retroactively extended through the end of 2014 most temporary tax provisions that expired at the end of 2013. In addition to extending the 9% floor, it also included an extension of 50% bonus depreciation under Code §168 to property acquired and placed in service during 2014 and, for certain properties with a longer production period, 2015.
- (i) Pursuant to Section 143 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), the rules in section 168(k) of the Code regarding bonus depreciation have been extended through 2020 and, for certain properties with a longer production period, 2021. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Dec. 18, 2015.
- (ii) Note: The default is to bonus depreciation and accordingly, a taxpayer must affirmatively elect out under 168(k)(7) if it does not wish to claim bonus depreciation. Generally, bonus depreciation only applies to property that has a life of 20 years or less (e.g., personal property and site improvements). Code §§ 168(k)(1) and (2). In general, bonus depreciation is not available for improvements that are capitalized as part of the building. However, certain qualified improvement property, i.e., certain internal improvements to “nonresidential rental property” placed in service after December 31, 2015, can qualify for bonus depreciation. Code §§ 168(k)(2)(A)(i)(IV) and 168(k)(3). A LIHTC building can include qualified improvement property eligible for bonus depreciation if commercial rent represents more than 20% of gross rent received from the building (i.e., if the LIHTC building is classified as nonresidential rental property). Code §§169(k)(3) and 168(e)(2). Qualified improvement property does not include costs of building enlargements, elevators/escalators or internal structural framework but may include costs such as non-loadbearing walls, doors, flooring, plumbing, HVAC and other items determined to be non-structural framework. Code §168(k)(3)(B). Historically, taxpayers have wanted to avoid having a LIHTC building classified as nonresidential rental property because such classification requires that the building be depreciated over 39 years versus 27.5 years. However, in light of the new bonus depreciation rules, a LIHTC building that includes



significant commercial space could claim bonus depreciation on qualified improvement property, which may be a significant enhancement to the project's yield and pricing. Note: If the LIHTC building also generates historic tax credits, the taxpayer must elect out of bonus depreciation with respect to any qualified improvement property in order to preserve historic tax credits. This is not an issue (i.e., the taxpayer does not need to elect out of bonus depreciation) in a typical LIHTC project that also includes historic tax credits but little or no commercial space (i.e., a LIHTC building that is classified as residential rental property), since the type of property eligible for bonus depreciation (site work and personal property) are not QRE eligible.

- (iii) Note: LIHTC follows depreciation. Taking bonus depreciation may cause an investor to run out of capital during the Credit Period and could result in a reallocation of LIHTC, particularly in bond-financed projects.
- b. Comment: The PATH Act was signed into law on December 15, 2015, permanently extending the 9% minimum applicable percentage for non-federally subsidized new buildings. See Rules Committee Print 114-40, Text of House Amendment #2 to the Senate Amendment to H.R. 2029, Military Construction and Veterans Affairs and Related Agencies Appropriations Act, 2016, Sec. 131 (December 15, 2015).
- c. Comment: The Affordable Housing Credit Improvement Act of 2016, introduced by Senators Maria Cantwell and Orrin Hatch on May 19, 2016, proposed a permanent minimum 4% rate for acquisition and bond-financed developments. See S. 2962, 114th Congress (2016). Among other changes, it also calls for a phased-in 50 percent expansion in federal LIHTCs through 2020. This bill was reintroduced in the 115th Congress. See S. 548, 115th Cong. (2017).
- d. Comment: In his comprehensive proposal for tax reform (discussed in greater detail in VIII.L.1., infra), House Ways and Means Committee Chairman David Camp has proposed eliminating the 4% credit entirely.
- e. Note: The District Court for the district of Puerto Rico held that the temporary creation of a fixed 9% floor for rehabilitation credits does not create an entitlement or property interest in low-income housing tax credits, Jardin de las Catalinas, LP v. Joyner, 861 F. Supp. 2d 12 (D.P.R. 2012). In the decision, the District



Court confirmed that an applicant for tax credits has no recognizable property interest in purportedly “promised” tax credits because an allocating state agency has absolute discretion to determine whether an applicant receives credits under the state’s Qualified Allocation Plan. On appeal, the First Circuit affirmed the District Court’s entry of judgment on other grounds but did not discuss the lower court’s determination that the plaintiffs lacked a constitutionally protected property interest in “promised” tax credits. Jardin de las Catalinas, LP v. Joyner, 766 F.3d 127 (1st Cir. 2014). Note: There is no reason to believe that the permanency of the 9% floor would change this analysis as under its Qualified Allocation Plan the allocating agency retains absolute discretion in awarding credits.

2. For a particular project, the “applicable percentage” is that in effect for either:
  - a. the month in which the project is placed in service; or
  - b. at the election of the taxpayer, the month in which the taxpayer and the housing credit agency enter into a binding agreement as to the dollar amount of annual credits to be allocated. Code §42(b)(1)(A)(ii)(I), Treas. Reg. §1.42-8(a) and Notice 89-1 provide that this binding agreement must:
    - (i) be in writing;
    - (ii) specify the dollar amount of credits (although the regulations are not entirely clear on this point, the taxpayer should be held to the same standard used in obtaining a carryover allocation, meaning the dollar amount of credits may be specified either on a project basis or on a building by building basis);
    - (iii) specify whether the credit relates to newly constructed, substantially rehabilitated or existing building(s);
    - (iv) be binding under state law on the taxpayer, the agency and all successors in interest; and
    - (v) be dated and signed by the parties during the month in which requirements (i) through (iv) are met.
  - c. In the case of a bond-financed project for which no allocation is made, at the election of the taxpayer, the month in which the bonds are issued may be used. Code §42(b)(1)(A)(ii)(II) and Treas. Reg. §1.42-8(b).









(defined in D., infra). An increase in Qualified Basis to which the 2/3 credit applies is typically attributable to an increase in the percentage of occupancy by low-income tenants.

- a. If the original credit allocation is insufficient to utilize the 2/3 credit, the credit agency is permitted to make an additional allocation in the year in which the 2/3 credit becomes available.
- b. For bond-financed projects which do not receive credit allocations but anticipate a 2/3 credit, it is suggested that the Section 42(m)(2) letter issued on or before completion provide sufficient cushion to support the additional 2/3 credit.

**D.** Note that claiming the 2/3 credit will also require new or amended Form(s) 8609 and amendments to the extended use agreement. See III.E., infra. Compliance Period.

The low-income portion of a project must be maintained as such for fifteen years, beginning with the commencement of the Credit Period (the “Compliance Period”), or credits will be subject to recapture. See V., infra. See also III.E., infra, relating to the requirement of an “extended use” commitment beyond 15 years.

## **II. ELIGIBLE BASIS/QUALIFIED BASIS**

Calculation of costs qualifying for credits first requires determination of “Eligible Basis” and then the portion thereof attributable to low-income units which is referred to as “Qualified Basis.”

### **A. New Buildings and Substantial Rehabilitations.**

1. Eligible Basis is the adjusted basis of the residential rental portion of a building determined as of the close of the first year of the Credit Period, subject to certain modifications. See II.C., infra.
2. Portion of Eligible Basis constituting Qualified Basis (the “Applicable Fraction”) is determined annually and is the lesser of
  - a. Low-income units as percentage of total residential units (“Unit Fraction”); or
  - b. Floor space of low-income units as percentage of total floor space of all residential units (“Floor Space Fraction”).

Note: A unit is not a low-income unit until it is actually occupied by low-income tenants. Qualified occupancy is not required for placement in service of a unit but is required for inclusion of the unit in Qualified Basis. During the first year of the Credit Period, the applicable fraction is determined on a monthly basis. A unit will be treated as a low-income unit (and therefore includable in the monthly applicable fraction) provided that



the unit has been in service for the full month and is occupied by a qualified tenant by the end of the month. Rev. Rul. 2004-82, 2004-2 C.B. 350.

If the Credit Period begins in the year a unit is placed in service, but occupancy of the unit by low-income tenants does not occur until the following (or any subsequent) year, there is an “increase” in Qualified Basis and only 2/3 of the applicable percentage is used to determine credits for this increase. See I.C.4., supra. Under these circumstances an election to defer commencement of the Credit Period until the year after placement in service may be advisable. See I.A.5., supra.

3. Qualified Basis may be reduced to the extent that the quality of low-income units is less than other units. Code §42(d)(3).
4. Comment. In the case of a substantial rehabilitation, costs includable in Eligible Basis may be incurred over a period of several years. For example, if a 24-month period designated as the placed-in-service date ends on January 1, 2005, it will include expenditures incurred beginning on January 1, 2003. The commencement of the Credit Period can be deferred until January 1, 2006, I.A., supra, so that includable costs are those incurred through December 31, 2006, the end of the first year of the Credit Period.
5. A unit occupied by a resident manager or a full-time, resident security officer is not a residential rental unit for purposes of Code §42 and thus is excluded from both the numerator and denominator of the fractions used to calculate qualified basis. Program Manager Technical Advice 2014-22, CCA POSTN-111812-14 (June 2, 2014); Rev. Rul. 92-61, 1992-2 C.B. 7; Rev. Rul. 2004-82, 2004-2 C.B. 350 (August 30, 2004); PLR 9538015 (June 16, 1995); see also PLR 9330013 (April 29, 1993) (similar treatment of units occupied by maintenance personnel but different treatment of model units which were held to be “residential rental units” included not only in Eligible Basis but also in the denominator of the fraction used to calculate Qualified Basis). The recent CCA clarified that charging rent, utilities or both to a resident manager or maintenance personnel does not cause the unit to be treated as a residential rental unit (it remains a facility reasonably required for the project) and that the general-public-use requirement does not apply to units for resident managers or maintenance personnel because such units are facilities reasonably required for the project, not residential rental units. Program Manager Technical Advice 2014-22, CCA POSTN-111812-14 (June 2, 2014).
6. Because Eligible Basis is fixed at the end of the first year of the Credit Period, subsequent expenditures do not increase Qualified Basis and do not qualify for the 2/3 credit.



## B. Existing Buildings.

1. The Eligible Basis of an existing building is also generally its adjusted basis as of the end of the first year of the Credit Period, but does not include so much of adjusted basis as is determined by reference to the basis of other property held by the person acquiring the building. Code §42(d)(2)(C). However, the Eligible Basis of an existing building is zero unless the following four requirements are satisfied.
  - a. The building must be acquired by “purchase” (as defined in Code §179(d)(2)) from an unrelated seller. Code §§42(d)(2)(B)(i) and (D)(iii).
  - b. 10 years must have elapsed since the date the building was last placed in service.
  - c. The building must not have been previously placed in service by the purchaser or a related party with respect to the purchaser. A person will be treated as a “related party” with respect to the purchaser if the relationship between such person and the purchaser is one specified in Sections 267(b) or 707(b)(1) of the Code or the person and the purchaser are engaged in trades or businesses under common control (within the meaning of Code §§52(a) and (b)). Code §42(d)(2)(D)(ii). Comment: In determining whether a person and/or a partnership is related to a partnership, Code §707(b)(1) looks to whether there was ownership of either a capital interest or a profits interest. There is no guidance on the meaning of the term “profits interest” in this context. Thus, if a general partner is given a greater than 50% interest in the proceeds from a sale of property (following the repayment of all the capital contributions of the limited partner), or is paid an unreasonably large incentive management fee (i.e. 60% of gross cash receipts with no dollar cap), the general partner might be treated as having a more than 50% profits interest with respect to such partnership.
  - d. Substantial rehabilitation costs are incurred. Code §42(d)(2)(B)(iv).
2. Waivers and exceptions to the 10-year rule.
  - a. Pursuant to Code §42(d)(6), as amended by HERA, the 10-year requirement in 1.b. above is automatically waived for federally-assisted or state-assisted projects.
    - (i) For this purpose, a building is federally-assisted if it is substantially assisted, financed or operated under any housing program administered by HUD or the Rural



Housing Service of the Department of Agriculture, including Section 8 of the United States Housing Act of 1937, §§221(d)(3), 221(d)(4) or 236 of the National Housing Act and §515 of the Housing Act of 1949.

- (ii) A state-assisted building is a building which is substantially assisted, financed or operated under any state law similar in purposes to the laws referred to in (i) above.
  - (iii) Comment: Although the exception to the 10-year rule for federally or state assisted projects has been law for several years, there is no guidance on the scope of this exception (and, according to IRS personnel present at the ABA Forum in Washington, D.C. in May 2017, none is forthcoming), for example, the extent to which HOME or CDBG funding can be considered federal assistance and when such assistance is considered “substantial.” There is also no guidance on whether the assistance must pre-date the acquisition and, if so, for how long.
- b. A waiver of the 10-year rule no longer requires a private letter ruling from the IRS which, in turn, required the requesting party to obtain a certification from HUD, FmHA, the RTC, FDIC or other appropriate agency that a condition for waiver has been satisfied.
- c. In determining if 10 years have elapsed since a building was last placed in service, the following placements in service are disregarded:
- (i) Placements in service by government entities and qualifying nonprofit organizations, if the 10-year rule had been satisfied at the time of such placements in service. See PLR 200652015 (December 29, 2006); PLR 8851046 (Sept. 27, 1988); PLR 8834054 (May 27, 1988).
  - (ii) Placements in service by mortgagees, provided the mortgagees transfer the property within 12 months, if the 10-year rule had been satisfied at the time of such placements in service. Comment: If a state housing finance agency, other governmental entity or qualifying nonprofit organization forecloses on property, it ought not to be subject to the requirement that it resell the property within 12 months, but there is no authority directly on point.



- (iii) In the case of a single family home, placement-in-service by individual owners who used the building only for a principal residence.
  - (iv) Placement-in-service by persons who acquired the property either with a carryover basis from their transferors or with a stepped-up basis by reason of inheritance. Terminations of partnerships occurring on or after May 9, 1997 provide the “new” partnership with a carryover basis in property of the terminated partnership. Treas. Reg. §1.708-1(b)(4)(iv), Example (ii). Thus, such a termination is disregarded for purposes of the 10-year rule. PLR 200614019 (April 7, 2006); PLR 200508009 (February 25, 2005); PLR 200502019 (January 14, 2005).
  - (v) Note: Certain tax-free transfers in which the transferee takes a substituted basis rather than a carryover basis (e.g. liquidating distributions from partnerships or like-kind exchanges) are not disregarded.
- d. In PLR 200204006 (January 25, 2002), the IRS held that a Code §743(b) adjustment to basis was not a placed-in-service event for purposes of Code §42(d)(2)(B)(ii)(I). See also PLR 200614019 (April 7, 2006).
  - e. A foreclosure of purchase-money debt secured by partnership interests (which resulted in a termination of the old partnership and formation of a new partnership under Code §708), and the subsequent sale by the new partnership to the taxpayer within 12 months of foreclosure satisfied the 10-year rule pursuant to the exception provided for mortgagees in possession for less than 12 months. PLR 200235018 (May 29, 2002). Although not addressed in this ruling, an alternative basis for concluding that the 10-year rule is satisfied is that the termination of the old partnership, even if unrelated to a foreclosure, does not constitute a placement in service for purposes of that rule. See PLR 200508009 (February 25, 2005); PLR 200502019 (January 14, 2005).
  - f. As a general matter, a transfer of property results in a new placement in service if, as of the date of transfer, the property is ready and available for its intended purpose. Rev. Rul. 91-38. 1991-2 C.B. 3, 5. However, acquisition of a property that is not fit for habitation or other use is not considered a placement in service. PLR 200009032 (December 3, 1999); PLR 9402010 (Oct. 6, 1993).

- g. The IRS has ruled that a transfer of property followed by a rescission of the transfer within the same taxable year did not constitute a transfer for federal tax purposes and, thus, did not result in a new “placement in service.” See PLR 200309009 (February 28, 2003) (ruling based on transfer/rescission rule of Rev. Rul. 80-58, 1980-1 C.B. 181).
  - h. A prior placement in service in a nonresidential use, e.g., as a warehouse, will be taken into account. Rev. Rul. 91-38, Question 9.
  - i. A transfer of property pursuant to a court-ordered restructuring of a housing program did not constitute a transfer and, therefore, did not result in a new “placement in service” for purposes of the 10-year rule. PLR 9735007 (May 22, 1997).
  - j. An assignment by a mortgagee of its successful foreclosure bid on a low-income property to an affiliate of the mortgagee who, as a matter of course, holds title to any real estate collateral acquired by mortgagee, was treated as though the affiliate had acquired the project by foreclosure of a security interest held by the affiliate and therefore the acquisition by the affiliate was treated as an acquisition by the “mortgagee” and disregarded for purposes of the 10-year rule pursuant to the exception provided for mortgagees in possession for not more than 12 months. PLR 200003037 (October 26, 1999).
  - k. 10-year requirement in 1.b. and 1.c. above does not apply to a purchase during the Compliance Period; instead the purchaser “steps into the shoes” of the seller and may continue to claim credits based on the seller’s Eligible Basis. Code §42(d)(7). PLR 200652015 (December 29, 2006). See V.A.1. below concerning potential credit recapture.
3. As with new buildings, determine Qualified Basis for existing buildings based on lesser of Unit Fraction or Floor Space Fraction. See II.A.2. supra.
  4. An increasing number of projects are being syndicated for a second or even a third time. Assuring acquisition credits for an existing building can raise a number of structuring concerns in avoiding a purchase from a related person and/or a prior placement in service by a related person. Consider the following examples (keeping in mind that HERA changed the ownership percentage for related person status from 10% to 50%):
    - a. Project X was constructed and placed in service in 1980 by Sponsor through Partnership A in which a Sponsor affiliate was

the general partner and individual investors were limited partners. Operating profits and losses were allocated 99% to the limited partners and 1% to the general partner with gain on sale 60% to the limited partners and 40% to general partner. In 1997 half the limited partners transferred their interests to the Sponsor. Project X was then re-syndicated by a sale from Partnership A to Partnership B in which operating profits were allocated .01% to a new Sponsor affiliate and 99.9% to a bank investor (Bank I) with gain on sale allocated 9.9% and 90.1%, respectively. Sponsor now proposes to cause Partnership B to sell the Project to Partnership C in which another Sponsor affiliate will have .01% of operating profits and 90% of gain on sale and another bank investor (Bank II) unrelated to Bank I will have 99.99% and 10%, respectively. Partnership C is unrelated to Partnership B so the acquisition by Partnership C should be by “purchase”. Partnership C arguably is also not related to Partnership A as of the time Partnership A placed the Project in service in 1980 even though they may have become related by the time Partnership A sold the Project to Partnership B in 1997. The transfer of limited partner interests in Partnership A to Sponsor should not constitute a placement in service by Partnership A.

- b.** Assume the facts are the same as in (a) above except that in 2010 Bank I exited Partnership B by transferring its interest to Sponsor in a transaction that resulted in a tax termination of Partnership B. Although such a transfer increases Sponsor’s interest in Partnership B to more than 10%, a level that would preclude acquisition credits on the 1997 purchase, the IRS has informally indicated that, absent a pre-arranged transfer plan, the 1997 acquisition credits should not be subject to disallowance or recapture. Although a placement in service as a result of a tax termination does not trigger the 10-year rule in Section 42(d)(2)(B)(ii), it is less clear that such a placement in service cannot trigger Section 42(d)(2)(B)(iii) regarding prior placement in service by a related person with respect to a subsequent purchaser. In any event, to satisfy the “purchase” requirement, Sponsor and persons related to Sponsor will have to limit their residual interest in Partnership C to not more than 50%.
- c.** Assume the facts are the same as above except that in 2011 Bank II acquired Bank I. The 1997 placement in service by Partnership B should not preclude acquisition credits for Partnership C because Bank I and Bank II were not related at that time.

### C. Special Rules for Calculating Eligible Basis.





1. Exclude from Eligible Basis costs not attributable to residential rental property, e.g., land and commercial space.
  - a. The IRS has ruled that a garage connected to a residential unit but rented through a separate, nonmandatory lease agreement is not residential rental property for purposes of Section 42. PLR 201149011 (December 9, 2011). Therefore, the adjusted basis of the garage is not includible in calculating Eligible Basis. However, optional payments for the use of the garage are not taken into account as rent for purposes of Section 42(g)(2). See III.B.4.g. and h. infra.
2. Include costs allocable to common areas, recreational facilities and functionally related and subordinate facilities.
  - a. Such facilities must be made available on a comparable basis to all tenants without a separate fee. H.R. Rep. No. 841, 99th Cong. 2d Sess. II-89 to II-90 (1986).
  - b. The IRS has ruled that the cost of a kitchen that is used to prepare meals for which a separate fee is charged is not includable in Eligible Basis. PLR 9338013 (June 23, 1993). The cost of coin-operated laundry machines is not includable in Eligible Basis although the cost of the building containing laundry facilities is includable provided all tenants have access to such building. See Guide for Completing Form 8823, ch. 8, Category 11e.
  - c. The IRS has ruled that the cost of a community building with meeting rooms, laundry facilities, a kitchen, management offices, and classrooms equipped for child care that is used to provide social services for which a separate fee will not be charged is includable in Eligible Basis. PLR 9822026 (February 23, 1998). See also PLR 199948025 (September 9, 1999); 13.c., infra.
3. Include land preparation costs only if they are so inextricably associated with the low-income building, common areas, recreational facilities or functionally related and subordinate facilities that the land preparation will be retired, abandoned or replaced contemporaneously with such items. For example, the costs of clearing, grubbing and general grading to prepare a site suitable for any type of structure are inextricably associated with the land and are added to the cost of the land, and as a result are not includable in Eligible Basis, while the costs incurred for fill dirt that is used to set the foundation of a low-income building are treated as inextricably associated with the low-income building and are therefore includable in Eligible Basis. TAMs 200043015-17 (July 14, 2000).





4. The IRS on examination may recharacterize certain fees paid to developers as attributable, in whole or in part, to services other than the acquisition, construction, or rehabilitation of a building and exclude them from Eligible Basis. In settling the case of Williamsburg Gardens, a Limited Partnership, Thomas E. Connelly, Jr., Tax Matters Partner v. Comm’r, the Commissioner and the taxpayer agreed to re-characterize 20% of a “developer fee” which taxpayer had included in Eligible Basis as syndication costs, land costs, and organization costs not includible in Eligible Basis. Tax Court Docket No. 10953-98 (December 10, 1998). The Commissioner permitted a developer fee of 15% of the amount of Eligible Basis to be included in Eligible Basis. See also TAM 200043017 (July 14, 2000); 11, infra.
5. The IRS has ruled that local impact fees (i.e., one-time costs with respect to a piece of property that are assessed when new construction takes place and may relate to such items as roads, water capital, educational facilities, law enforcement and fire/rescue facilities) incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under Code §§263(a) and 263A. Rev. Rul. 2002-9, 2002-1 C.B. 614 (February 15, 2002); compare TAM 200043016 (July 14, 2000). The IRS subsequently modified its conclusion in TAM 200043016 with respect to the impact fee issue in light of Rev. Rul. 2002-9. PLR 200216027 (April 19, 2002). Relying on Rev. Rul. 2002-9, the IRS has ruled that infrastructure improvements such as streets and underground utility connections that are constructed by a developer in connection with a low-income building but conveyed to a municipality and, thus, dedicated improvements within the meaning of §1.263(a)-4(d)(8)(iv), are indirect costs that may be capitalized under §263A into the basis of the Project's residential rental buildings and includible in Eligible Basis. PLR 200916007 (Jan. 5, 2009). The IRS has also ruled that costs to relocate an easement as required by a city for issuance of permits are indirect costs that may be capitalized under §263A into the basis of the Project's residential rental building and thus, includible in Eligible Basis. PLR 201515007 (November 4, 2014).
6. No reduction for depreciation. Code §42(d)(4)(D).
7. The IRS has held that costs associated with the issuance of tax-exempt bonds (including FHFA fees, state board fees, rating agency fees, trustee fees, underwriter fees, investment fees, legal fees, inspection fees, and costs for photos, prints and renderings) are excluded from Eligible Basis, regardless of whether the costs are allocable to construction activities. TAM 200043015 (July 14, 2000). In reaching its conclusion, the IRS first held that bond issuance costs could not be included in a project's Eligible Basis because such costs are amortized as Code §167 intangibles and not subject to depreciation under Code §168 (as required by Code §42(d)(4)). Next, the IRS considered the taxpayer's argument that a



portion of the bond issuance costs (those relating to construction activities) were indirectly includable in Eligible Basis because they were capitalized under Code §263A to the produced property and the produced property was depreciable property. The IRS rejected this argument by holding that, regardless of whether the costs were capitalized to depreciable property under Code §263A, the costs were not includable in Eligible Basis because they did not qualify (within the meaning of Code §142 and as required by Code §42(d)(4)) as either residential rental property or costs used for residential rental property nor did they qualify as costs for property used in a common area or provided as comparable amenities to all residential rental units in the building. Id.

8. Costs associated with obtaining a construction loan may be capitalized and amortized over the life of the loan, and any amortized deductions incurred during the construction period should be capitalized under Code §263A and added to the basis of the produced property. The IRS has taken the position that the property being produced includes the land, land improvements and the building, and that the taxpayer must reasonably allocate the amortization deductions among all of the produced property. As a result, the taxpayer may include in Eligible Basis only those amortized deductions that are properly allocable to produced property that qualifies as residential rental property. TAMs 200043016-17 (July 14, 2000). The IRS has also allowed taxpayers to use the “substitute cost method” to determine Eligible Basis. PLR 200305015 (January 1, 2003).
9. Tax credit application and allocation fees paid to the housing credit agency are not includable in Eligible Basis. Rev. Rul. 2004-82, 2004-2 C.B. 350.
10. The IRS has held that nonrecourse notes taken to finance the construction of a building are genuine debt includable in the Eligible Basis of the building despite the fact that such notes may have lengthy terms (30 years) with significant accruals of interest and do not require payments of principal or interest prior to the maturity date. FSA 199948006 (August 31, 1999). Note: The FSA does not address the deductibility (or adequacy) of accrued interest.
11. The IRS has held that the deferred portion of a developer fee represented by a developer fee note is includable in the Eligible Basis of a project, provided there is clear evidence that the note will be repaid at maturity. In reaching its conclusion that the developer fee note was a non-contingent obligation, the IRS considered the following facts: (i) although payments prior to maturity were contingent on cash flow and proceeds of capital transactions, the note was payable at maturity for a fixed amount; (ii) the general partners of the partnership were obligated to contribute to the partnership the amount necessary to repay the



developer fee note upon maturity (which was the thirteenth anniversary of the completion date); and (iii) the general partners had the right to refinance the property within one year prior to maturity of the developer fee note in order to repay the note in full. TAM 200044004 (July 14, 2000). Note: On September 18, 2014, the IRS released its updated Audit Technique Guide (ATG) for the Low-Income Housing Tax Credit (LIHTC) Program. See L.2., infra. Chapter 8 of the ATG indicates that the terms and conditions of a deferred developer fee note and/or other documents may suggest that the taxpayer does not intend to pay the deferred fee and that this issue is of particular concern if the parties to the transaction are related. The ATG indicates that the lack of an interest rate, contingent or substantially delayed payments, subordination to payment of other debts that make it unlikely that payment on the deferred fee would ever be made, the existence of a right of first refusal held by the developer for a price equal to the outstanding debt on the project, or an obligation on the part of a general partner who is or is related to the developer to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date may indicate that the deferred fee is not bona fide debt and thus should not be included in Eligible Basis. In a letter to the IRS dated March 27, 2014, the Tax Credit-Equity Financing Committee of the American Bar Association on Affordable Housing and Community Development Law (“ABA Forum”) provided comments on the draft ATG published by the IRS in December 2013. In its letter, the ABA Forum noted that the lack of a stated interest rate, which is common in the industry, should not be viewed as indicative that the taxpayer has no intention of paying the deferred fee as it is not unusual in the context of a low-income housing transaction for debt instruments to bear no interest or below- market rates of interest and below-market interest rates were expressly sanctioned by Congress under Section 3002(b) of HERA, which modified Code Section 42(i)(2)(A) by eliminating the concept of “below market federal loans” with the effect of permitting low or no interest rate loans to be included in Eligible Basis. See Code §467(g) indicating that regulations, which have not yet been issued, would be required to impute interest on deferred payments for services. Additionally, IRS and judicial guidance does not support a conclusion that nominal or no interest is, by itself, determinative of true debt status and the Code acknowledges the existence of no or below-market interest rate loans. The ABA Forum also argued that if the IRS believes that a portion of a deferred fee represents interest, the IRS should recharacterize a portion of the deferred fee as interest under the imputed interest rules rather than excluding the entire fee from Eligible Basis under the theory that the deferred fee does not represent true debt. The ABA Forum also noted that if the developer is a qualified nonprofit organization, government agency or a tenant organization, under Code Section 42(i)(7) no federal income tax benefit, including the benefit of tax credits and depreciation attributable to the inclusion of a deferred



development fee in basis, may be denied to a taxpayer merely because the developer has a right of first refusal to purchase the property at a purchase price equal to outstanding debt plus exit taxes. Finally, the ABA Forum noted that an obligation on the part of the general partner to contribute funds to enable the partnership to pay the deferred fee by a specified date does not suggest that the taxpayer does not intend to pay the deferred fee but the contrary. An obligation on the part of the general partner to contribute capital sufficient to pay the deferred fee on or before its maturity date suggests that the taxpayer intends to pay the deferred fee and suggesting that such an obligation evidences an intent not to pay the deferred fee is in direct conflict with TAM 200044004. In the TAM, the general partner was obligated to make additional capital contributions at the maturity of the development fee obligation in an amount sufficient to enable the taxpayer to repay the deferred fee. The IRS viewed this fact as a positive indicator that the deferred developer fee was not contingent – “While payments are contingent prior to maturity – it is payable at maturity for a fixed amount that is not contingent.”

12. Relocation Costs. In Appendix C of the updated ATG, the IRS takes the position that costs attributable to moving a qualified low-income household and providing temporary housing for the household during rehabilitation are expensed as ordinary and necessary business expenses under Code Section 162 and thus are not included in Eligible Basis. At the American Bar Association Forum on Affordable Housing and Community Development 2015 Annual Meeting, IRS representatives indicated that the IRS believes relocation costs should be expensed rather than capitalized because such costs are not associated with construction but rather are related to the landlord’s obligation to provide housing to tenants. Many practitioners believe that costs to relocate tenants from a building incurred solely to rehabilitate the building should be capitalized as an indirect cost to the building under Code Section 263A (or may be capitalized pursuant to an election under Section 266) and accordingly should be included in Eligible Basis. Query: Whether state housing agencies will accept relocation costs as part of a taxpayer’s cost certification in light of the IRS’ position in the updated ATG that such costs are to be expensed.
13. Reduce Eligible Basis to the extent costs are funded with federal grants, see I.B.3.d., supra.
14. Eligible Basis of new buildings, including substantial rehabilitations, may be increased to 130% of what it would otherwise be if HUD determines that the building is located in either a qualified census tract or a difficult development area. Code §42(d)(5)(B). Any building (other than bond-financed projects for which no allocation is made) placed in service after July 30, 2008 which is designated by a state housing credit agency as requiring the enhanced low-income housing credit for that building to be



financially feasible as part of a qualified low-income housing project will be treated, for purposes of the rules governing the enhanced low-income housing credit, as located in a designated difficult development area. Code §42(d)(5)(B)(v). For calendar year 2000 and prior years, a qualified census tract is defined as a census tract in which at least 50% of the households have an income of less than 60% of the area median gross income. Commencing in 2001, the definition is expanded to include any census tract with a poverty rate of 25% or more. Code § 42(d)(5)(C)(ii)(1), as amended by the 2000 Act. Current HUD designations of qualified census tracts and difficult to develop areas effective for allocations made, and bond-financed buildings placed in service, on or after January 1, 2017 are listed in 81 Fed. Reg. 200 (October 17, 2016). Similar to the 2016 designations, the period for which QCT and DDA designations remain effective is 730 days (2 years). Beginning with the 2016 designations, DDAs in metropolitan statistical areas (MSAs) are divided by ZIP codes, not by counties, resulting in a greater number of small area difficult development areas (SADDAs).

- a. Note: In a notice published in 80 Fed. Reg. 78749 (December 17, 2015), HUD announced that the 2015 DDAs and QCTs would also be effective for two years instead of one.
- b. HUD has clarified how "multiphase" LIHTC projects are to be treated when DDA or QCT designations change between phases. In the case of a multiphase project, the applicable DDA or QCT status of the site of a multiphased bond-financed project for all phases of the project is that which was applicable when the project received its first allocation of LIHTC, as certified in writing by the LIHTC-allocating agency. The applicable DDA or QCT status of the site of the project for all phases of the project is that which was applicable when the building(s) in the first phase were placed in service or when the bonds were issued as certified in writing by the LIHTC-allocating agency. 72 FR 9961-01 (March 6, 2007).
- c. Announcement 91-112, 1991-31 I.R.B. 36, confirms that this 130% rule is available for bond-financed new construction or rehabilitation.
- d. Comment. HUD makes new difficult to develop area designations annually. Beginning with the 2016 designations, metropolitan difficult to develop areas will use Small Area Fair Market Rents, rather than metropolitan-area Fair Market Rents, for designating metropolitan difficult to develop areas.
- e. Comment. Application of the 130% rule to bond-financed projects increases the amount of credits available because there is



no corresponding charge against the state volume cap. See IV.C.3., infra.

- f.** The definition of Eligible Basis for a project located in a qualified census tract includes a portion of the building (of a character subject to the allowance for depreciation, and not otherwise included in Eligible Basis) used as a community service facility (such as a childcare center or employment training center), provided the increase in Eligible Basis of any building placed in service after July 30, 2008 shall be limited to 25% of the total Eligible Basis not exceeding \$15,000,000 plus 10% of the remaining total Eligible Basis of the project. A community service facility means any facility designed to serve primarily individuals with incomes 60% or less of area median income. Code §42(d)(4)(C), as amended by the 2000 Act. This requirement is satisfied if the following conditions are met (Rev. Rul. 2003-77, 2003-2 C.B. 75):
- (i)** the facility is used to provide services that will improve the quality of life for community residents;
  - (ii)** such services are demonstrated to be appropriate and helpful to individuals in the area of the facility whose incomes are 60% or less of area median income. This requirement may be satisfied through the use of a market study such as that required to be conducted by the qualified allocation plan, or a similar study;
  - (iii)** the facility is located on the same tract of land as one of the buildings comprising the project; and
  - (iv)** any fees charged for the services provided, are affordable to individuals whose incomes are 60% or less of area median income.
- g.** The IRS has ruled that a portion of a qualified low-income building leased to a local police department for use in its outreach program may qualify as a community service facility. Rev. Rul. 2004-82, 2004-2 C.B. 350. Note: The Revenue Ruling does not indicate whether the building owner charged the police department rent and if so, whether such rent was equal to fair market rent. Query: Can a building owner charge rent to tenants who provide services at the project that are affordable to individuals whose income is 60% or less of AMI without converting such space into commercial space which is excluded from Eligible Basis?





- (i) Note: The basis of the community service facility is allocated among the buildings based on some reasonable method (e.g., units or square footage). This is similar to how costs attributable to common areas are allocated among buildings. If buildings will be placed in service over multiple years, buildings placed in service in the earlier year can only include costs from the community service facility in eligible basis if such costs were incurred prior to the end of the year in which such buildings were placed in service (unless the owner elects to defer the start of the credit period). As a result, to the extent costs associated with the community service facility, or other common elements, are incurred in a later year, the buildings placed in service in the first year may not be able to include their share of those costs in basis and that portion of the costs would not generate credits for any of the buildings. When a project located in a difficult development area received an allocation in Year 1, and seeks an additional allocation in Year 2 when the area in which it is located is not a difficult development area, the maximum amount allocable in Year 2 is equal to the excess of the amount of credits that would be allocable to the project in Year 2 based on 100% of its Eligible Basis over the amount of credits allocated to the project in Year 1. PLR 9712003 (December 11, 1996).
  - (ii) Use of bond proceeds to finance community service facility. Bond counsel takes the position that bond proceeds cannot be used to finance a community service facility that is used by non-residents on the basis that the facility is not functionally related and subordinate to the residential rental project.
- h. Comment: Legislation providing an appeal process for difficult to develop area and qualified census tract designations was introduced in the House in 2014; however, the bill was never passed. H.R. 5198, 113th Congress (2014).
  - i. Comment: Legislation has been introduced in the House to provide a 50% Eligible Basis boost for rental housing targeting extremely low-income households for allocations made after December 31, 2014. H.R. 2721, 114th Congress (2015). This bill was referred to the Subcommittee on Higher Education and Workforce Training on November 16, 2015; however, the bill was never passed. See also H.R. 1662, 114th Congress (2015).

#### D. Property Purchased During Construction.





When a project which has received a carryover allocation of credits (See IV.B.4., infra) is purchased during construction, the purchaser's Eligible Basis equals the seller's Eligible Basis (whether the purchase price is greater or less than the seller's Eligible Basis) plus any costs incurred by the purchaser after the purchase, to the extent includable in Eligible Basis. Rev. Rul. 91-38, Question 4.

### III. DEFINITION OF “QUALIFIED LOW-INCOME BUILDING”

A. Must be subject to the Modified Accelerated Cost Recovery System.

B. Must be part of “Qualified Low-Income Housing Project”.

1. A “qualified low-income housing project” is a project for “residential rental property” (II.C.1, supra) that satisfies both a tenant-income requirement and a rent-restriction requirement under either of two minimum set aside tests:
  - a. 20-50 test: 20% or more of residential units are rent-restricted and occupied by individuals whose income at initial occupancy is not more than 50% of area median gross income (“AMGI”); or
  - b. 40-60 test: 40% (25% in NYC) or more of residential units are rent-restricted and occupied by individuals whose income at initial occupancy is not more than 60% of AMGI.

For property placed in service in 2006, 2007, and 2008 in a nonmetropolitan area within the Gulf Opportunity Zone, and after July 30, 2008 in rural areas (as defined in section 520 of the Housing Act of '49, 42 USC 1490), the income-targeting rules are applied by replacing the “area median gross income” standard with a “national nonmetropolitan median gross income” standard. Code §42(i)(8). Any determination of AMGI for a project may not be less than the determination of AMGI for the project for the preceding calendar year. Code §42(g)(4).

2. Generally, the 20-50 or 40-60 tests must be satisfied by the end of the first year of the Credit Period and for the duration of the Compliance Period.
3. The proposed Affordable Housing Credit Improvement Act of 2017 includes a third minimum set aside test using an income-averaging mechanism as an alternative to the 20-50 test and 40-60 test. Under the average income test, the project would constitute a qualified low-income housing project if at least 40 percent of the residential units were rent-restricted and occupied by tenants whose income did not exceed the imputed income limitation designated for the respective unit. The imputed income limit for each unit in a project must be designated as 20, 30, 40, 50, 60, 70, or 80 percent of AMGI. The average of the imputed



income limitations must not exceed 60 percent of AMGI. See S. 2962, 114th Congress (2016).

4. Taxpayer must elect either test irrevocably in the taxable year in which the project is placed in service. Code §42(g)(1). The IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that it acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government. Treas. Reg. 301.9100-3(a); PLR 201501005 (September 25, 2014); PLR 201342003 (November 1, 2013); PLR 201328002 (July 12, 2013); PLR 201302014 (January 11, 2013); PLR 201134022 (August 26, 2011); PLR 201010017 (March 12, 2010); PLR 200807010 (February 15, 2008); PLR 200737011 (September 14, 2007); PLR 200731001 (August 3, 2007). In addition, the IRS may grant an extension of time to make such an election under the same standard in order to allow a taxpayer to correct an inadvertent mistake as to which test is being selected. PLR 201206002 (February 10, 2012).
5. A unit is “rent-restricted” if rents paid by the tenant do not exceed 30% of the “imputed” income limitation. Income is imputed at the applicable 50% or 60% limitation for each individual occupying the unit, assuming that a studio apartment houses one person and that apartments with separate bedrooms house 1.5 persons per bedroom. (See Rev. Proc. 94-9, 1994-1 C.B. 555, regarding the calculation of rent restrictions for projects receiving allocations prior to 1990).
  - a. For purposes of the “rent-restriction” requirement, imputed income may increase above but cannot decrease below a floor which will be based on AMGI at the date of the credit allocation or, if the taxpayer elects, at the time the building is placed in service. Rev. Proc. 94-57, 1994-2 C.B. 744. No such floor exists for purposes of the tenant income requirements. See 6.e., infra.
  - b. For this purpose rents include utilities allowances. See Treas. Reg. §1.42-10 for definitions of applicable utility allowances for different types of projects (e.g. FmHA, Section 8). Final regulations published in the Federal Register on July 29, 2008, amended Treas. Reg. §§1.42-10 and 1.42-12 by updating the utility allowances regulations to provide new options for estimating tenant utility costs, including use of an energy consumption model estimates calculated by either a properly licensed engineer or a qualified professional commissioned by the building owner. Treasury Decision 9420, 07/29/2008. Those rules were updated and finalized in Treasury Decision 9755, 02/08/2016. Utility costs paid by a tenant based on actual consumption in a submetered rent-restricted unit are treated as paid directly by the tenant, and not by or through the owner of the



building. Treas. Reg. §1.42-10(a); Notice 2009-44, 2009-21 I.R.B. 1037 (May 5, 2009). In August 2012, the IRS published proposed regulations further clarifying the treatment of submetering arrangements. Pursuant to the proposed regulations, if two or more utilities are treated as submetered, the building owner must separately state the amount billed to tenants for each submetered utility. The proposed regulations, which were issued in 2012, were adopted, as amended, effective March 3, 2016. Treasury Decision 9755, 02/08/2016. An actual consumption submetering arrangement for purposes of a utility allowance in a residential low-income housing unit possesses all of the following attributes:

- (i) the building owner (or its agent or other party acting on behalf of the building owner) pays the utility provider for the particular utility consumed by the tenants in the unit;
- (ii) the tenants in the unit are billed for, and pay the building owner (or its agent or other party acting on behalf of the building owner) for, the unit's consumption of the particular utility;
- (iii) the billed amount reflects the unit's actual consumption of the particular utility. In the case of sewerage charges, however, if the unit's sewerage charges are combined on the bill with water charges and the sewerage charges are determined based on the actual water consumption of the unit, then the bill is treated as reflecting the actual sewerage consumption of the unit; and
- (iv) the utility rate charged to the tenants of the unit does not exceed the utility company rate incurred by the building owner for that particular utility. Proposed Treas. Reg. §1.42-10(e).

Final Regulations published in the Federal Register on March 3, 2016 further amended Reg. §1.42-10, and provided rules for determining the applicable utility allowance based upon whether the building or tenants receive rental assistance from the Rural Housing Service (RHS), rents and utilities of the building are reviewed by HUD, or the applicable public housing authority sets the utility allowances. See Treas. Reg. §1.42-10. The permanent regulations do not include a requirement to determine the actual monthly cost of administering an actual-consumption submetering arrangement. Rather, a building owner may charge tenants an administrative fee in accordance with a State or local law and future guidance published by the Treasury Department and IRS in



the Internal Revenue Bulletin (IRB). If tenants are charged a fee for administering an actual-consumption submetering arrangement, then gross rent will include any amount by which the monthly fee exceeds the greater of (i) five dollars, (ii) an amount designated by publication in the IRB, or (iii) the lesser of a dollar amount specifically set under a State or local law or a maximum amount designated in the IRB. Treas. Reg. 1.42-10; see also T.D. 9755.

Temporary regulations were also issued in 2016. They extend the principles of the submetering rules to situations in which a building owner sells energy produced from a renewable source directly to tenants. To the extent tenants consume this energy, the building owner may not charge tenants rates in excess of those the local utility company would have charged if they had acquired energy from that company instead. Treas. Reg. 1.42-10T; see also T.D. 9755.

- c. Rents do not include Section 8 assistance or any comparable rental assistance program.
- d. If, because of an increase in a tenant's income above 50% or 60% of AMGI as the case may be, rental assistance is decreased and rents payable by a tenant are increased, a unit may still qualify as "rent restricted" if the total subsidy and rent for the unit does not exceed what the total would have been had the tenant's income not increased above those levels and this limitation of the total subsidy and rent is mandated by Federal statute.
- e. Rents do not include payments made to the unit owner to the extent that such owner pays an equivalent amount to FmHA under Section 515 of the Housing Act of 1949.
- f. The IRS has ruled that a one-time application fee charged to tenants to reimburse the owner's out-of-pocket costs for obtaining credit checks and references for tenants is not included in rents. PLR 9330013 (April 29, 1993).
- g. Rents do not include charges for meals and other services such as laundry, housekeeping and assistance to elderly tenants, even if the services are substantial, provided that the services are optional. Treas. Reg. §1.42-11(a); Rev. Rul. 91-38, Question 12; PLR 8945036 (Aug. 15, 1989); PLR 8944042 (Aug. 8, 1989); and PLR 8920003 (Jan. 17, 1989). Services may not be considered optional unless there is a practical alternative for tenants to obtain them from sources other than the project or the project owner. Treas. Reg. §1.42-11(b)(1). Apparently, meal service may be



treated as optional even when the units contain no kitchen facilities, provided there is a practical alternative for tenants to obtain meals other than from a common dining facility. PLR 8945036.

- h.** Rent does not include the optional fee for access to and use of a garage by tenants. PLR 201149011 (December 9, 2011).
- i.** Payments for services which are not optional are generally included in rents (PLR 8921035 (Feb. 23, 1989)), even if building owners are required by law to provide the services. Continual or frequently provided nursing, medical or psychiatric services are presumed not to be optional and may cause a building not to be treated as for use by the general public. Treas. Reg. §1.42-11(b)(2); see D.3., *infra*. However, payment for “support services” designed to enable elderly or disabled tenants to remain independent may be excluded from rents provided that the payments are funded by a governmental or charitable program and the funding of services is not separable from the funding of rent. Code §42(g)(2)(B)(iii); Treas. Reg. §1.42-11(b)(3)(ii)(A); PLR 9526009 (March 27, 1995).
- j.** Rents do not include refundable fees associated with renting a low-income housing unit, such as security deposits. IRS Publication, Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, Chapter 11, “Gross Rent(s) Exceed Tax Credit Limit(s)”.

  - (i)** Comment: Uncertainty exists as to whether a tenant’s required prepayment of his or her last month’s rent would constitute rent for purposes of calculating the maximum chargeable rent. If prepaid last month’s rent is included in gross rent under Code §42(g)(2), the first month’s rent for projects requiring such payments would likely exceed the maximum allowable rent. However, HUD’s Occupancy Handbook provides that a project owner may require any tenant to pay the security deposit or the last month’s rent in a guaranteed form. HUD Handbook 4350.3: Occupancy Requirements of Subsidized Multifamily Housing Programs, Chapter 6, “Lease Requirements and Leasing Activities, §6.28(A). HUD’s recognition of this practice may suggest that a tenant’s required upfront payment of his or her last month’s will not be considered rent for such purposes.



**k.** Comment: Use of low-income housing tax credits to finance assisted-living facilities for low-income elderly has generated considerable interest. Although Code §42 may not have been drafted with these types of facilities in mind, tax credits are available if the services regularly provided are not medical or skilled nursing services so that the facility is not viewed as a hospital, nursing home sanitarium or intermediate care facility. See Rev. Rul. 98-47, 1998-2 C.B. 399, describing the types of services that may be provided to elderly residents consistent with the residential character of a building for purposes of Code §§142(d) and 145(d). (Rev. Rul. 98-47 appears to negate the threat posed by PLR 9740007 (June 27, 1997), holding that an assisted-living facility was not a residential rental property for family units within the meaning of Code §145(d) because it was, in essence, a health care facility and therefore was eligible to be financed with qualified 501(c)(3) bonds without qualifying as a residential rental project under Code §142(d).) See also PLR 199949044 (September 14, 1999) (holding that an assisted-living facility was residential rental property for purposes of Code §42.) In addition, the rent restrictions applicable to tax credit projects may be satisfied either (i) by making charges for the services optional, that is, not required as a condition of occupancy or (ii) by obtaining nonseparable assistance for rent and services for eligible tenants, typically SSI with a state supplement. The “optional” test ought to be satisfied, even if these services are essential for tenants, when a practical and viable alternative exists to obtaining the services from the project owner.

**(i)** Comment: In addition, legislation was introduced that would treat projects for moderate-income seniors (individuals sixty-two or older whose income is 140% or less of the income limitations described in Code §42(g)(1)) as qualified low-income housing tax projects under Section 42(g) of the Code; however, this bill was never passed. H.R. 6295, 112 Congress (2012). A bill was introduced in 2016 entitled the Middle-Income Housing Tax Credit Act of 2016, which proposed a 50% present value credit for buildings in which 60 percent or more of the residential units in the project are rent restricted and occupied by individuals whose income are less than 100 percent of area median gross income and the project is not federally subsidized or financed with proceeds of a federally funded grant. S. 3384, 114th Congress (2016).

**6.** Generally, the same rules that apply for purposes of determining whether a project is a “qualified residential rental project” under Code §142(d)



also apply for purposes of defining a “qualified low-income building” under Code §42(g). Code §42(g)(4).

- a. The published HUD section 8 limits are used to determine the income limitations for the project. CCA 201046014 (November 19, 2010).
- b. HERA amended Code §142(d) to permit bond financing of SRO units and student housing meeting the requirements of Code §§42(i)(3)(B)(iv) and (D).

7. Income determinations:

- a. Generally, must be made and certified at least annually. Treas. Reg. §1.42-5.
  - (i) Waiver of annual certification may be obtained for buildings 100% occupied by low-income tenants. Rev. Proc. 2004-38, 2004-2 C.B. 10. Note: After HERA, a waiver is no longer necessary as the annual income certification is no longer required for projects that are 100% LIHTC. Code Section 42(g)(4).
  - (ii) Required supporting documentation generally consists of tenant’s tax returns, W-2s or statements from third parties such as employers or agencies paying unemployment compensation (Treas. Reg. §1.42-5(b)(1)(vii)), but may consist of tenant’s signed sworn statement if tenant’s assets do not exceed \$5,000. Rev. Proc. 94-65, 1994-2 C.B. 798. If the tenant’s assets do not exceed \$5,000, the tenant’s sworn statement may also be sufficient to show that the tenant is not receiving child support. Rev. Rul. 2004-82, 2004-2 C.B. 350. If a tenant is receiving housing assistance payments under Section 8 of the United States Housing Act of 1937, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant’s income does not exceed the applicable limit under Code §42(g). Treas. Reg. §1.42-5(b)(1)(vii). IRS has relaxed this documentation requirement in order to encourage the owners of low-income housing units to rent on a temporary basis vacant units to certain displaced low-income individuals who reside in major disaster areas. Rev. Proc. 2007-54, 2007-2 C.B. 293.
  - (iii) A landlord may terminate the tenancy of a low-income tenant for failure to recertify his or her income. 2 Macon





Street Associates, L.P. v. Sealy, 929 N.Y.S.2d 353 (N.Y. App. Div. 2011); OLR, MM, L.P. v. Bracero, 2014 NY Slip Op 50652(U) (4/10/2014). A landlord may also terminate the tenancy of a purportedly low-income tenant for false certification of income and failure to disclose sources of income. 501 West 41st Street Associates, LLC v. Annunziata, 957 N.Y.S.2d 264 (N.Y.C. Civ. Ct. 2012).

(iv) Substantial rehabilitation expenditures which are treated as a new building under Code §42(e) do not require a separate tenant income certification at the time of placement in service, provided the taxpayer completes a tenant income certification at the time of acquisition of the project and as new tenants are admitted throughout the rehabilitation process. PLR 200044020 (August 3, 2000).

b. A low-income unit will not lose its status as such if the income of its occupants rises above the applicable limits, (50% or 60% of AMGI), provided that the occupant's income was initially within those limits, that the unit remains rent-restricted and that if the occupant's income rises above 140% of such limit (170% in a deep rent skewed project) causing the unit to become a so-called "over-income unit", all available units in the building (of a size comparable to, or smaller than, the over-income unit) are rented to occupants whose income does not exceed the applicable limits until such time as the percentage of low-income units in the building (excluding the over-income units) equals the percentage of low-income units on which the credit is based. This rule is known as the "available unit rule". See Treas. Reg. §1.42-15. See also CCA 200137028 (June 14, 2001).

(i) In a multiple building project, the "available unit rule" is applied separately to each building. Treas. Reg. §1.42-15(e). For tax-exempt bond purposes, there is also an "available unit rule," which, under HERA, is also applied on a building-by-building basis for buildings allowed low-income housing tax credits. Code §142(d)(3)(C).

(ii) "Comparable unit" means, with the exception of deep rent skewed projects, a residential unit which is comparably sized or smaller than the over-income unit and which is located in the same building as the over-income unit. In deep rent skewed projects, any available unit is a comparable unit.

(iii) A comparable unit must be measured using the same method (floor space or number of bedrooms) as was used



by the taxpayer to determine qualified basis for the credit year in which the comparable unit became available.

- (iv) If a previously qualified over-income tenant moves to a vacant unit within the same building which unit was, immediately prior to its vacancy, occupied by a qualified low-income tenant, both the vacated unit and the newly occupied unit may qualify as low-income units, although the continued qualification of each is subject to the “available unit rule.” Treas. Reg. §1.42-15(d).
  - (v) If any available comparable unit is rented to a nonqualified resident, all over-income units in the same building for which the available unit was a comparable unit lose their status as low-income units.
  - (vi) Not renewing a tenant’s lease when a tenant’s increase in income conflicts with the requirements of a local, state or other federal program (but does not conflict with §42 because of §§42(g)(2)(D)(i) or (ii)), does not mean that the building is not a qualified low-income building under §42(c)(2); but an owner is required to continue the tenancy of a tenant who satisfied the applicable income limitation upon initial occupancy unless good cause exists not to renew the lease. Program Manager Technical Advice 2015-003, CCA POSTN-109692-15 (March 26, 2015).
  - (vii) A unit is not available for purposes of the “available unit rule” when the unit is no longer available for rent due to a reservation that is binding under local law. See CCA 200137028 (June 14, 2001).
- c. There are safe harbors pursuant to which a unit can qualify as a low-income unit even if a tenant is over-income at the commencement of the Credit Period, provided that the tenant was at or below the applicable income limit at the later of the date the taxpayer acquired the building or the date of initial occupancy. Rev. Proc. 2003-82, 2003-2 C.B. 1097 (November 21, 2003). These safe harbors are helpful when the Credit Period occurs after the later of such dates because of either an election to defer commencement of the Credit Period until the year following placement in service or, in the case of an acquisition of an existing building, the requisite rehabilitation expenditures are not incurred until a year following the year of acquisition. The safe harbors apply only if the unit is rent-restricted and otherwise qualifies as a low-income unit (see D.1, *infra*) from the later of the date of acquisition or initial occupancy until the beginning of the



first year of the Credit Period and, in the case of an existing building, if there has been a credit allocation, binding commitment, or an issuance of tax-exempt bonds, by the end of the taxable year in which such later date occurs.

- d.** In the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, a low-income unit occupied by an over-income tenant at the time of acquisition continues to qualify as a low-income unit provided the extended use agreement (“EUA”) entered into in connection with the original syndication of the project remains in effect at all times until a new EUA is entered into as part of the re-syndication of the project and the existing EUA requires that the project maintain the same percentage of low-income tenants and restricted rents for a period of at least 15 years following the expiration of the Compliance Period with respect to the original syndication. MSSP Training Guide, Guide for Completing Form 8823, Chapter 4, Category 11a Household Income Above Income Limit Upon Initial Occupancy. The state agency must also review the initial tenant income certification. If the household qualified at the time it moved in, then the unit is in compliance even if it is now over-income. MSSP Training Guide, Guide for Completing Form 8823, Chapter 5, Category 11b Owner Failed to Correctly Complete or Document Tenant’s Annual Income Recertification. If the unit was determined to be an over-income unit under Section 42(g)(2)(D) of the Code at the time of the household’s last recertification, then the owner of the project is subject to the so-called “available unit rule” (unless the project is a 100% low-income housing tax credit project, in which case the available unit rule does not apply).
- e.** In the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, an over-income unit in a mixed-income project will continue to qualify as a low-income unit if the over-income tenant is temporarily relocated during the rehabilitation of such tenant’s unit provided the over-income tenant returns to her original unit or occupies a different unit in the same building following the rehabilitation.

  - (i)** The MSSP Training Guide provides that when a household moves to a different unit in the same building, the newly occupied unit adopts the status of the vacated unit. Thus, if a current household, whose income exceeds the applicable income limitation moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit and the vacated unit assumes the status the newly occupied unit had immediately before



it was occupied by the current resident. However, if an over-income tenant moves to a low-income unit in a different building, the newly occupied unit will not qualify as a low-income unit unless the project is 100% LIHTC. The vacated unit will be treated as a vacant unit.

- (ii) Tenants in a 100% LIHTC project can transfer between buildings even if they are over-income. Since annual certifications are no longer required for projects that are 100% affordable, the IRS does not require owners to determine if a tenant's income is less than 140% of the income limit before allowing a tenant to transfer between buildings in a 100% LIHTC project. See MSSP Training Guide, Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, Tenant Moves to Another Low-Income Unit, Example 2.
- (iii) Comment: The MSSP Training Guide does not explicitly address how these rules apply in the context of a temporary relocation of over-income tenants during the rehabilitation of an existing LIHTC project as part of an acquisition/rehabilitation or a rehabilitation by the current owner of the project. However, Example 1 under “Previously Income-Qualified Households” is instructive. In the example, owner (“O”), who previously received Section 42 credits to construct new low-income housing, applies for and receives an allocation of low-income housing tax credits in 2007 to rehabilitate the existing low-income buildings following the expiration of the 15-year compliance period with respect to the original syndication on December 31, 2005. The rehabilitation is completed and O starts claiming credits in 2009. On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit in the Project (“Unit A”). John and Mary timely complete their income recertification each year 2005 through 2008. Unit A has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period. Unit A is a low-income unit on January 1, 2009 when O begins claiming the credit. If Unit A was determined to be an over-income unit at the time of the household's last recertification in January of 2008, then O is subject to the available unit rule, if applicable. Although not explicitly stated, John and Mary are presumably temporarily relocated off-site since Unit A is taken out of service during rehabilitation. It logically follows that if John and Mary



were over-income at the time of their most recent recertification, Unit A will continue to qualify as a low-income unit following the rehabilitation and re-occupancy by John and Mary following their temporary relocation provided the available unit rule, if applicable, is satisfied.

- f. For deep rent skewed projects, the unit will not continue to qualify if any available low-income unit is rented to a tenant whose income exceeds 40% of AMGI. See PLR 9848005 (July 2, 1998).
- g. AMGI may, of course, increase or decrease during the Compliance Period. Determinations whether an occupant's income satisfies the applicable limit at initial occupancy and exceeds the 140% limit thereafter are made based on the AMGI at the time of such determinations. Rev. Rul. 94-57, 1994-2 C.B. 5. Thus, a decrease in AMGI will not cause a tenant's income to exceed the level required for initial occupancy but will lower the level at which the 140% limit is exceeded.
- h. The income of all occupants of a unit, whether or not legally related, must be combined and then compared to AMGI of a family of the same size in determining if the tests are satisfied. Rev. Rul. 90-89, 1990-2 C.B. 8.
- i. If a military service member occupies a unit in a qualified building located near qualified military installations, any amount paid to the member as a basic allowance for housing is not included in the member's income for purposes of determining whether the building qualifies for the LIHTC or whether the unit is a low-income unit.
  - (i) Comment: A tax extenders package approved by the Senate Finance Committee on July 21, 2015 proposed extending through December 31, 2016 this provision, which expired at the end of 2014. See Joint Committee on Taxation, "*Description of the Chairman's Mark of a Bill to Extend Certain Expired Tax Provisions*" (JCX-101-15), July 17, 2015. With some modification, much of the tax extenders package became law as part of the Consolidated Appropriations Act, 2016, including this provision, which was made permanent. . Pub. L. No. 114-113, Dec. 18, 2015.

8. Deep Rent Skewing.



- a. 15% of low-income units occupied by individuals whose income is not more than 40% of median income;
- b. All low-income units are rent-restricted; and
- c. Rent for each low-income unit does not exceed 1/2 of rent for other unrestricted units.

**C. Multiple Buildings.**

1. One of the more confusing aspects of Code §42 is that some provisions apply to “buildings” while others apply to “projects.” Moreover, multiple buildings may be treated either as a single project or as multiple projects.
2. Generally, each building is treated as a separate project unless multiple buildings which are eligible to be treated as a single project are identified by the taxpayer before the close of the calendar year in which the first building is placed in service. Code §42(g)(3)(D); see also Form 8609, line 8(b) and the related instructions. The identification period may be extended by the IRS when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that granting relief would not prejudice the interests of the government. PLR 201606023 (November 2, 2015); PLR 201516061 (December 23, 2014); PLR 201441002 (June 5, 2014); PLR 201411015 (March 14, 2014); PLR 201410034 (March 7, 2014); PLR 201410033 (March 7, 2014); PLR 201410032 (March 7, 2014); PLR 201410031 (March 7, 2014); PLR 201410027 (March 7, 2014); PLR 201324014 (June 14, 2013); PLR 201115008 (April 15, 2011); PLR 200723017 (June 8, 2007); PLR 200723023 (March, 1, 2007).
  - a. For this purpose a qualified low-income “building” may be an apartment building, a single-family dwelling, a townhouse, a rowhouse, a duplex or a condominium. Notice 88-91, 1988-2 C.B. 414; PLR 200107022 (February 16, 2001); PLR 9120021 (Feb. 19, 1991); PLR 9101006 (Jan. 4, 1991); PLR 8910015 (Dec. 7, 1988); PLR 8920073 (Feb. 23, 1989).
  - b. Separate condominium units of a building may be treated as a single building for purposes of determining whether the building (and its structural components) is residential rental property or nonresidential real property under Code §168(e)(2). PLR 201103006 (October 5, 2010).
  - c. Notwithstanding contrary language in Notice 88-91 (and the updated ATG), a building leased to a cooperative housing corporation should be a qualified low-income building. PLR 9538012 (June 15, 1995); PLR 8941021 (July 13, 1989).



3. Among the provisions of Code §42 which are applied on a project-wide basis and, therefore, may operate differently, depending on whether multiple buildings are treated as a single project or separate projects are (a) the 10% carryover allocation computation under Code §42(h)(1)(E)(ii), (b) the rules for credit allocations for projects with multiple buildings, (c) the satisfaction of the 20-50 or 40-60 tests pursuant to Section 42(g), (d) the “vacant unit” rule (see D.5., *infra*), and (e) the 25% limitations attributable to community service facilities (see II.C.12.c., *supra*).
  
4. Multiple buildings may be treated as part of a single project if they contain similarly constructed units and are owned by the same person, located on the same or contiguous parcels of real estate and financed pursuant to a common plan. Treas. Reg. §1.103-8(b). However, buildings that could not be treated as a single project because of their lack of proximity may be so treated if 100% of the units in each building are rent restricted. Code §42(g)(7). Note: Although the statute appears clear on its face that the only requirement to qualify for this exception is that 100% of the units be rent restricted, the ATG suggests that 100% of the units must also be occupied by qualified low-income households. Audit Guide, page 12-47. IRS personnel present at the ABA Forum in Washington, D.C. in May 2016 stated that the IRS’ position is that 100% of the units must be rent restricted and occupied by qualified low-income households. A number of practitioners in the audience objected, arguing that the language of the statute is clear on its face. In a letter to the IRS dated March 27, 2014, the Tax-Credit Equity Financing Committee of the American Bar Association Forum on Affordable Housing and Community Development Law stated “The [Audit] Guide’s statement that all units must be “Low-Income Units” results in the addition of a requirement that all units must be occupied by low-income persons. The clear wording of Section 42(g)(7) requires only that the units be rent-restricted and thus the change from “low income unit” [to] rent restricted is recommended.”

Note: There is no comparable “scattered site” exception under the tax-exempt bond rules so that buildings which are not proximate may constitute multiple projects for those rules and a single project for purposes of the Credit. Comment: There is, as yet, little guidance on the meaning of “similarly constructed units” which could be a concern for a project consisting of a high-rise building and townhouses or of buildings constructed at different times. Units need not be of the same size or have the same number of bedrooms to be “similarly constructed” so long as they are of similar quality and type of construction. See T.D. 7840, 1982-2 C.B. 38. Query: May “units” be similarly constructed even if the buildings in which the units are located are not similarly constructed?





- a.** Comment: In order to simplify the “scattered site” exception, the ABA Section of Taxation has suggested amending section 42(g)(7) to remove the rent restriction requirement and instead provide that buildings that could not be treated as a single project because of their lack of proximity be so treated if all the buildings in the project are owned by the same person and financed pursuant to a common plan. ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate (March 11, 2013).
- 5.** If a building is part of a project consisting of multiple buildings, the following rules apply for purposes of the 20-50 and 40-60 tests:

  - a.** Other buildings placed in service by the end of the first year of the first building’s Credit Period and designated by the taxpayer may be taken into account for purposes of determining whether the 20-50 test or 40-60 test has been satisfied with respect to both the first building and the other buildings, provided that, in the aggregate, the other buildings and the first building satisfy those tests by the end of the first year of the first building’s Credit Period.
  - b.** When determining the Credit Period and Compliance Period for the first building, the building is treated as placed in service on the most recent date that any other building elected for aggregation by the taxpayer was placed in service.
  - c.** The 1990 Act changed the testing date to the end of the first year of the Credit Period from the 12-month period following the date when the building was placed in service. The 1990 Act did not, however, make parallel changes to the provisions for multiple buildings. These provisions still refer to the 12-month period after the first building is placed in service as the time limit for aggregating other buildings with the first building for purposes of satisfying the qualification tests.
  - d.** A building (other than a “first” building) tested on an aggregate basis under a. above, may not be a qualified low-income building unless the remaining building or buildings in the project satisfy those tests without regard to such building.

**D. Definition of Low-Income Units.**

- 1.** Generally a low-income unit must:

  - a.** be rent-restricted; (see II.B.5, supra)



- b.** be occupied by individuals who meet the applicable income limitations (see B.6.b., supra, concerning increases in tenants' income and the "available unit rule");
- c.** be suitable for occupancy under regulations not yet issued that will take into account local health, safety and building codes; and
- d.** be used other than on a transient basis, which will generally be the case if the initial lease term is six months or longer, even if the tenant is permitted to occupy the unit on a rent-free basis for one month or less. PLR 9330013 (April 29, 1993). See also PLR 200044020 (August 3, 2000) (providing that units in an acquisition/rehabilitation project which are occupied by tenants with month-to-month tenancy and a documented long-term history of tenancy in the project will satisfy the requirement that low-income units be used on other than a transient basis, provided the tenants had initial leasehold terms of 6 months or longer with the prior owner of the project and that the new owner does not plan to change the use of the units). Note: While the IRS requires a lease term of at least 6 months, many state credit agencies require initial lease terms of 12 months.

**2.** Exceptions:

- a.** Transitional housing for homeless individuals, as defined in the McKinney Act, is not subject to 1.d. above, provided that:
  - (i)** it is used exclusively to facilitate such transition; and
  - (ii)** within the project a government agency or nonprofit organization provides counseling and supportive services to such individuals.

Comment: The requirement of exclusive use precludes combining transitional housing with other types of affordable housing in the same building.

- b.** Single-room-occupancy ("SRO") units are not treated as failing to satisfy 1.d. simply because they are rented on a month-to-month basis, so long as they are suitable for occupancy and are actually used for occupancy on a non-transient basis. SRO units in groups with shared kitchen, living room and, in some cases, shared bathroom facilities which satisfied HUD Section 8 quality standards were ruled "suitable for occupancy." PLR 9452030 (September 30, 1994). SRO units in groups with shared kitchen and bathroom facilities with minimum lease terms of 30 days were ruled to be used for occupancy on a non-transient basis. PLR 9814006 (December 18, 1997). SRO units provided to



homeless individuals whose residency privileges were conditioned on their participation in, and compliance with, the project owner's social service programs, when there was no lease agreement entered into between the "tenants" and the project owner, were ruled not to be used for occupancy on a non-transient basis. PLR 9811020 (December 2, 1997).

3. To qualify for credits under Code §42, units must also be "for use by the general public," meaning that units must be rented on a non-discriminatory basis in accordance with HUD Rules and Regulations. Treas. Reg. §1.42-9. The IRS has ruled that a project which was open to all homeless individuals, but with a preference to homeless individuals with alcohol and/or chemical dependency, is for use by the general public. PLR 9814006 (December 18, 1997). Any unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not for use by the general public. Treas. Reg. §1.42-9(b). See B.4.g.-i., supra, regarding charges for services. A project will not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants with special needs, who are members of a specified group under a Federal program or State program or policy that supports housing for such a specified group, or who are involved in artistic or literary activities. Code §42(g)(9).
4. Student housing does not qualify for the low-income housing credit. However, a unit will not fail to qualify as a low-income unit merely because it is occupied by an individual who is: (I) a student and receiving assistance under title IV of the Social Security Act (42 USC 601 et seq.); (II) enrolled in a job training program receiving assistance under the Job Training Partnership Act (PL 97-300, 10/13/1982) or under other similar federal, state, or local laws; or (III) a student who was previously under the care and placement responsibility of a foster care program under part B or part E of title IV of the Social Security Act. Code §42(i)(3)(D)(i). A unit will generally be considered to be occupied by low-income individuals if all of the occupants of such units are students who are married and file a joint income tax return or who are single parents and their children and such parents are not dependents of another individual and such children are not dependents of persons other than their parents. Code §42(i)(3)(D). See also, PLR 200339022 (June 20, 2003) (ruling that a unit occupied by a single, 50-year old full-time law student, who satisfied the Code §42(g) income limitations and was not a "dependent" under Code §152, qualifies as a low-income unit).
  - a. Legislation has been introduced to include a full-time student who previously was a homeless child or youth (as defined by section 725(2) of the McKinney-Vento Homeless Assistance Act) or a full-time student who previously was a homeless veteran (as



defined by section 2002(1) of title 38, United States Code) in the group of students permitted to occupy a unit without disqualifying it from treatment as a low-income unit. H.R. 2721, 114th Congress (2015); S. 1412, 114th Congress (2015). The Senate bill was introduced on May 21, 2015 and referred to the Committee on Finance. The bill including these provisions was introduced in the House on June 10, 2015 and referred to the House Committee on Ways and Means, among others. As of June 2016, the most recent action regarding the House bill was its referral to the Subcommittee on Higher Education and Workforce Training. There has been no progress regarding the Senate bill since its initial introduction and referral. Similar legislation previously had been introduced in recent years. On May 19, 2016, legislation was again introduced that proposed adding a full time student who was previously a homeless child or youth (as defined by section 725(2) of the McKinney-Vento Homeless Assistance Act) and a full time student who was previously a homeless veteran (as defined by section 2002(1) of title 38, United States Code) as students permitted to occupy a unit without disqualifying it from treatment as a low-income unit. H.R. 5290, 114th Congress (2016). As of August 1, 2017, the bill had been referred to the Committee on Ways and Means, but there has been no further action on this bill.

**5. Vacant Units.**

- a.** The “vacant unit rule” provides that a low-income unit will not lose its status as a low-income unit for purposes of the set-aside requirement, as well as for determining qualified basis, merely because it becomes vacant, provided reasonable attempts are made to rent the unit or the next available unit of comparable or smaller size to a qualified tenant before another unit in the project is rented to a nonqualifying individual. Treas. Reg. 1.42-5(c)(ix). A unit is not available for purposes of the vacant unit rule when the unit is subject to an agreement that is binding under state law. A “reasonable attempt” to rent a vacant unit requires utilizing “customary methods” of advertising apartment vacancies in the area of the project. Customary methods will vary from location to location, but may include displaying a banner and “for rent” signs at the entrance to the project, placing classified ads in local newspapers and contacting local Section 8 voucher holders listed with the public housing authority. Rev. Rul. 2004-82, 2004-2 C.B. 350.
- b.** Unlike the available unit rule which is applied on a building-by-building basis, the vacant unit rule is applied on a project-wide basis. *Id.* Thus, the vacant unit rule should apply when a tenant



moves from one unit to another within the same “project” even if the units are in separate buildings. Rev. Rul. 2004-82, 2004-2 C.B. 350. Query: Absent an election on Form 8609 to treat separate buildings as a single project, each building will be treated as a separate project. Multiple buildings may also be grouped in one or more projects, as described in III.C.4., supra. Does the vacant unit rule apply if a tenant moves between two buildings which are in, or are treated as, two separate projects?

- c. See IX.I.4., *infra*, for special rules regarding the application of the vacant unit rule in the context of temporary occupancy by certain individuals displaced by Hurricanes Katrina and Rita.
- d. During the period of tenant relocation in the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, an unoccupied low-income unit is treated as an “out of compliance unit” rather than a vacant unit. The “non-compliance” is corrected when the unit is again suitable for occupancy. See MSSP Training Guide, Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, Chapter 4, Category 11a Household Income Above Income Limit Upon Initial Occupancy, Income Qualifying Households During First Year of the 10-Year Credit Period.
  - (i) Comment: Credit in the first year of the Credit Period is allowed for each full month a unit is in service based on qualified occupancy at the end of the month. Code §42(f)(3)(B). Accordingly, any unit taken out of service for rehabilitation during the first year of the Credit Period is treated as out of compliance and thus no credits are available in the first year of the Credit Period with respect to such unit during a month (or portion thereof) it remains out of compliance. Example: A building with 10 low-income units is acquired on December 31, 2014 and rehabilitated over the following year, with the rehabilitation completed on or before December 31, 2015. The first year of the Credit Period is 2015. In the course of the rehabilitation each unit is taken out of service and the tenant relocated offsite for 5 weeks, which, in the case of one unit stretches over 3 months. As no credit is allowed for the month or portion thereof that a unit is out of service, there will be 99 unit-months of credits in 2015 (out of a maximum 120 unit-months in the first year of the Credit Period).

#### E. Extended Use Requirements.



In addition to the foregoing requirements, a building will not be eligible for credits unless an “extended low-income housing commitment” is in effect with respect to the building. Code §42(h)(6).

1. The commitment must be to maintain as low-income units for 15 years after the end of the Compliance Period (or such later date specified in the commitment) the percentage of units specified in the commitment.
2. The allocation of credits (or the amount of credits allowable for a bond-financed project) cannot exceed the amount necessary to support the percentage of low-income units specified in the commitment.
3. The commitment must:
  - a. be enforceable by former, present and future tenants who meet the applicable income limitations;
  - b. be binding on all successors of the taxpayer;
  - c. be recorded pursuant to state law as a restrictive covenant;
  - d. prohibit a disposition of any portion of the building to which the commitment applies without the disposition of the remainder of the building to the same transferee; But see PLR 200703024 (January 19, 2007) (holding that the foregoing prohibition may be made inapplicable if agreed to by the owner and the allocating agency as part of a plan to provide tenants with right of first refusal in accordance with Code Section 42(i)(7)). See VI.B.3., infra.
  - e. prohibit the refusal to lease to any prospective tenant because such prospective tenant holds a Section 8 voucher or certificate; and
  - f. provide for a restriction on evictions and rent increases which applies during the extended use period and continues for the three years following a termination of the commitment unless a tenant exercises a right of first refusal to purchase the project. Rev. Rul. 2004-82, 2004-2 C.B. 350. Commitments entered into prior to January 1, 2006 that lack particular language to this effect will be treated as conforming provided that (i) the commitment contains “catch-all” language requiring the building owner to comply with the requirements of Code §42, (ii) the housing credit agency notifies the owner on or prior to December 31, 2005 that the restrictions on evictions and rent increases apply throughout the commitment period, (iii) the building owner includes in its annual certification to the agency a statement that the restrictions on evictions and rent increases were not violated (the agency is



required to report a failure to make such a certification on Form 8823), and (iv) if the commitment is amended after December 31, 2005, the amendment includes language clearly providing that the restrictions on evictions and rent increases apply throughout the commitment period. Commitments entered into after December 31, 2005 must provide that the restrictions on evictions and rent increases apply throughout the commitment period and owners must certify annually to the housing credit agency that these restrictions have not been violated (a failure to make such a certification will be reported on Form 8823). Rev. Proc. 2005-37, 2005-2 C.B. 79.

4. The extended use requirements (and presumably all the other provisions of the Revenue Reconciliation Act of 1989) apply to projects receiving allocations after 1989, even if they also received allocations for prior years. Rev. Rul. 92-79, 1992-2 C.B. 10.
5. Termination of Extended Use Commitment
  - a. The commitment shall terminate prior to the extended-use period:
    - (i) on the date the building is acquired by foreclosure (or instrument in lieu thereof);
    - (ii) if the housing credit agency is unable to timely present a “qualified contract” to purchase the low-income portion of the building, but termination under this provision or (i) above will not permit the eviction of low-income tenants or increases in their rents for 3 years following the termination; or
    - (iii) if, by its terms, the commitment is terminated or suspended when a tenant exercises a right of first refusal (see VI.B.3., infra) to purchase the project, Rev. Rul. 95-49, 1995-2 C.B. 7.
  - b. In Nordbye v. BRCP/GM Ellington, the Court of Appeals for the State of Oregon held that a former tenant of a low-income housing project has the right to enforce an extended use commitment despite a “release agreement” between the owner of the project and the state housing credit agency to terminate the agreement early, Nordbye v. BRCP/GM Ellington, 266 P.3d 92 (Or. Ct. App. 2011). The Court stated that the “release agreement” did not override a qualified low-income tenant’s right to enforce the extended use agreement as created under Section 42(h)(6)(B)(ii) of the Code. Additionally, the Court noted that neither of the situations explicitly identified in the Code that





permit an extended-use period to be terminated early applied to the present situation (See III.E.5.a.i and ii, *infra*). Following remand, however, when the case returned on appeal, the Court of Appeals held that the plaintiff lost standing when she was no longer eligible for the low-income housing and the case therefore became moot. Nordbye v. BRCP/GM Ellington, 349 P.3d 639 (Or. Ct. App. 2015).

c. In Mashni v. Foster, the Arizona Court of Appeals reversed a lower court decision and held that a receiver of an apartment complex was authorized to reject low-income housing covenants immediately upon taking possession as the low-income-housing covenants were contractual obligations and the broadly written appointment order authorized the receiver to reject contracts affecting any party or the property. 323 P.3d 1173 (Ariz. Ct. App. 2014).

d. Comment: The provision for terminating the commitment upon foreclosure is helpful in the case of mortgages which are subordinate to the commitment. Foreclosure of a superior mortgage would normally extinguish the commitment as a matter of law without the three-year prohibitions on evictions and rent increases, but Rev. Rul. 2004-82 makes it clear that the extended use commitment is not valid unless those prohibitions continue for three years. If, during this three-year period, a low income tenant vacates a unit, it is not clear whether the unit must be rent restricted for any subsequent tenant for the remainder of such period.

e. Comment. When a project is constructed on leased land, it is unclear whether the extended use commitment can terminate upon termination of the ground lease. If the termination of the ground lease is the result of a default, arguably the ground lessor's position is analogous to that of a mortgagee and termination of the commitment would be appropriate.

6. Qualified Contracts. Code §§42(h)(6)(F)-(K). In May 2012, the IRS finalized and adopted previously issued proposed regulations (Proposed Treas. Reg. §1.42-18) defining the qualified contract formula and many of the terms used therein.

a. A qualified contract must be presented within one year after requested by taxpayer, which request may not be made until after the fourteenth year of the Compliance Period;

b. Must be a bona fide contract to acquire (within a reasonable time) the non-low-income portion of the project for fair market value



and the low-income portion of the project, that is, the applicable fraction of the project specified in the extended use commitment, for the “low-income portion amount”; and

- c. Under the final Regulations, the fair market value of the non-low-income portion of the building should reflect the existing and continuing restrictions on the building set forth in the extended use commitment. The final Regulations provide that the non-low-income portion also includes the fair market value of the land underlying the entire building, both the non-low-income portion and the low-income portion, regardless of whether the building is entirely low-income as well as items of personal property not included in Eligible Basis that will be conveyed pursuant to the qualified contract. Treas. Reg. §1.42-18(b)(3).
  - (i) Note: These provisions are the same as under the Proposed Regulations.
- d. The low-income portion amount is an amount not less than the applicable fraction specified in the extended use commitment multiplied by the sum of:
  - (i) the “outstanding indebtedness” secured by, or with respect to, the building (defined in Treas. Reg. §1.42-18(c)(3)),
  - (ii) the “adjusted investor equity” in the building (as defined in Treas. Reg. §1.42-18(c)(4)),
  - (iii) other capital contributions (as defined in Treas. Reg. §1.42-18(c)(5)) not reflected in i. or ii. above, minus
  - (iv) the amount of cash distributions from (or available for distribution from) the building. Note: In response to comments concerned with project reserves distorting the low-income portion of the building, the final Regulations explicitly provide that cash available for distribution includes reserve funds so long as the reserve funds are not legally required by mortgage restrictions, regulatory agreements, or third party contractual agreements to remain with the building following the sale. Treas. Reg. §1.42-18(c)(6)(i)(B).
- e. “Outstanding indebtedness” is defined as the remaining stated principal balance of any indebtedness secured by, or with respect to, the building that (i) does not exceed the amount of “qualifying building costs,” (ii) is indebtedness under general principles of Federal income tax law, and (iii) is actually paid to the lender upon the sale of the building or is assumed by the buyer as part of



the sale of the building. Treas. Reg. §1.42-18 (c)(3). “Qualifying building costs” means costs included in the adjusted basis of depreciable property that qualifies as residential rental property, including costs incurred after the first year of the Credit Period. Treas. Reg. §1.42-18(b)(4).

- (i) Note: In response to comments, the IRS removed the requirement in the Proposed Regulations that discounted “outstanding indebtedness” having an interest rate below AFR. Proposed Treas. Reg. §1.42-18(c)(3)(ii).
  
- f. “Adjusted investor equity” means, with respect to any calendar year, the cash invested by owners for qualified building costs. Thus, equity paid for land, credit adjuster payments, tax credit application fees, operating deficits, and legal, syndication and accounting costs. Treas. Reg. §1.42-18(c)(4)(i). Comment: If “outstanding indebtedness” exceeds “qualified building costs,” seemingly “adjusted investor equity” must be zero. Also, to the extent that upward credit adjusters result from increases in qualified building costs, it does seem logical to exclude payment for such adjusters from adjusted investor equity.
  - (i) Adjusted investor equity is increased annually by a cost-of-living adjustment based on the Consumer Price Index calculated pursuant to a methodology consistent with inflation adjustments made under section 1(f) of the Code; and
  - (ii) Adjusted investor equity is taken into account only to the extent there existed an obligation to invest as of the commencement of the Credit Period. Query whether there is a sufficient “obligation” to invest if the obligation is contingent upon conditions expected to occur after the commencement of the Credit Period or representations and warranties concerning the project or subject to adjustment if tax benefits are less than forecasted.
  
- g. In Canton Club East Partners Limited Divided Housing Association Limited Partnership v. Michigan State Housing Development Authority, the plaintiff had sought to be released from its obligation to maintain a project as affordable housing for 30 years by requesting that the Michigan State Housing Development Authority (MSHDA) find a buyer to purchase the property at the qualified contract price within one year of the request. 116 AFTR 2d 2015-6943 (W. D. Mich. 2015). Plaintiff submitted a qualified contract request to MSHDA, including a calculation of the qualified contract price of \$9,779,458, on



February 20, 2014. MSHDA sent Plaintiff a letter stating that the one-year period to find a buyer commenced on February 20, 2014 and that the qualified contract price was \$9,700,000. On February 19, 2015, MSHDA sent Plaintiff an agreement for the purchase of the property for \$9,700,000. Plaintiff responded that the amount stated was not the correct qualified contract price and argued that because MSHDA had failed to secure a purchaser for the correct qualified contract price, Plaintiff was excused from compliance during the extended use period. MSHDA sought to re-list the property at the correct qualified contract price on an expedited basis but Plaintiff refused and filed a complaint asserting a claim under 28 U.S.C. §1983, which creates a remedy for those denied rights, privileges or immunities secured by the Constitution and laws. Plaintiff asserted a §1983 claim based on MSHDA's alleged violation of Section 42 of the Code. MSHDA argued that because Section 42 does not create an enforceable right that may support a cause of action under §1983, Plaintiff had failed to state a claim. Relying on the Supreme Court's decision in Gonzaga Univ. v. Doe, 536 U.S. 273 (2002), in which the Supreme Court concluded that when Congress wants to create new rights enforceable by either §1983 or an implied right of action, it must do so in clear and unambiguous terms, the Court held that Section 42(h)(6)(E) does not contain "clear and unambiguous" language indicating an intent on the part of Congress to create a new individual right and therefore may not serve as the basis for a §1983 claim.

Comment: The final regulations incorporated many comments received from practitioners. One exception is the inclusion of a fair-market-value cap for the qualified contract price. Many commentators noted that the qualified contract price might exceed the fair market value of a project under certain circumstances. Ultimately, the IRS and the Treasury concluded that they did not have authority to issue a fair-market-value cap for the low-income portion of the qualified contract amount under Section 42(h)(6)(E)(i) of the Code.

The proposed regulations allowed the state housing agency to adjust the fair market value of the building if, after a reasonable period of time within the one-year offer of sale period, no buyer has made an offer. Proposed Regs. §1.42-18(c)(1). In response to criticisms that this discretionary adjustment would distort property valuations and purchaser demand, the IRS changed this provision to allow the state housing agency and the owner of the project to agree to adjust the fair market value of the non-low-income portion of the building during the one-year offer of sale period. Treas. Reg. §1.42-18(c)(1)(iii). However, if no agreement between state housing agency and the owner is reached, the fair market value of the non-low-income portion of the building determined at the time of the agency's offer of sale of the building to the public will remain



unchanged. Moreover, the buyer and the owner, not the agency as provided in the Proposed Regulations, must adjust the amount of the low-income portion of the qualified contract formula to reflect changes in the components of the qualified contract formula such as mortgage payments which reduce outstanding indebtedness between the time of the agency's offer of sale to the general public and the building's actual sale closing date. Treas. Reg. §1.42-18(c)(1)(ii).

Despite concern over potential abuses resulting from the vague definition of "bona fide offer," the final Regulations do not provide a more specific and restrictive definition of the term.

Note: It is not uncommon for an applicant to waive the requirement that the credit agency seek a qualified contract in its tax credit application in order to obtain additional points.

#### IV. ALLOCATION OF CREDIT

##### A. Allocation Required.

In order to be eligible for the credit, any building not financed with tax-exempt bonds must receive an allocation of credits from the state housing credit agency and the amount of the credits claimed with respect to a project cannot exceed the amount allocated. Code §42(h)(1)(A). Note that this general rule contemplates a separate allocation for each building in a project.

##### B. Timing and Duration of Allocation.

1. General. Although Code §42(h)(1)(B) provides that the allocation must be made "not later than" the year the building is placed in service, the intent is that allocations be made in the year of placement in service. Conf. Rep. to P.L. 100-647, §1002(1)(14)(A); Notice 89-1, 1989-1 C.B. 620.
2. Binding commitment exception. An allocation may be made subsequent to the placing of a project in service if, on or before the placed in service date, the housing credit agency had made a binding commitment to allocate a specified dollar amount of credits to the project in a specified later taxable year. Code §42(h)(1)(C); see PLR 8941035 (July 14, 1989). See also I.C.1.b., supra. Note: There is no provision for project-based binding commitments, which must be made on a building-by-building basis.
3. Exception for increase in Qualified Basis. If, after a project receiving an allocation is placed in service, it is determined that the Qualified Basis of the project is in excess of that contemplated in the original allocation, the allocation may be increased to reflect such excess not later than the close of the first year to which the additional credits apply. Code §42(h)(1)(D).

- a. Any increase in Qualified Basis after the first year of the Credit Period must be attributable to an increase in the percentage of low-income units, rather than an increase in Eligible Basis.
  - b. Credits for the increase in Qualified Basis are determined based on 2/3 of the “applicable percentage” used for the original credit.
4. Carryover Allocations: 10% Test. An allocation made prior to the year a building is placed in service will nevertheless be valid if the building is placed in service by the end of the second succeeding calendar year following the year in which the allocation is made (see I.A.6., supra, regarding placement in service) and, as of the date which is 12 months after the date that the allocation was made, the taxpayer’s basis in the project is more than 10% of the reasonably anticipated basis in the project as of the close of such second succeeding calendar year. Code §42(h)(1)(E); Treas. Reg. §1.42-6. Allocations made under this 10% rule are referred to as “carryover allocations.” State credit agencies frequently require satisfaction of the 10% test in advance of these statutory deadlines.
- a. “Basis in the project” is determined under Code §§1012 and 1016. It is not the same as Eligible Basis and thus includes costs allocable to land and commercial space. Treas. Reg. §1.42-6(b)(1). Because Code §1016 applies, reasonably anticipated basis adjustments for depreciation or for the rehabilitation tax credit should be taken into account. However, the 30% increase in Eligible Basis for projects in difficult development areas or qualified census tracts is not taken into account. Treas. Reg. §1.42-6(b)(2)(ii).
  - b. Basis in the project includes all items that are properly capitalizable as part of the basis of land or depreciable property. Treas. Reg. §1.42-6(b)(2)(i). Thus, financing, syndication or organizational costs generally will not count. Compliance monitoring fees will count only if they are capitalizable with respect to land or depreciable property. Preamble to T.D. 8520 (March 2, 1994). Tax credit application and allocation fees are not includible in a building’s Eligible Basis. Rev. Rul. 2004-82, 2004-2 C.B. 350.
  - c. Proposed Regulations and Notice 89-1 provided that a taxpayer had to own a project to have any basis in it. The final Regulations reverse this rule. Thus, deposits or nonrecoverable costs will count, provided they are properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project. Treas. Reg. §1.42-6(b)(2)(i). When a project is to be on leased land, costs that are capitalizable into a leasehold estate



ought to qualify so long as the lessee is treated, for federal income tax purposes, as the owner of the buildings on the leased property. Comment: Although neither Code §42(h)(1)(E) nor Treas. Reg. §1.42-6(b)(2)(i) require the taxpayer to be treated as the owner of the project in order to have basis in the project and be eligible to obtain a carryover allocation, state agencies may impose such a requirement (e.g., Massachusetts conditions the issuance of a carryover allocation on the receipt of evidence demonstrating that the taxpayer has satisfied the 10% rule and ownership of the project by the taxpayer).

- d.** Construction costs are added to basis when paid or incurred, depending on whether the taxpayer uses the cash or accrual method of accounting. Treas. Reg. §1.42-6(b)(2)(iii). The accounting method of a pass-through entity controls for this purpose. Treas. Reg. §1.42-6(e)(1); Notice 89-1.
- e.** Reasonable development fees, including fees to a related party, count to the extent they could be included in basis under the accrual method of accounting, taking into account the economic performance rules of Code §461(h). Treas. Reg. §1.42-6(b)(2)(iv).
- f.** Basis taken into account for purposes of the 10% rule includes basis in land or buildings that was not incurred in anticipation of a tax-credit allocation, such as the basis in land or buildings acquired years prior to the making of a tax credit application. Treas. Reg. §§1.42-6(b)(1) and (4), Ex. 1.
- g.** Under Code §263A(f), interest is required to be capitalized only during the “production period” which generally corresponds to the period of physical construction activity. Thus, Code §263A does not support capitalizing interest incurred with respect to raw land prior to the commencement of construction for purposes of the 10% test. In contrast, carrying costs other than interest are required to be capitalized even if construction has not yet commenced. Von-Lusk v. Commissioner, 104 T.C. 207 (1995). Pre-construction interest may be capitalized if an election to do so is made under Code §266. This election must be made annually. Treas. Reg. §1.266-1(c)(2)(i). Note that under the “avoided cost” method for calculating construction interest in Treas. Reg. §1.263A-9, interest on indebtedness incurred to acquire land or an existing building may, during the construction period, be allocated to construction expenditures.
- h.** Based on the updated ATG, relocation costs apparently will not be included in basis for purposes of the 10% test. See Appendix





C, Audit Technique Guide for IRC Section 42, updated September 2014. The exclusion of relocation costs from Eligible Basis is uncertain, especially if a Section 266 election is in effect. Some states will allow such costs if the accountants are willing to include them in the cost certification. In a deal with 4% credits, deduction of these costs as an operating expense may eventually produce the same or greater tax savings than 10 years of credit.

- i.** By the date that is 1 year from the date the allocation is made, the agency must verify satisfaction of the 10% test, either by obtaining the certification of the taxpayer (under penalties of perjury) along with supporting documentation or by obtaining certifications of counsel or accountants regarding satisfaction of the 10% requirement. Code §42(h)(1)(E)(ii); Treas. Reg. §1.42-6(c); Rev. Rul. 92-40, 1992-1 C.B. 4.
- j.** Treas. Reg. §1.42-6(d) sets forth specific information that must be included in a valid carryover allocation. See also Notice 89-1.
- k.** For purposes of the 10% rule, a partnership is a “taxpayer” so that a partner who acquires an interest in the partnership after satisfaction of the 10% rule but before a project is placed in service may enjoy the benefits of this rule, at least so long as the partnership does not terminate prior to the placed in service date. PLR 9044037 (Aug. 2, 1990). See also Treas. Reg. §1.42-6(e)(2) and Rev. Rul. 91-38, 1991-2 C.B. 3.
- l.** Projects located in Presidentially-declared major disaster areas are entitled to six additional months to satisfy the 10% requirement and an additional year to satisfy the placed in service requirement, provided that such additional time is approved by the state housing credit agency. Rev. Proc 2014-49, 2014-37 I.R.B. 535; Rev. Proc. 2007-54, 2007-2 C.B. 293; Rev. Proc. 95-28, 1995-1 C.B. 704.
- m.** Pre-paid rent under a long-term lease should count toward satisfaction of the 10% test. Some practitioners take the position that pre-paid rent must actually be paid, in cash, in order to count toward the 10% test while others are willing to treat pre-paid rent evidenced by a note as counting toward the 10% test provided some portion of the pre-paid rent (e.g., a minimum of 10%) is actually paid in cash.
- n.** See Paul, “Securing Carryover Allocations of Low-Income Housing Tax Credits,” 13 The Real Estate Tax Digest 79 (1995).



5. Project-based Allocations. Code §42(h)(1)(F) permits allocations to be made on a project basis rather than on a building-by-building basis if the following three requirements are met:
  - a. the allocation is made for a calendar year no earlier than the first calendar year for which an allocation may be made for any building in the project and no later than the end of the calendar year in which the last building in the project is placed in service;
  - b. the allocation only applies to buildings placed in service during or after the calendar year in which the allocation is made; and
  - c. the portion of such allocation for any building in the project is specified by the end of the calendar year in which the building is placed in service.

Project-based allocations may offer valuable flexibility when an allocation is sought for a project with a specified qualified basis but the number of buildings in the project or the distribution of low-income units among those buildings is uncertain. For purposes of c. above, a rehabilitated building is deemed placed in service at the same time it is placed in service for purposes of Code §42(e)(4)(A). See PLR 9506016 (Nov. 4, 1994); I.A.6., supra.

6. Once made, an allocation is good for the entire Compliance Period.

### C. Determination of State Ceilings.

1. Ceiling for each year is the sum of the following components:
  - a. For calendar year 2017, this is the greater of \$2.35 multiplied by the state population or \$2,710,000 (the “population component”). Rev. Proc. 2016-55. (November 7, 2016). Note: This has increased from the greater of \$2.35 multiplied by the state population or \$2,710,000 for 2016.
    - (i) Comment: Legislation was reintroduced in the House to increase the per-capita allocation from \$2.30 to \$2.70 for allocations made in calendar year 2015 or later. H.R. 2721, 114th Congress (2015); see also H.R. 1662, 114th Congress (2015). H.R. 2721 and related bill H.R. 1662 each were referred to multiple committees, but as of August 1, 2017, no further action has been taken on either bill. Legislation also was introduced to increase the availability of new markets tax credits (NMTCs) and LIHTCs in communities affected by natural disasters between 2012 and 2015. The bill proposed retroactively increasing the annual ceiling in those areas to \$8 per person or 50 percent of a state’s



annual LIHTC ceiling, whichever is higher. It also proposed increasing the NMTC allocation for 2012 to 2015. If the bill were passed, it contemplates that the retroactive increases would allow for a carryover of the unused newly-increased ceiling or limitation. S. 1795, 114th Congress (2015); H.R. 3110, 114th Congress (2015). The Senate bill was referred to the Committee on Finance, and the House bill was referred to the House Committee on Oversight and Government Reform. However, as of August 1, 2017, there has been no further action on either bill. Query whether a retroactive allocation would allow credits to be carried forward only one year, or if they would be able to be carried forward to multiple years. Bills covering only one specific geographic area also have been introduced to temporarily increase the state housing credit ceiling for a particular state following an environmental crisis. See, e.g. Louisiana Flood and Storm Devastation Tax Relief Act of 2016, H.R. 6137, 114th Congress (2016); Emergency East Chicago Housing Relief Act of 2016, H.R. 6166, 114th Congress (2016).

- b.** the amount of credits returned during the calendar year (the “returned credit component”). This component will include credits issued pursuant to carryover allocations in the previous year where the taxpayer did not meet the 10 percent requirement as of the applicable date. Treas. Reg. §1.42-6(a)(2)(ii);
- c.** the amount of credits, if any, allocated by the Secretary to the State from a “national pool” of unused credits from other states (the “national pool component”). Treas. Reg. §1.42-14(e). Only states which allocated their entire ceilings in the preceding year and which apply by May 1 of the current year are eligible to receive allocations from the national pool. In Rev. Proc. 2015-49, 2015-41 I.R.B. 555 (October 8, 2015), the IRS announced the amounts of unused housing credit carryovers allocated to 30 qualified states and Puerto Rico for calendar year 2015. The unused credit ceiling for the preceding calendar year (the “unused carryforward component”) is the excess for the calendar year, if any, of the sum of the population component, returned credit component, and national pool component for the calendar year over the aggregate credit dollar amount allocated for the calendar year reduced by the credit dollar amount allocated from the unused carryforward component for the calendar year. Treas. Reg. §1.42-14(a)(1); Treas. Reg. §1.42-14(b). Note that this calculation prevents unused credits from being carried forward for more than one year.





- a. be subject to public approval (e.g., hearing);
  - b. set forth criteria used to determine housing priorities (e.g., production of new family housing, production of new elderly or special needs housing, or preservation of expiring use projects);
  - c. give preference to projects that will serve the lowest income tenants for the longest period;
  - d. give preference to projects located in qualified census tracts which contribute to a concerted community revitalization plan;
  - e. provide a procedure that the agency will follow in monitoring for noncompliance with the plan and in notifying the IRS of such noncompliance (See IV.E., *infra*, regarding monitoring procedures);
  - f. provide selection criteria for specific projects that include location, housing needs and project characteristics, sponsor characteristics (including whether the project involves the use of existing housing as part of a community revitalization plan), tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project;
  - g. require that a comprehensive market study be conducted for all projects prior to making a credit allocation, which study shall be conducted at the developer's expense by a third party approved by the agency; and
  - h. require the agency to make available to the general public a written explanation for any allocation of a housing credit dollar amount which is not made in accordance with the established priorities and selection criteria of the agency.
3. Analysis of Financial Feasibility.
- a. Must be made three times:
    - (i) at the time of the application for credits;
    - (ii) when the allocation is made; and
    - (iii) when the project is placed in service.
  - b. Analysis shall take into account all sources and uses of funds, including syndication proceeds and the reasonableness of



developmental and operational costs, and the taxpayer must certify the full extent of other subsidies.

- c. To complete the analysis of financial feasibility when a project is placed in service, the agency must receive from the taxpayer a schedule of project costs and, for projects with more than 10 units, the schedule of project costs must be accompanied by a Certified Public Accountant's audit report on the schedule, which audit report must be unqualified (an agency may also require an audited schedule of project costs for projects with fewer than 11 units). Treas. Reg. §1.42-17(a)(5).
4. Courts will often show deference to a state housing agency's interpretation of its qualified allocation plan and allocations of credits made thereunder. For example, in In the Matter of New Jersey Housing and Mortgage Finance Agency 2009 Final Cycle of Low-Income Housing Tax Credit Awards, the Superior Court of New Jersey stated that in order to successfully challenge and set aside the New Jersey housing agency's allocation of tax credits under its qualified allocation plan, a project had to prove that the agency's determination was "arbitrary, capricious and unreasonable." In the Matter of New Jersey Housing and Mortgage Finance Agency 2009 Final Cycle of Low-Income Housing Tax Credit Awards, No. A-5049-09T2, 2013 BL 321137 (N.J. Super. Ct. App. Div. Apr. 25, 2013). Moreover, the Court noted that withdrawing funds from projects that had already received allocations and relied on the agency's decision in response to a challenge would substantially impair those projects and the rights of third parties. Similarly, in Tgr Affordable Hous. v. De La Vivienda De P.R., the Court of Appeals of Puerto Rico affirmed that the Puerto Rico housing agency's denial of an application could stand where it was based on the exercise of its sound judgment in light of the evaluation criteria in the duly adopted qualified allocation plan and there was no evidence that the agency had acted arbitrarily, unreasonably or without rational basis. PR 2014 App. LEXIS 3764 (P.R. Ct. App. Sept. 15, 2014).
5. However, an interested party may challenge a state housing agency's allocation of credits as having a discriminatory or disparate impact on certain minority groups. Notably, the United States Supreme Court recently held that disparate impact claims are cognizable under the Fair Housing Act on a challenge to the Texas Department of Housing and Community Affairs' allocation of low-income housing tax credits in Dallas, Texas. Tex. Dep't of Housing & Cmty. Affairs v. The Inclusive Cmty. Project, Inc., 135 S. Ct. 2507 (2015). On remand of this case to the U.S. District Court for the Northern District of Texas, Dallas Division, the court found that the plaintiff, The Inclusive Communities Project, Inc., had not proved a prima facie case that a challenged practice caused a discriminatory effect and therefore dismissed the disparate



impact claim. The Inclusive Cmty. Project, Inc. v. Tex. Dep't of Housing & Cmty. Affairs, No. 3:08-CV-0546-D (N.D. Tex. Aug 26, 2016).

- a. Comment: HUD Office of General Counsel issued guidance regarding the application of the discriminatory effects and disparate treatment methods of proof in Fair Housing Act cases in which a housing provider justifies an adverse housing action on the basis of an individual's criminal history. Office of General Counsel Guidance on Application of Fair Housing Act Standards to the Use of Criminal Records by Providers of Housing and Real Estate-Related Transactions, U.S. Department of Housing and Urban Development, April 4, 2016. HUD stated that if a policy or procedure that restricts access to housing on the basis of criminal history disparately impacts members of a protected class, such as race or national origin, then the policy or practice violates the Fair Housing Act, unless it is "necessary to serve a substantial, legitimate, nondiscriminatory interest of the housing provider" or the interest cannot be served by another practice that would have a less discriminatory effect. Rev. Rul. 2016-29; 2016-52 I.R.B. 875.
- b. In Revenue Ruling 2016-29 the IRS determined that when a state housing credit agency's QAP strongly favored applications for projects with affirmative local support, the outcome was allocations that perpetuated residential racial and economic segregation. In that case the local agency erroneously believed that local support was required in order to award credits to a project. The IRS explained that the Code requires the local jurisdiction to have a "reasonable opportunity" to comment on a proposal to allocate housing credits to a project in the jurisdiction, but localities should not have veto power over a project.
- c. In Notice 2016-77, the IRS stated that locating LIHTC projects in QCTs exacerbates concentrations of poverty. Therefore, it said that section 42(m)(1)(B)(ii)(III) grants a preference to such placement only if "there is an added benefit to the neighborhood in the form of the project's contribution to a concerted community revitalization plan." The IRS is considering providing guidance to clarify the Code's preference and requests public comment. Notice 2016-77, 2016-52 I.R.B. 914.

#### E. Compliance Monitoring.

1. Agencies must specify in their qualified allocation plans a procedure for monitoring a project for noncompliance. Pursuant to Treas. Reg. §1.42-5, the procedure must include requirements for (i) recordkeeping and





retention of records, (ii) certification and review of the project by the agency to ensure, among other things, that the project satisfies the applicable minimum set-aside test, that it is suitable for occupancy, taking into account local health, safety and building codes, and that the owner has received an annual income certification from all low-income tenants, (iii) physical inspection of the project, including a requirement that the agency conduct an on-site inspection of all buildings in the project by the end of the second calendar year following the year the last building in the project is placed in service and at least once every three years thereafter, including, generally, with respect to at least 20% of the project's low-income units, an inspection of the units and a review of the rent records and low-income certifications for the tenants in those units, and (iv) notification of noncompliance.

2. In order to satisfy the minimum standards established by Treas. Reg. §1.42-5 for compliance monitoring, an agency has the right to require specific documentation from owners of low-income projects and, if an owner fails to provide an agency with the requested documentation such that the agency is prevented from determining whether a project is in compliance with Code §42, the agency can properly treat the project as being out of compliance with Code §42. CCA 199944019 (August 4, 1999). An electronic storage system may be used to satisfy the minimum standards of Treas. Reg. §1.42-5. Rev. Rul. 2004-82, 2004-2 C.B. 350.
3. As part of the compliance monitoring standards imposed by Treas. Reg. §1.42-5, an agency must have the right to perform on-site inspections of any low income housing project at least through the end of the applicable Compliance Period. Treas. Reg. §1.42-5(d)(1). In conducting its inspections, the agency must determine (a) whether the buildings are suitable for occupancy under local health, safety, and building codes; or (b) whether the buildings and units satisfy the uniform physical condition standards for public housing established by HUD. An agency may use the HUD uniform physical condition standards to perform an on-site inspection and a violation of this standard alone is sufficient to establish that a unit is unsuitable for occupancy. CCA 201042025 (October 22, 2010). However, if a violation is found, the taxpayer may raise as an affirmative defense that under the application of a local health, safety, or building code to the facts, local law reaches a favorable result for the taxpayer.
  - a. The IRS introduced a temporary Physical Inspections Pilot Program in Michigan, Minnesota, Ohio, Oregon, Washington, and Wisconsin in an attempt to avoid duplicative physical inspections and reduce compliance costs. Notice 2014-15, 2014-12 I.R.B. 661 (February 27, 2014); Notice 2012-18, 2012-10 I.R.B. 438 (February 8, 2012). Under the program, state agencies were permitted to use either their current property-inspection protocol



or adopt HUD's Real Estate Assessment Center (REAC) inspection protocol. If a project was physically inspected by HUD and satisfied the REAC inspection protocol, then the agency was deemed to have met its on-site inspection requirement for the buildings in the project. In early 2014, the IRS extended the duration of the program through December 31, 2014. Notice 2014-15, 2014-12 I.R.B. 661 (February 27, 2014).

4. The IRS published new final and temporary regulations regarding compliance-monitoring, effective February 25, 2016. Treas. Reg. §1.42-5; Treas. Reg. §1.42-5T; see Treasury Decision 9753, 02/25/2016. The regulations “revise and clarify the requirement to conduct physical inspections and review low-income certifications.” T.D. 9753. The regulations authorize the IRS to publish guidance in the IRB regarding the minimum number of units which must be physically inspected and for which low-income certification is required. Revenue Procedure 2016-15, published concurrently with the regulations, provides that the minimum number of low-income units which must be inspected and for which low-income certification must be performed is the *lesser* of 20 percent of the low-income units in the project or the number set forth in the chart contained in the revenue procedure. Rev. Proc. 2016-15, 2016-11 I.R.B. 435, Feb. 23, 2016. Whether this rule should apply to projects with a small number of low-income units remains subject to comment, and an exception for small projects may be created when the temporary regulations are finalized. The regulations do not adopt the REAC protocol; however, they do authorize the IRS to provide guidance in the IRB regarding exceptions from or alternate means of satisfying the physical inspection provisions of §1.42-5(d), and Revenue Procedure 2016-15 states that the REAC protocol satisfies §1.42-5(d) and the physical inspection requirements contained in §1.42-5T(c)(2)(ii). Vacant low-income units still must be included in the population of units from which units are selected for inspection, even if the inspections are completed under the REAC protocol. The revenue procedure also provides that if inspections are completed under the REAC protocol, the requirement in §1.42-5T(c)(2)(iii)(A) that all buildings must be inspected does not apply (the “all-buildings requirement”). The IRS rationale is that the oversight provided by HUD (or for inspections performed under the section 515 program, by the Rural Housing Service), substitutes for the all-buildings requirement. Additionally, the regulations eliminate the same-units requirement, decoupling the physical inspection and low-income certification review. Different units, and a different number of units, may be chosen for each of the physical inspection requirement and the low-income certification review, provided units must be selected separately and in a random manner. Selection of a unit for physical inspection may not influence whether that unit is selected for low-income certification review, or vice versa. The inspections and reviews do not need to take place at the same time.



5. Under Code §42(1)(3), each agency which allocates any housing credit amount to any building for any calendar year shall submit to the IRS an annual report specifying (A) the amount of housing credit amount allocated to each building for such year, (B) sufficient information to identify each such building and the taxpayer with respect thereto, and (C) such other information as the Secretary may require. The penalty under Code §6652(j) shall apply to any failure to submit the report required. Because Code §42(1)(3) specifies a requirement for only one annual report, it is not possible to fine an Agency multiple times for one year. However, if the report is inaccurate or incomplete (e.g., missing required forms that make up the report) or late, the agency has not satisfied its duty under Code §42(1)(3), and it may be fined \$100, regardless of the fact that an annual report was submitted. CCA 200913013 (February 20, 2009). See also CCA 201046014 (Nov. 19, 2010).
6. If upon review, the IRS determines that an agency is not meeting its compliance monitoring requirements or that the agency is not making allocations of credit pursuant to a qualified allocation plan (as defined in Code §42(m)(1)(B)) that meets the requirements under Code §42(m)(1)(A), then the Service has the authority to reduce the amount of low-income housing credit allocated by an agency to a building to zero. CCA 200913013 (February 20, 2009).

#### F. Set-Aside for Non-profit Organizations.

Ten percent of each state's credit ceiling must be allocated to projects in which a "qualified nonprofit organization" owns an interest (directly or through a partnership) and "materially participates" (within the meaning of Code §469(h)) throughout the Compliance Period. Code §42(h)(5). The ownership and material participation tests may be satisfied by the use of a for-profit corporation wholly-owned by one or more qualified nonprofit organizations. Credits allocated from the non-profit set-aside and subsequently returned do not retain their non-profit set-aside character. Treas. Reg. §1.42-14(h).

1. The organization may be exempt under either Code §501(c)(3) or 501(c)(4), must have as one of its exempt purposes the fostering of low-income housing and may not be affiliated with or controlled by a for-profit organization. See Code §42(h)(5)(C).
  - a. For this purpose, a non-profit organization is not considered "affiliated with" a wholly-owned for-profit subsidiary. See S. Rep. No. 3209, 101st Cong., 2d Sess., p. 20 (1990).
  - b. Organizations seeking exemption under Code §501(c)(3) may have as their charitable purposes relief of the poor or distressed, combating economic deterioration or urban blight, lessening the burdens of government or, occasionally, historic preservation.

Treas. Reg. §1.501(c)(3)-1(d)(2); Rev. Rul. 70-585, 1970-2 C.B. 115. Demonstrating an “exclusively” charitable purpose may be problematic for sponsors of mixed-income projects that are not located in blighted areas. Rev. Proc. 96-32, 1996-1 C.B. 717, supersedes Notice 93-1, 1993-1 C.B. 290, and provides a “safe harbor guideline” that an organization will be considered charitable with respect to a mixed-income project if the following requirements are satisfied:

- (i) At least 75% of units are occupied by tenants at or below 80% of median income and, inter alia, either the 40-60 test or the 20-50 test is satisfied. The 75% test may not be satisfied by elderly or handicapped tenants who do not meet the income test. Up to 25% of the units may be rented at market rates to tenants who have incomes in excess of the low-income limit.
- (ii) Actual occupancy by poor and distressed residents is achieved after a reasonable start-up period for new construction. For existing projects requiring construction or rehabilitation, a reasonable transition period is allowed for an organization to place the project in service. Whether an organization's transition period is reasonable is determined by reference to all relevant facts and circumstances. For projects that do not require substantial construction or substantial rehabilitation, a one-year transition period to satisfy the actual occupancy requirement will generally be considered to be reasonable. If a project operates under a government program that allows a longer transition period, this longer period will be used to determine reasonableness. Note: There is no provision for a transition period to increase rents for tenants with incomes in excess of the applicable limits to “market” rates.
- (iii) The housing is affordable to charitable beneficiaries, which is deemed satisfied by the adoption of a rental policy that either follows government imposed rental restrictions or otherwise provides for relief of the poor and distressed.
- (iv) If the project consists of multiple buildings, they must share the same grounds, each building must satisfy the three preceding components of the safe harbor, or each building must be for sale or rental “exclusively” to persons at or below 80% of median income.







- d. A conflict of interest policy must be adopted.
- e. The applicant must review a Phase I environmental report and exercise due diligence to minimize risks concerning environmental indemnification.
- f. There must be a fixed price construction contract with a bonded contractor.
- g. Operating deficit guaranties must be limited to either or both of 5 years from break-even or six months of operating expenses including debt service.
- h. Tax credit adjusters must either limit payment under each adjuster provision to an amount not in excess of the aggregate amount of developer and other fees (payable and deferred) to the applicant (or any affiliate) in connection with the project or provide that payments on account of such adjusters be treated as capital contributions which are distributable prior to any other distribution upon a sale or refinancing.
- i. The GP must secure a right of first refusal in accordance with Code §42(i)(7).
- j. Repurchase obligations may not exceed the amount of capital contributions, which, apparently, does not permit investors to recover their “loads”.
- k. For most actions requiring the consent of the limited partners, the operative documents must provide that such consent shall not be unreasonably withheld.
- l. Removal of the general partner shall only be made for cause and after notice and a reasonable period to cure.

General partner applicants must identify a specific proposed housing project to be operated by the limited partnership but do not need to file a copy of a final limited partnership agreement upon execution. See memorandum issued by the IRS on July 30, 2007 from the Director of EO Rulings and Agreements.

- 5. As part of its training materials, the IRS previously published an article intended to review its position on the participation of tax-exempt organizations in partnerships with for-profit entities. See Salins and Fontenrose, Housing Partnership Agreements, published as part of the IRS’s Exempt Organizations-Technical Instruction Program for FY 2003 (2002). This article set forth criteria that were much stricter than those in the April 25, 2006 memorandum described in the preceding paragraph or





in previously stated IRS positions. Among the provisions viewed as jeopardizing exempt status were (i) guaranty, indemnification and return of capital provisions which require the tax-exempt organization to put its charitable assets at risk in order to protect the investment of for-profit limited partners and (ii) management provisions allowing for general partner removal or operational approvals by for-profit limited partners which indicate that the tax-exempt organization does not have effective control over the activities of the partnership.

Tax credits allocated from the non-profit set-aside may be subject to disallowance if ownership or “material participation” of the nonprofit organization terminates during the Credit Period. CCA 201352009 (December 27, 2013); Ch. 6, Audit Technique Guide for IRC Section 42, updated September 2014. In CCA 201352009, the Service disallowed credits for a taxable year where a project owner failed to maintain the involvement of a qualified nonprofit organization in a project previously allocated credits under the Code §42(h)(5)(B) non-profit set-aside, as of the close of a taxable year. The Service indicated that a recapture of credits is not appropriate for violation of the nonprofit set-aside because such a violation does not result from or cause a reduction in qualified basis. Credits may be disallowed for the year in which such violation occurs or continues, but after expiration of the Credit Period, there are effectively no Credits to disallow and no tax penalty for the violation. However, the Service stated that the project owner would be able to claim credits for the taxable year in which the violation is corrected (assuming the project owner is otherwise eligible to claim credits for that taxable year in question). In a letter dated March 27, 2014 to the IRS, the ABA Forum expressed concern that the approach adopted in the CCA and the updated ATG, which the ABA Forum believes is inconsistent with the statutory language, could have a negative effect on projects involving nonprofit organizations. In the letter, the ABA Forum noted that “Nothing in the text of Section 42 or the legislative history provides the tax treatment for a failure to maintain the involvement of a qualified nonprofit organization in a project throughout the Compliance Period...[and] unless the credit allocation is invalid because the state agency violated Section 42(h)(5) and credits are therefore disallowed under Section 42(h)(1), there is no basis for finding that a taxpayer who receives credits from the nonprofit setaside [sic] will lose those credits if the requirements of Section 42(h)(5) are not met throughout the Compliance Period.” In the letter, the ABA Forum argued that the nonprofit set-aside is a requirement placed upon the state allocating agency and should be deemed satisfied when the agency makes a determination in good faith that a project will satisfy the requirements of Section 42(h)(5)(B) throughout the Compliance Period based on the commitments required of the taxpayer in the extended use agreement. Query: Many states have historically allocated more than the statutorily required 10% of their housing credit amount to projects involving qualified nonprofit organizations. It remains to be seen whether the approach taken in the CCA and the ATG will act as a disincentive to states to allocate more than the statutory minimum to projects involving qualified nonprofit organizations given the



potential risk that such credits will be disallowed if the requirements of Section 42(h)(5)(B) are not satisfied throughout the Compliance Period.

6. The updated ATG, citing to the legislative history, provides the following guidelines in defining material participation:
  - a. Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer;
  - b. Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else's decisions or periodic consultation with respect to general management decisions is not sufficient.
  - c. Participation must be maintained through the year. Periodic consultation is not sufficient.
  - d. Regular on-site presence at operations is indicative of material participation.
  - e. Providing services as an independent contractor is not sufficient.
7. Comment: The ATG notwithstanding, the "material participation" standards in Code Section 469(h) are not easily applied to nonprofits. In instances where corporations are required to materially participate in an activity, Code Section 469(h) contemplates participation by one or more shareholders owning 50% or more of the stock. Nonprofits, on the other hand have no shareholders and, thus, can only participate through employees, which is not contemplated in Section 469(h), Treas. Reg. §§1.469-5 or 1.469-5T.
8. Note: Participation by a nonprofit organization may have favorable state or local tax consequences. For example, the Massachusetts Department of Revenue held that the purchase of building materials and supplies was exempt from MA sales tax when, during the entire construction period, the project was owned by a limited partnership the partners of which were owned by the same nonprofit corporation and, upon completion, a for-profit entity was admitted to the partnership as an investor limited partner. LR 01-13 (November 15, 2001); see also M.G.L. ch. 64H, §6(f). Some states may also provide property tax relief for affordable housing with nonprofit sponsors. See Paul, "Emerging Tax Considerations for Non-Profit Sponsors of Affordable Housing," 12 The Real Estate Tax Digest 181 (1994).

## G. Special Rules.



1. Each agency may allocate only to buildings within its jurisdiction.
2. In the event allocations exceed the ceiling, projects that received allocations last lose them first.
3. The first-year convention (see I.A.1., supra) does not apply in determining the amount of credit allocated to a particular project.

#### H. Bond Financed Projects.

1. The 50% Test.
  - a. Buildings which are financed with tax-exempt bonds may be eligible for low-income housing credits without an allocation of credits from the state housing credit agency. If 50% or more of the aggregate basis of any building and the land on which the building is located is financed with tax-exempt bonds, low-income housing credits attributable to the entire Eligible Basis of the building may be allowed without an allocation of credits from the applicable state agency. Code §42(h)(4)(B). If less than 50% of the aggregate basis of any building and the land on which such building is located is financed with tax-exempt bonds, only low-income housing credits that are attributable to the bond-financed portion may be claimed without an allocation of credits from the applicable state agency. Code §42(h)(4)(A).
  - b. In computing the 50% test, the basis of any building is determined by using the building's cost basis under Code §1012, rather than its adjusted basis under Code §1016, and is determined without regard to any Eligible Basis adjustment allowed for buildings located in high cost areas under Code §42(d)(5)(B). PLR 199917046 (January 29, 1999). Furthermore, "building" is not limited to Code §1250 property, but includes all property (including Code §1245 property and depreciable land improvements) financed with the proceeds of the tax-exempt bonds, as well as any functionally related and subordinate facilities. PLR 200035016 (May 30, 2000). Note: Although the ATG informally indicates that relocation costs are not includible in basis, it may be advisable to include them in basis for purposes of the 50% test to avoid failing that test should the Service's position with respect to relocation costs be reversed or successfully challenged.
  - c. Generally, a taxpayer cannot separately meet the 50% test in Code §42(h)(4)(B) with respect to the acquisition and the rehabilitation of a single building. PLR 200035016 (May 30, 2000). However, an IRS letter ruling suggests that a taxpayer may separately meet



the 50% test with respect to rehabilitated property which is treated as a “separate new building” under Code §42(e)(1) when the existing building received a previous allocation and none of the rehabilitation expenditures treated as a “separate new building” were previously included in the basis of the existing building. PLR 200335030 (August 29, 2003). This ruling did not address whether the basis in the land on which the rehabilitated property was located should be included in the calculation of the 50% test as required by Code §42(h)(4)(B). Note: In PLR 200335030, the IRS also ruled that the tax-exempt financing did cause the existing building to be “federally subsidized” despite the fact that such financing was attributable solely to the rehabilitated property.

- d.** Informally, the IRS has taken the position that bond proceeds must actually be drawn and expended in order to count toward the 50% test. The mere issuance of bonds that are taken into account for volume cap purposes is not sufficient. When a building is completed late in the year, but cost requisitions are not paid until the following year, the 50% test would not be satisfied and credits would not be available until the year following completion. See also PLR 201049018 (December 10, 2010).
- e.** Income from the temporary investment of the sale proceeds of tax-exempt bonds that accrues through the date when a project is placed in service may be counted as bond proceeds for purposes of satisfying the 50% test under Code §42(h)(4)(B). Rev. Rul. 2002-21, 2002-1 C.B. 793. PLR 200022042 (June 5, 2000); PLRs 200109011-014 (November 22, 2000).
- f.** A critical question in this context is how long tax-exempt bonds must remain outstanding in order to enable a building to be treated as bond-financed. The IRS has ruled that tax-exempt bonds which are redeemed on or after the date that a building is placed in service may nevertheless be treated as financing such building for purposes of Code §42(h)(4). PLR 9853036 (October 1, 1998); PLR 200324025 (February 27, 2003); PLR 200324042 (March 6, 2003); PLR 200334011 (May 7, 2003). The result is the same even if the redemption occurs prior to the end of the first year of the Credit Period, as, for example, when the Credit Period begins in the year after placement in service. PLR 201049018 (December 10, 2010). This PLR also indicates that the expenditures of bond proceeds after placement in service but prior to the end of the first year of the Credit Period counts toward the 50% test. Furthermore, the IRS has ruled that tax-exempt bonds which are outstanding at the end of the first year of the Credit Period of a building and which are used to repay construction expenditures or take out a construction loan made with respect to



that building would be treated as financing such building for purposes of Code §42(h)(4). PLR 201049018 (December 10, 2010); PLR 199912023 (December 22, 1998); PLR 9816018 (January 14, 1998).

2. A Building which is financed with tax-exempt bonds is considered “federally subsidized” (unless the taxpayer elects to reduce the Eligible Basis by the amount of the bond proceeds) and, therefore, is eligible only for low-income housing credits with a present value equal to 30% of the low-income portion of the building.
3. In order to generate low-income housing tax credits, tax-exempt bonds must be taken into account under volume cap provisions of Code §146 and principal payments on the financing provided with the tax-exempt bonds must be applied within a reasonable period of time to redeem the bonds. The ceiling on private activity bonds for calendar year 2017 is the greater of \$100 multiplied by the State population or \$305,315,000. Rev. Proc. 2016-55 (November 7, 2016). The increase in the bond cap indirectly increases the amount of low-income housing credits available, since projects financed by private activity bonds qualify for credits without an allocation from the state’s credit volume cap. Note: The IRS has informally taken the position that, when tax-exempt bonds which are subject to the volume cap are refunded with new bonds which do not require a new volume cap allocation but which continue to be tax-exempt under the refunded bonds’ original volume cap allocation, the new tax-exempt bonds are not treated as “taken into account” under the volume cap provisions of Code §146 and thus the new tax-exempt bonds do not generate low-income housing credits. This position, which seems questionable, is only of concern when a refund occurs prior to placement in service. See IV.H.1.e., supra.
4. Scattered site projects are not eligible for financing with tax-exempt bonds unless each scattered site qualifies as a “qualified residential rental project” under the bond rules. See Code §142(d); Treas. Reg. §1.103-8(b)(4)(ii). See also III.c.4 supra.
5. A single building project may qualify as a qualified residential project eligible for tax-exempt bond financing under Code §142(d) even if the low-income and market rate units in such building are owned by different taxpayers, allowing one taxpayer to retain the economic benefits available from the market rate units. PLR 200601021 (January 6, 2006). Apparently, the requirement that multiple buildings have the same owner (see Treas. Reg. §1.103-8(b)(4)(ii)) was not a concern because, for bond purposes (other than the bond available unit rule), this was a single building. This ruling paves the way for attracting tax credit investors to 80-20 projects, while preserving the investment in the market-rate units for economic investors.



6. A building financed with the proceeds of tax-exempt bonds cannot be used on a transient basis and must contain “separate and complete facilities for living, sleeping, eating, cooking and sanitation.” Treas. Reg. §1.103-8(b)(8)(i). However, HERA amended Section 142 of the Code to allow tax-exempt bonds to be used to finance SRO housing. Section 142(d)(2)(D) of the Code provides that a unit will not fail to be treated as a residential unit merely because the unit is an SRO unit within the meaning of Section 42 of the Code. Accordingly, SRO units may be financed with tax-exempt bond proceeds even though such units provide shared eating, cooking and sanitation facilities.
7. Units are deemed to be rented or available for rental on a continuous basis for purposes of §1.103-8(b)(5)(i), and continuously occupied by low-income tenants for purposes of §1.103-8(b)(5)(ii), during the period the Project is being renovated, where due to safety and engineering reasons, repairs required that the units be vacated during the renovation and the developer entered into replacement leases which permit the low-income tenants to reoccupy the low-income units upon completion of the renovations, thus effectively prohibiting developer from re-leasing the low-income units to other prospective tenants. PLR 200923008 (June 5, 2009).
8. Not all costs includable in Eligible Basis are “good” costs for bond purposes. For example, costs associated with a community service facility or roads and other infrastructure improvements use by nonresidents are not “functionally related” to housing and thus are not “good” costs for bond purposes. Many bond counsel also take the position that developer fee are not “good” costs if the developer is a related party.
9. See Paul, “Tax-Exempt Financing for Multi-Family Housing: A Primer,” 15 The Real Estate Tax Digest 215 (July 1997).

#### I. Correction of Administrative Errors.

1. As mandated by Code §42(n)(4), Treas. Reg. §1.42-13 provides rules for corrections of “administrative errors and omissions” by agencies with or without IRS approval. Such approval is generally required if the error is not corrected by the end of the year in which it is made and the correction affects the amount of the credit allocation or the state’s credit ceiling or carryover. Treas. Reg. §1.42-13(b)(3)(iii).
2. Pursuant to Treas. Reg. §1.42-13(b)(3)(vi), automatic approval is granted by the IRS if: (i) the correction is not made before the close of the calendar year of the error or omission and the correction is a numerical





change to the housing credit dollar amount allocated for the building or multiple-building project; (ii) the administrative error or omission resulted in an allocation document (including a carryover allocation) that either did not accurately reflect the number of buildings in a project or the correct information (other than the amount of credit allocated on the allocation document); (iii) the administrative error or omission does not affect the agency's ranking of the building(s) or project and the total amount of credit the agency allocated to the building(s) or project; and (iv) the agency corrects the administrative error or omission by following the procedures established by the IRS. The drafter of this regulation has indicated informally that, in determining whether the correction is a numerical change to the housing credit dollar amount allocated for the building or multiple-building project, the IRS intends that this language be read very broadly and takes the position that virtually every correction is a numerical change to the housing credit dollar amount (i.e. if the wrong address is listed for a building, to correct it requires a numerical change because arguably the amount allocated to the correct building was \$0.)

3. To correct an administrative error or omission which has been granted automatic approval by the IRS pursuant to Treas. Reg. §1.42-13(b)(3)(vi), the agency is required by Treas. Reg. §1.42-13(b)(3)(vii) to: (i) amend the allocation document to correct the administrative error or omission and indicate on the amended allocation document that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii)"; (ii) if correcting the allocation document requires including any additional B.I.N.(s) in the document, the document must include any B.I.N.(s) already existing for buildings in the project and, if possible, the additional B.I.N.(s) should be sequentially numbered from the existing B.I.N.(s); (iii) if applicable, amend Schedule A to Form 8610 and attach a copy of this schedule to Form 8610 for the year in which the correction is made, indicating on Schedule A that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii)"; (iv) if applicable, amend Form 8609 and attach the original of this amended form to Form 8610 for the year the correction is made, indicating on Form 8609 that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii); and (v) mail or otherwise deliver a copy of any amended allocation document and any amended Form 8609 to the affected taxpayer.
4. See, e.g., Treas. Reg. §1.42-13(c), PLR 201527017 (March 26, 2015) (administrative error occurred when incorrect allowable credit amount and maximum qualified basis amount were listed on Form 8609), PLR 201451018 (August 28, 2014) (state agency committed administrative error when Forms 8609 incorrectly attributed credits from that year's credit ceiling to buildings placed in service the prior year), PLR 201311007 (March 15, 2013) (state agency failed to update Carryover Allocation to reflect new location of project), PLR 201237013





(September 14, 2012) (state agency incorrectly tracked and double counted certain returned low-income housing tax-credit dollar amounts leading to allocations of credits in excess of state ceiling), PLR 201104024 (October 21, 2010) (state agency committed an administrative error when it made a supplemental allocation of credits in excess of state ceiling), PLR 200419016 (May 7, 2004) (in a project-based allocation, incorrect credit dollar amount listed on the Forms 8609 issued with respect to the buildings in the project (although project's aggregate credit figure was accurate)), (PLR 200226035) (June 28, 2002) (state agency incorrectly determined the final amount of credits to be allocated based on the review of the reasonableness of development costs in the year of allocation rather than in the year that the building was placed in service), PLR 199924033 (March 19, 1999) (state agency applied new developer fee limits to project after carryover allocation was executed and project was placed in service), PLR 9842023 (October 16, 1998) (incorrect Eligible Basis calculations for each building in project), PLR 9701014 (Sept. 30, 1996) (incorrect number of buildings in project), PLR 9609028 (Nov. 30, 1995) (failure to include developer fee in project costs), PLR 9602007 (Sept. 27, 1995) (mathematical error in carryover allocation), PLR 9512012 (December 23, 1994) (ineligible costs included in basis), PLR 9240011 (July 1, 1992) (carryover allocation issued to prior owner of project), and PLR 9712003 (December 11, 1996) (invalid rate lock election), for examples of correctable administrative errors.

## V. RECAPTURE OF CREDIT

### A. Recapture Events During Compliance Period.

1. Sale or disposition of interest in project.
  - a. Recapture may be avoided if project is “reasonably expected” to continue to be operated as a qualified low-income building. Seller no longer needs to post a bond or pledge US Treasury Securities for a period required by Secretary. Notwithstanding the seller’s “reasonable expectations,” actual non-compliance by a buyer will subject the seller to recapture. Accordingly, it may be necessary for the parties to negotiate an indemnity. Rev. Proc. 2008-60 provides the procedures for taxpayers to follow when relying on reasonable expectations and electing to no longer maintain a surety bond or a TDA to avoid recapture. The otherwise applicable statute of limitations is extended until three years after IRS is notified of noncompliance with the low-income housing tax credit rules. Code §42(j)(6)(B)(i). The three year extension of the applicable statute of limitations commences on the postmark date of the notification letter delivered to IRS at the address where the most current Form 8609 would be filed. Rev. Proc. 2012-27, 2012-21 I.R.B. 940 (May 2, 2012). Rev. Proc.



2012-27 provides the procedures for taxpayers notifying the IRS of noncompliance with the low-income tax credit rules. To make such notification, the taxpayer must submit a letter to the IRS, signed by the taxpayer, containing:

- (i) A lead-in declaration stating: “By this letter I am making the notification prescribed by §42(j)(6)(B)(i) of the Internal Revenue Code.”;
  - (ii) The taxpayer’s name, address, and taxpayer identification number;
  - (iii) The name (if any), address, and Building Identification Number of each building to which the taxpayer’s disposition relates (if a taxpayer received a credit from a pass-through entity but does not know any of the preceding information, the taxpayer must provide the name and employer identification number of the pass-through entity from which the taxpayer received the credit);
  - (iv) To the extent known, the name, address, and taxpayer identification number of any person(s) to whom increases in tax result as a consequence of the credit recapture; and
  - (v) A concluding declaration stating: “Under penalties of perjury, I declare that I have examined this letter and the representations made therein, and to the best of my knowledge and belief, they are true, correct, and complete.”
- b.** Prior to the revision of the regulations under Code §708 in 1997 (see II.B.2.c.(iii), supra), dispositions of partnership interests were generally treated as recapture events (unless a. and b. above were satisfied). Exceptions were provided for: (i) “de minimis” transfers of up to one-third of partner’s “greatest total interest” in the project through the partnership at any point in time (Rev. Rul. 90-60, supra); (ii) dispositions of interests in large partnerships (see C., infra); (iii) the transfer of partnership interests from a parent corporation to its wholly-owned subsidiary (PLR 9737006 (June 11, 1997)); and (iv) the transfer of partnership interests to a trust upon the death of a partner (assuming the partnership agreement provided that the death of a partner would not cause the partnership to terminate) (PLR 9801028 (September 30, 1997)). Although not specifically addressed in PLR 9801028, it is likely that this exception to the recapture rules also applies to a transfer of partnership interests to the deceased’s estate. Query whether a reduction in a partner’s distributive share of credits by virtue of a reallocation of tax losses under the Code §704 rules is



a “disposition” for this purpose. See Treas. Reg. §1.47-6; but see PLR 8651050 to the effect that a reallocation of income and gain to a general partner pursuant to Section 704(b) does not change the limited partners’ share of “general profits” for the purpose of triggering recapture of rehabilitation credits allowable under Section 47 of the Code.

- c. In PLR 199924064 (March 17, 1999), the IRS held that, in the context of transfers between members of an affiliated group, the disposition of interests in several partnerships which resulted in the deemed contribution of Code §42 property to new partnerships under Treas. Reg. §1.708-1(b)(1)(iv) would not be treated as a disposition of Code §42 property resulting in recapture of low-income housing tax credits under Code §42(j). In reaching this conclusion, the IRS stated that little guidance is available to illustrate when, under Code §42(j), a reduction in qualified basis of a building with respect to a taxpayer has occurred or when there has been a disposition that requires the posting of a bond to avoid recapture. The IRS therefore relied upon the analogous application of provisions concerning the recapture of the investment tax credit (“ITC”), including Treas. Reg. §1.47-3(f)(1) which provides for an exception to the ITC recapture rules in the case of a mere change in form of conducting a trade or business. The IRS expressed no opinion, however, regarding the application of Treas. Reg. §1.708-1(b)(1)(iv) to the technical termination of a large partnership (see C, infra). See also PLR 200445015 (November 5, 2004) (transfer of partnership interest to fourth-tier subsidiary in a series of Code §351 transactions did not result in a recapture event, transferor was deemed to hold the interest constructively after the transfer); PLR 200018022 (January 26, 2000); PLR 2000121016 (February 17, 2000).
- d. The sale of bare legal title to a project owned by a partnership to its general partner was not considered a disposition or change in ownership of its interest in the project, and did not trigger recapture. PLR 9903005 (January 22, 1999). See also PLR 200029044 (April 24, 2000); PLR 200206037 (February 8, 2002). PLRs 200232018-20 (August 9, 2002); PLRs 200233013-15 (August 16, 2002).
- e. The termination of a building’s extended use period upon foreclosure, or an instrument in lieu of foreclosure, was not considered to be the disposition of a building or an interest therein. CCA 201146016 (November 18, 2011). Therefore, while the disposition of a building upon foreclosure may ultimately result in recapture, neither the disposition of the



building nor the related termination of an extended use period on foreclosure results in the automatic recapture of credits.

2. Failure to qualify as a qualified low-income building. Note: For recapture purposes, disqualification literally seems to be determined on a building-by-building basis even though qualification may have been determined with respect to other buildings in the same project.
3. Reduction in number of low-income units without disqualification may result in partial recapture, i.e., reduction in Qualified Basis. A reconfiguration of the type of units (i.e., from one and two bedrooms to three bedrooms), where the number of units, percentage of low-income units, and rent charged were not changed, did not result in recapture. PLR 9846008 (November 13, 1998). Recapture will be triggered if a decrease in Qualified Basis results from an audit by the Service of a taxable year subsequent to a closed taxable year. CCA 201136023 (September 9, 2011). The Service may recalculate a taxpayer's Qualified Basis in a closed taxable year in order to make a determination of Qualified Basis in an open taxable year as well. Bentley Court II Limited Partnership, et al. v. Comm., TC Memo 2006-113 (5/31/2006).
4. Failure to repay loan from non-profit organization described in VI.C.2., infra.
5. No recapture upon casualty if project reconstructed within reasonable period. CCA 200134006 (August 24, 2001), states that (i) the meaning of casualty loss for tax credit recapture purposes should be consistent with the tax principles for a casualty loss under Code §165, (ii) the state agency must report to the IRS the reduction in qualified basis resulting from a casualty loss, and (iii) there is no support for the taxpayer continuing to claim credits for units which are out of service due to a casualty loss (unless the units are located in a federally declared disaster area). If a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, which is a reasonable period, then there is no recapture and no loss of credits. If the owner had failed to restore the building by the end of the taxable year, no credits would be allowed for the entire taxable year, even if the reasonable period (or reasonable restoration period) to restore the building extends into the next taxable year. CCA 200913012 (February 20, 2009). Note: The IRS further ruled that reconstruction completed within two years of the casualty was within a reasonable period based on general tax principles under Code §165. If the building's qualified basis is not restored within the reasonable period (or reasonable restoration period), then the building will be subject to recapture under Code §42(j)(1) in the taxable year in which the disaster occurred and the owner cannot claim credits on the building for that taxable year. The owner also will lose all credits claimed during the restoration period. CCA



200913012 (February 20, 2009). In Rev. Proc. 2007-54 the IRS announced that an owner of a building that is beyond the first year of the Credit Period would not be subject to recapture or loss of credit if the building's qualified basis suffered a reduction because of a disaster that caused the President to issue a major disaster declaration, provided the building's qualified basis is restored within a reasonable period. The IRS has determined that it is appropriate to extend the restoration period provided under Rev. Proc. 2007-54 for qualified low-income buildings located in the GO Zone. Notice 2007-66. Code §42(j)(4)(E) only provides recapture relief for casualty events; it does not provide the allowance of credits during the period of time that the building is being restored due to casualty events not covered under Rev. Proc. 2007-54. CCA 200913012 (February 20, 2009). Rev. Proc. 2014-49 (August 21, 2014) modifies and supersedes Rev. Proc. 2007-54. In Rev. Proc. 2014-49 and Rev. Proc. 2014-50 (August 21, 2014), the IRS provided updated guidance about temporary relief from requirements including carryover allocations, recapture, compliance monitoring, buildings in the first year of the Credit Period, the amount of credit allowable to a building that has been restored and emergency housing for qualified rental housing developments financed by low-income housing credits or tax-exempt bonds in designated major disaster areas.

6. Because recapture only occurs when there is a decrease in qualified basis from one year to the next, a discovery that Qualified Basis has been overstated since the beginning of the Credit Period should not be a recapture event. Instead, the correct Qualified Basis is determined as of the beginning of the Credit Period and excess credits claimed will be disallowed for all open years. FSA 199908037 (November 25, 1998). Such an adjustment is permitted for open years even though the first year of the Credit Period is closed.

## B. Amount Subject to Recapture.

1. “Accelerated portion of the credit”, that is, the excess of the credits claimed over the credits that would be allowable if they were claimed ratably over the 15-year Compliance Period. (No recapture of unused credits.)
  - a. Comment: The ABA Section of Taxation has suggested that the Compliance Period be changed to a ten-year period coinciding with the Credit Period and the extended use period be extended to twenty (20) years after the close of the Compliance Period. These changes would simplify compliance issues and resolve issues related to accelerated credit recapture. ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate (March 11, 2013).



2. Interest determined under Code §6621 as if accelerated portion had been deficiency in each year for which it is recaptured.
3. No deduction for interest described in 2, even for corporations.
4. Credits for the month in which a project is sold are allocated entirely to the buyer or the seller based upon who owned the project for the most days in the month. Code §42(f)(4); Rev. Rul. 91-38, Q&A 5, 1991-2 C.B. 3; PLR 9330013 (April 29, 1993). Note: The Senate Report of the Budget Reconciliation Act of 1993 states that the buyer and seller may agree to use either a daily proration or the mid-month convention (the Rev. Rul. 91-38 standard) but no amendment reflecting this choice was included in the Act. S. Rep. 103-36, 103rd Cong., 1st Sess., p. 199 (1993).

#### C. Large Partnerships.

1. Treated as the “taxpayer” for purposes of recapture determination; dispositions of partnership interests are not taken into account.
2. Recapture allocated in proportion to income sharing percentages for the year of recapture, even if those percentages differ from the sharing percentages for the year of credit.
3. The foregoing rules apply only to a partnership which has more than 35 partners (with spouses counted as only one partner) unless the partnership elects not to have these rules apply.

## VI. LIMITATIONS ON CREDIT

### A. Regular Section 38 Rules Apply.

1. There is a one-year carryback and twenty-year carryforward for unused Credits. Code §39.
2. The LIHTC may offset alternative minimum tax (“AMT”) liability. To the extent attributable to buildings placed in service after Dec. 31, 2007, the §42 LIHTC is included in the list of specified credits in Code §38(c)(4)(B)(ii) as amended. The tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation of Code §38(c)(1) with respect to the low-income housing credit, so that the low-income housing tax credit may offset the AMT liability.

### B. Section 183 and Similar Limitations Do Not Apply.

1. The “not for profit” rules of Code §183 do not apply to disallow losses, deductions or credits attributable to the ownership and operation of a



qualified low-income building for which credits are otherwise allowable. Treas. Reg. §1.42-4(a).

2. Although other principles of tax laws such as “sham,” “economic substance” or “ownership” analysis may limit such tax benefits, Treas. Reg. §1.42-4(b), most Congressionally-mandated tax incentives, such as the low-income housing tax credit, are not circumscribed by such principles. See, e.g. Treas. Reg. §1.701-1-2(d), Ex. 6; see also VIII.D.1., infra.
3. Code §42(i)(7) provides that “no federal income tax benefit” shall be disallowed because a qualified nonprofit organization, government agency, tenants’ organization or resident management organization has a “right of 1st refusal” (“ROFR”) to purchase the “property” at the end of the Compliance Period. Query: Does the property include reserves and other personal property? A purchase option does not come within this provision because, unlike a “right of 1st refusal,” an option entitles the holder to force a sale of the project. See 136 Cong. Rec. E 2925 (1990). The right of first refusal must be exercisable for a fixed price not less than the sum of:
  - a. the principal amount of all indebtedness encumbering the property other than indebtedness incurred within the 5-year period ending on the date of purchase; and
  - b. the amount of federal, state and local income taxes attributable to such sale.
  - c. there is no statutory requirement that a ROFR be limited in duration. However, most, if not all, investors insist on a time limit, e.g., 12 to 36 months after the expiration of the Compliance Period. As a result, investors have an incentive to “wait out” the ROFR in order to realize potential economic upside on sale.
  - d. Note: On May 9, 2016, a group of national developers and organizations that support nonprofit housing development submitted a letter to the IRS requesting that guidance regarding the exercise of the right of first refusal be included on the 2016–2017 Priority Guidance Plan. The letter asked the IRS to clarify that (1) a third-party offer from a party related to the nonprofit for less than fair market value should be sufficient to trigger the right of first refusal, arguing that this trigger would effectuate the law’s intent and arguing that the limited partner’s status as a partner should be protected, (2) the reference in section 42(i)(7) includes partnership assets other than the real estate, including reserves, and (3) the ROFR could be exercised by the purchase of the partnership interest or the purchase of the property. See Nonprofit





Housing Organizations Comments on Notice 2016-26, Recommending Right of First Refusal Project for 2016–2017 Priority Guidance Plan, May 9, 2016.

- e. Note: S. 548, introduced by Senators Cantwell and Hatch in February 2017, would replace the right of first refusal with a purchase option for either the property or the investor’s partnership interest.
- f. Note: In Homeowner’s Rehab Inc. and Memorial Drive Housing Inc. v. Related Corporate V SLP, L.P. and Centerline Corporate Partners V L.P., No. 14-3807 BLS2 (Sept. 13, 2016 Sup. Ct. Mass.) plaintiffs brought suit to enforce their right to exercise the right of first refusal conferred upon it at the time the partnership was formed. The court allowed plaintiff’s motion for summary judgment, agreeing that under the partnership’s documents, the plaintiffs had the right to exercise a right of first refusal at the lesser of the “Section 42 Price”, the “Third Party Price as specified in the Disposition Notice” or the “Restricted Market Price”. The defendants in the case appealed and this case is currently pending before the Commonwealth of Massachusetts Appeals Court. See Homeowner’s Rehab Inc. and Memorial Drive Housing Inc. v. Related Corporate V SLP, L.P. and Centerline Corporate Partners V L.P., No. 2017-P-0102.

### C. Application of At Risk Rules.

- 1. Generally, regular investment tax credit rules apply.
  - a. Nonrecourse financing is treated as amount “at risk” only if
    - (i) the property is not acquired by the taxpayer from a related person (within the meaning of Code §465(b)(3)(C)); and
    - (ii) such financing is received from a lender in the business of lending (other than the seller of the property) or a government agency. Code §49(a)(1)(D).
  - b. At risk limitations do not apply to widely-held C corporations.
  - c. For partnerships or S corporations, limitations are applied at the partner or shareholder level.
- 2. Loans from a qualified nonprofit organization, see IV.F.1., supra, may also be included in amounts at risk whether or not such organization would be a qualified lender provided that



- a. the loan is secured by the project (unless not permitted by the Federal agency holding or insuring a mortgage on the project);
  - b. the loan represents not more than 60% of the project's Eligible Basis, determined at the close of each taxable year; and
  - c. the loan is repaid on the first to occur of
    - (i) maturity;
    - (ii) 90 days after close of Compliance Period, if the loan represents seller financing;
    - (iii) 90 days after the earlier of the date the building ceases to be a qualified low-income project or the date which is 15 years after the close of a Compliance Period; or
    - (iv) The date of sale of the project or refinancing of the loan.
3. The interest rate on loans described in 2 above may be 1% below the AFR.
  4. PLR 9207027 (Nov. 19, 1991) deals with a partnership which included partners that were and were not subject to the "at risk" rules and which invested in several projects, some of which utilized financing that did not satisfy those rules. In order to achieve equal tax benefits for all partners, the partnership agreement provided for special allocations pursuant to which the partners subject to the at risk rules received a higher share of benefits from projects which utilized only qualifying financing and the other partners received a higher share of benefits from projects which did not utilize only qualified financing. These special allocations were recognized as valid under Code §704(b).
  5. There is as yet no specific guidance concerning the transfer of a project from an owner not subject to the at risk rules to a taxpayer who is subject to those rules. The issue is whether the specific "step into the shoes rule" or the rule fixing Eligible Basis as of the end of the first year of the Credit Period would trump application of the at risk rules.

**D. Application of Passive Activity Rules.**

1. Taxpayers subject to passive loss rules may claim low-income housing tax credits equivalent to \$25,000 of deductions ( $\$25,000 \times 35\% = \$8,750$ ) regardless of whether he or she actively participates or materially participates. Code §469(i) and (j)(5).

**VII. MASSACHUSETTS LOW-INCOME HOUSING TAX CREDIT**



## A. Timing and Amount of Credit.

1. The Massachusetts Department of Housing and Community Development or its successor agency (the “Department”) may authorize annually, effective January 1, 2013 until January 1, 2020, low-income housing tax credits equal to the total sum of (i) twenty (20) million dollars, (ii) unused Massachusetts low-income housing tax credits, if any, for the preceding calendar years, and (iii) any Massachusetts low-income housing tax credits returned to the Department by a qualified Massachusetts project. M.G.L. ch. 62, §6I(b)(1); M.G.L. ch. 63, §31H(b)(1); 760 CMR 54.03(1). Please note that effective January 1, 2020, the Department’s annual authorization cap will be decreased from twenty (20) million dollars to ten (10) million dollars. 2013 Mass. Acts, ch. 129, §14. Under legislation approved in 2004, the Department may allow applicants to elect to receive the award in the form of a loan (in an amount not to exceed (as determined by the Department) the expected equity yield from a hypothetical sale of the credits), rather than state tax credits. However, the Department has indicated informally that it has never offered, and does not expect to offer, applicants the option to receive the award in the form of a loan.
2. The Massachusetts low-income housing tax credit is taken in annual installments over five years. A full year of credit may be claimed in the year the project first becomes a qualified project, typically when the project satisfies the 40-60 test or the 20-50 test provided an early election is timely made. The credit shall be subtracted from the amount of state tax otherwise due for each taxable period and shall not be refundable. Any amount of the available Massachusetts low-income housing tax credit which exceeds the tax due for a taxable year in the credit period may be carried forward to any of the five subsequent taxable years. The credit can be claimed by both individuals and corporations. M.G.L. ch. 62, §6I(c)(3); M.G.L. ch. 63, §31H(c)(3). Three types of qualified Massachusetts projects are eligible for an allocation of Massachusetts low-income housing credits: 1) projects to which the Department has made a prior allocation of federal low-income housing credits, 2) projects to which the Department makes a simultaneous allocation of federal low-income housing credits, and 3) projects with respect to which the federal low-income housing credit is allowable by reason of Code §42(h)(4) applicable to buildings financed with tax-exempt bonds. 760 CMR 54.04(1).
3. With the exception of unused Massachusetts low-income housing credits which may be carried forward (see A.2., supra) and except for credits claimed under regulations promulgated by the Department consistent with the rule set forth in Code §42(f)(2) (allowing credits for the first year of the credit period to be reduced if the building is in service less than 12 months of the first year, with the unused portion of the first-year



credit allowed in the 11<sup>th</sup> year), a qualified Massachusetts project shall not be eligible for any Massachusetts low-income housing tax credits for more than 11 taxable years. M.G.L. ch. 62, §6I(h); M.G.L. ch. 63, §31H(h).

**B. Allocation of Credit.**

1. A project must be a qualified Massachusetts project. M.G.L. ch. 62, §6I(c)(1); M.G.L. ch. 63, §31H(c)(1). The requirement that a person claiming the Massachusetts low-income housing credits must be allocated a federal low-income housing tax credit with respect to a project has been repealed.
2. The Department shall determine eligibility for and allocate the Massachusetts low-income housing tax credit in accordance with the standards and requirements set forth in Section 42 of the Code. M.G.L. ch. 62, §6I(b)(2); M.G.L. ch. 63, §31H(b)(2). The total Massachusetts low-income housing tax credit available to a project shall be authorized and allocated by the Department based on the project's need for the credit for economic feasibility. M.G.L. ch. 62, §6I(c)(2); M.G.L. ch. 63, §31H(c)(2). Note: Although projects eligible for the Massachusetts low-income housing tax credit must satisfy the 40-60 Test or the 20-50 Test, the amount of the Massachusetts low-income housing tax credit does not depend on the amount of Eligible Basis or qualified basis.
3. The Department must allocate the total available low-income housing tax credits among as many qualified Massachusetts projects as fiscally feasible, with the goal of increasing Massachusetts' stock of affordable housing units. M.G.L. ch. 62, §6I(b)(3); M.G.L. ch. 63, §31H(b)(3).
4. The existence of a right of first refusal to purchase the project after the close of the Compliance Period on the terms provided in Code §42(i)(7) shall not cause a Massachusetts low-income housing tax credit to be denied with respect to the project. M.G.L. ch. 62, §6I(6)(i) and (ii); M.G.L. ch. 63, §31H(6)(i) and (ii); See VI.B.3., supra.
5. All or any portion of the Massachusetts low-income housing tax credits issued to a project may be sold, transferred or assigned to parties who are eligible to receive the credits. M.G.L. ch. 62, §6I(f)(1); M.G.L. ch. 63, §31H(f)(1). In order to be eligible to receive the credits, the transferee need not be a partner in the partnership which owns the project for which Massachusetts credits are being transferred. The transferee is no longer required to be entitled to claim a federal low-income housing tax credit with respect to a project in Massachusetts that has received an allocation of state credits. 760 CMR 54.07(1).



6. On March 8, 2006, the Department of Revenue issued LR 06-2 interpreting certain provisions of the Massachusetts historic rehabilitation tax credit that parallel the Massachusetts low-income housing tax credit rules. In particular, the DOR ruled that (i) a partner who is otherwise allocated .01% of a partnership's profits, losses, deductions and gains may nonetheless be allocated 100% of the partnership's historic credits and (ii) a partner that is an exempt organization under Section 501(c)(3) of the Code is, if allocated historic credits, eligible to transfer such credits.
  
7. Note: Because state taxes are generally deductible for federal income tax purposes, an allocated state tax credit does not provide dollar-for-dollar tax savings. For example, a Massachusetts taxpayer in a 35% federal tax bracket will reduce its combined Federal and Massachusetts tax liability by only 65 cents for every dollar of the Massachusetts credit. However, a state tax credit that has been transferred (as opposed to allocated among those with a direct or indirect ownership interest in the asset generating the credit) is more valuable because it is treated differently. In this case, the IRS has ruled that the use of a certificated credit to discharge the transferee's state tax liability will nevertheless be treated as a "payment" of state taxes which, subject to AMT restrictions, may be deducted from federal taxable income (a non-transferable credit is merely a reduction of state tax liability, which is ineligible for the federal deduction). CCA 200445046 (October 29, 2004) (Massachusetts low-income housing and historic rehabilitation credits); PLR 200348002 (November 28, 2003). In CCA 201147024, the IRS examined the tax consequences of the sale of certain Massachusetts state tax credits, including the Massachusetts low-income housing credit. While noting that receipt of the state tax credits by the taxpayer who originally qualifies for the credits is not a taxable event, the IRS stated that when a credit is transferred to another taxpayer for value, the original recipient must recognize gain because the transaction is a sale for federal income tax purposes. For purposes of calculating such taxable gain, the original recipient's basis in the state tax credits is zero since the taxpayer did not purchase the credit. Moreover, the original recipient's taxable gain on the sale of the state tax credits constitutes capital gain (typically short-term unless the credit is held for a year and a day), unless the credits fall within one of the statutory exclusions in Code §1221(a). Correspondingly, the purchaser of the state credits receives a cost basis in the credits equal to the consideration paid for the credits plus any transaction costs incurred in acquiring the credits (unless excluded as de minimis costs under Treas. Reg. §1.263(a)-4(e)(4)). Finally, the IRS concluded that when the purchasing taxpayer buys the state tax credits for less than their face value, the taxpayer must recognize gain when the tax credits are ultimately used to satisfy a state tax liability. See also CCA 200211042 (February 2, 2002) (concluding that the use of state tax credits generates gain to the extent the face value

of the credits exceed the transferee's basis in the credits). See VIII.E., infra.

8. On August 10, 2016, the Massachusetts Governor signed into law comprehensive economic development legislation that included a donation tax credit (DTC), which creates a new option for utilizing the existing Massachusetts Low Income Housing Tax Credit. An Act Relative to Job Creation and Workforce Development, Mass. H. 4569, Aug. 10, 2016. The DTC expands the impact of Massachusetts LIHTC by providing a credit against Massachusetts income tax liability for property owners who donate existing housing or other structures to be converted to housing to a qualified nonprofit that is committed to preserving the property's long-term affordability. The DTC is worth 50 percent of the donated value and is subtracted from the amount of state tax otherwise owed. Combined with the federal charitable deduction, proponents of the DTC believe it will provide sufficient incentive for donation to be an economically viable alternative to selling a property. The program, which will be implemented and overseen by the Massachusetts Department of Housing and Community Development ("DHCD"), is expected to allow the state to fund more units or reinvest in deeper affordability than would otherwise be feasible. See Andrew Spofford, "The Donation Tax Credit—A New Affordable Housing Tool for Massachusetts". Though modeled on the federal charitable contribution deduction, unlike the federal charitable contribution deduction, which is claimed at the time the property is donated, the DTC cannot be claimed until an Eligibility Statement is issued by DHCD.

#### C. Recapture of Credit.

1. If a portion of any federal low-income housing tax credits taken on a project receiving Massachusetts low-income housing tax credits is required to be recaptured, the Massachusetts low-income housing tax credit authorized by the Department with respect to such project shall also be recaptured. The amount of state credits recaptured shall be equal to the amount of state low-income housing tax credits previously claimed times a fraction, the numerator of which shall be the amount of recaptured federal low-income housing tax credits and the denominator of which shall be the amount of federal low-income housing tax credits previously claimed. M.G.L. ch. 62, §6I(d)(2); M.G.L. ch. 63, §31H(d)(2).
2. Oddly enough, this means that a reduction in federal qualified basis can trigger recapture of the Massachusetts low-income housing tax credit, even though the amount of federal qualified basis may not have been taken into account in determining the amount of Massachusetts low-income housing tax credits allocated to the project.



3. If the Massachusetts low-income housing credit has been transferred, the transferee is liable for the recapture amount (notwithstanding any agreement between the transferor and transferee). 760 CMR 54.12(1). This provision is a major impediment to the marketing of this credit. Compare 830 CMR 63.38R.1(12), which provides that liability for recapture of transferred historic rehabilitation credits rests with the transferor.

## VIII. COLLATERAL TAX ISSUES

### A. Partnership Allocations.

Although a full discussion of the partnership allocation rules is beyond the scope of this outline, at least the following issues should be taken into account in structuring affordable housing partnerships.

1. Credits Generally. Low-income housing tax credits, unlike credits for historic rehabilitations, are not considered “investment tax credits.” See Code §38(b)(1)(5). Consequently, low-income housing tax credits are allocated in the same manner as the allocation of depreciation deductions with respect to the Qualified Basis on which these credits are claimed. See Treas. Reg. §1.704-1(b)(4)(ii); see also, Chief Counsel Advice 200812023 (March 21, 2008). Capital accounts are not reduced by the amount of these credits. In contrast, rehabilitation tax credits are allocated in proportion to the partners’ share of profits and result in a charge to the partners’ capital accounts.
2. Minimum Gain. Thus, partnership allocations of depreciation must be respected under Code §704(b) (or Code §704(c)) in order for allocations of low-income credits to work as intended. When depreciation and other deductions drive the capital accounts of the partners negative, a minimum gain analysis is required. Such analysis must show, in effect, that in a taxable disposition of the project for no consideration other than satisfaction of the debt to which it is subject, sufficient gain would be recognized to zero out the negative capital accounts of the partners. Note: Minimum gain may be generated even if the partners’ capital accounts are positive. Accordingly, a minimum gain analysis is necessary even if the partners will not go negative during the Credit Period.
3. Partner Nonrecourse Debt. If the partnership has loans from a partner or affiliates of a partner, including obligations concerning deferred development fees payable to such affiliates, and if the anticipated losses of the partnership, including depreciation, are sufficient to create partner minimum gain, the losses and accompanying credits may be subject to reallocation to the partner who made, or whose affiliate made, such loans. Such a reallocation is generally not required when the lending affiliate owns less than 80% of a partner. To prevent potential reallocations, it is





not uncommon for a project sponsor to divest itself of more than 20% of the ownership of the general partner when the project sponsor will have loans to, or deferred fees payable from, the partnership. Note: In order to utilize the 79/21 disaffiliation structure, the general partner or managing member must be a corporation or taxed as a corporation (i.e., make an election under the check-the-box regulations to be taxed as a corporation).

4. Nonrecourse Carveouts. Chief Counsel Memorandum 201606027 concluded that the existence of certain “bad boy guaranties” would cause a loan that was otherwise nonrecourse to become recourse. CCA 201606027, Feb. 5, 2016. The guaranties at issue created liability to the general partner if the general partner took certain actions that would negatively affect the partnership, such as admitting insolvency in writing, voluntarily declaring bankruptcy, or acquiescing in an involuntary bankruptcy. The CCA caused concern among practitioners as the nonrecourse carve-outs at issue are fairly standard in the industry. However, the following month, the IRS acknowledged that the inclusion of the nonrecourse carve-out provisions in loan agreements was a common practice in the commercial real estate industry, and seemingly reversed its earlier guidance. CCA AM2016-001, March 31, 2016. In the subsequent memorandum, the IRS stated that because it was not in the economic interests of the borrower or guarantor to commit the enumerated bad acts, and because the borrower or guarantor was the party in control of whether such acts occurred, it was unlikely the bad act would occur and, thus, the contingent payment obligation should be disregarded under §1.752-2(b)(4). Accordingly, unless the facts and circumstances of a particular situation dictate a different conclusion, this type of nonrecourse carve out provision generally will not cause a liability which is otherwise nonrecourse to be considered recourse until the contingency actually occurs.
5. Loans with a Built-In Forgiveness Feature. The IRS may treat a loan of federal funds with a built-in forgiveness feature as a federal grant rather than a loan and thus exclude the amount of such loan from credit basis. See Erickson Post Acquisition Inc., TC Memo 2003-218, non-acq A.O.D. 2006-001. If a loan with a built-in forgiveness feature is treated as a grant, it is likely to be income to the partnership. Partnership agreements in tax credit transactions often provide that grant income is allocable entirely to the general partner to avoid any reduction to the limited partner’s tax benefits. However, if project losses are expected to exceed the capital contributions of the investor limited partners, such an income allocation, which would result in a positive capital account for the general partner, may adversely affect the allocation of losses and credits to the investor limited partners.



6. See Paul, “IRC Section 704(b) Strategies for Low-Income Housing Partnerships” 14 Real Estate Tax Digest 165 (June 1996).

## B. Deferred Development Fees.

1. Bona Fide Debt. Any debt obligation, including an obligation to pay a deferred developer fee, must be respected as bona fide debt in order to be included in the basis of the project for credit and depreciation purposes. See Corbin West Limited Partnership v. Comm’r, T.C. Memo 1999-7 (January 15, 1999). At a minimum, this means that the obligation must have a definite maturity date and the partnership must be able to establish that it is likely to be paid on or before such date. See TAM 200044004 (July 14, 2000), discussed in II.C.110., supra. It is also recommended that the obligation be secured by a mortgage on the project, especially if it is to be taken into account in a minimum gain analysis.
  - a. A partnership was not allowed to include the amount of a developer’s fee to be paid to its general partner in its basis calculation for claiming a rehabilitation tax credit because, under the terms of the partnership agreement, the partnership was obligated to pay the developer’s fee “only to the extent of available cash” and a note evidencing the obligation to pay the fee was not executed until after the end of the year in which the partnership sought to include the full amount of the fee. Brassard v. United States, 183 F. 3d 909 (8<sup>th</sup> Cir. 1999).
2. Matching Income and Deductions. Generally Code §267 requires a matching of the year in which a fee paid by a partnership to a partner or “related person” is included in the partnership’s basis for depreciation purposes and the year in which it is included in the income of the payee. For this purpose, any partner and any owner of more than 5% of a corporate partner is a “related person.” Code §267(e)(1)(B) and (3)(B). This matching requirement is not a problem if the payee is a tax-exempt organization and the fee does not represent unrelated business taxable income. See PLRs 9438030 (June 28, 1994) and 8938002 (May 31, 1989), holding that development fees are not unrelated business taxable income. Taxable payees may take the position that Code §267(a)(2) applies only to the matching of income and “deductions” and, accordingly, does not preclude the claiming of credits on fees incurred by a partnership but not included in the income of a related cash basis payee. Such a payee may insist that the fee be unsecured, however, in order not to be deemed in receipt of “property” which represents taxable compensation. See Treas. Reg. §1.83-3(e).

## C. Partnership Anti-Abuse Regulations.



Treasury Regulations provide that if a partnership is formed or availed of in connection with a transaction, the principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of provisions of the Code dealing with the taxation of partnerships ("Subchapter K"), the IRS can recast the transaction to achieve tax results that are consistent with that intent. Treas. Reg. §1.701-2(b). The use of partnerships to take advantage of low-income housing tax credits does not appear to trigger these anti-abuse Regulations. The Regulations include an example involving a general partnership of three partners formed to own and operate a building qualifying for low-income housing tax credits, utilizing nonrecourse financing. The partnership agreement provides for a special allocation of all depreciation and tax credits to two partners in high tax brackets and none to the third partner which has net operating loss carryforwards in a manner that satisfies the Code §704(b) Regulations. The transaction in this example is stated not to be inconsistent with the intent of Subchapter K and not subject to recasting by the IRS. Treas. Reg. §1.701-2(d), Example 8. Note: Although not specifically addressed in the example, if the partner who is not allocated credits and depreciation made a capital contribution, satisfaction of the Section 704(b) rules should require a deficit restoration obligation from the other two partners.

#### D. Economic Substance.

1. Codification. Pursuant to Code §7701(o), entitled the "Clarification of Economic Substance Doctrine", a transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Under Code §7701(o), a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction. The legislative history of the Act states that tax benefits designed by Congress to effectuate a Congressional purpose or plan are not intended to be disallowed through Code §7701(o). It is not intended that a tax credit (for example, Code §42 low-income housing credit, Code §45 production tax credit, Code §45D new markets tax credit, Code §47 rehabilitation credit, Code §48 energy credit, and other such tax benefits which may be determined by the IRS) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the tax credit was intended to encourage. See footnote 344 of the Joint Committee's special report on the Health Care and Education Reconciliation Act of 2010.
2. In Historic Boardwalk Hall, LLC, et al. v. Commissioner, 136 T.C. No. 1 (January 3, 2011), the Tax Court determined that an LLC/partnership that

was formed by a state agency and historic tax credit investor, to allow the historic tax credit investor to invest in the rehabilitation of a historic building and obtain Code §47 credits, had objective economic substance, notwithstanding that the investment was not expected to produce a profit apart from the credits.

In Historic Boardwalk Hall, LLC, et al v. Comm., No. 11-1832, August 27, 2012, the Third Circuit reversed the Tax Court and held that a historic tax credit investor was not entitled to claim any credits generated by the rehabilitation because the investor lacked the upside potential and downside risk necessary to establish that it was a bona fide partner in the entity. It is unclear what, if any, application the Boardwalk holding has in the low-income housing tax credit context. We understand that informally the IRS has indicated that the position it took in Boardwalk and in a field service advice memorandum (FAA20124002F) was not necessarily intended to apply to low-income housing tax credit investments. Nevertheless, many low-income housing tax credit investments have some or all of the features that the Third Circuit and the IRS found objectionable in Boardwalk. For example, many low-income housing tax credit investments provide the investor's return almost exclusively from the tax credits and tax losses with little or no expectation of cash flow or residual value proceeds. In addition, low-income housing tax credit investors often obtain guarantees regarding the delivery of tax credits from the developer (or from an initial investor) that serve to insulate the investor from risks regarding the performance of the property.

There are significant differences between the low-income housing tax credit and the historic tax credit that should render these low-income housing tax credit investments distinguishable from the investment struck down in Boardwalk. LIHTC investments do not require a profit motive. See Treas. Reg. §1.42-4; see also Code §42(i)(7). State Credit agencies award low-income housing tax credits to projects based on their determinations that the credits are necessary for the financial feasibility of the project. Finally, realization of the credits requires that the property operate as affordable housing for the 15-year Compliance Period plus an additional extended use period of at least 15 years. Low-income housing tax credit equity, including equity invested after completion of construction, reduces the debt service requirements for a low-income housing tax credit project thereby enhancing its affordability.

On December 30, 2013, the IRS issued Rev. Proc. 2014-12 which provides a safe harbor for tax credit partnerships allocating historic tax credits to partners. Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (December 30, 2013) (as revised on January 8, 2014). The IRS will not challenge a partnership's allocation of historic tax credits to its partners if the partnership satisfies the requirements of the safe harbor. The safe harbor includes requirements for many common features of tax credit deals,



including (i) the timing and amount of the tax credit investor's contribution to the partnership, (ii) the amount and duration of the tax credit investor's interest in the partnership's income, gain and loss, (iii) the terms and funding of guarantees to the tax credit investor and (iv) the terms and availability of purchase and sale rights (e.g., call options). Per its terms, the Revenue Procedure does not apply to allocations of federal credits other than Code §47 historic tax credits (such as low-income housing tax credits) or to state credit transactions and "does not indicate the circumstances under which the Service may challenge allocations of such other credits." Id. at §3. To date, most low-income housing tax credit investments have not been structured to comply fully with this safe harbor.

#### E. Federal Tax Treatment of State Tax Credits.

1. In the Virginia historic tax credit cases, various investors and a promoter formed a partnership (the "Fund"), which invested in operating partnerships that undertook historic rehabilitations qualifying for a state tax credit, which they allocated to the Fund in consideration of capital contributions. Under the terms of the Fund partnership agreement, the investors contributed cash in exchange for the allocation of state tax credits allocated to the Fund by the operating partnerships. The investors also executed option agreements granting the Fund an option to repurchase the investors' interests for their fair market value for a period of one year. Investors were admitted to the Fund between November, 2001 and April, 2002 and all were bought out by the Fund in May, 2002, claiming large capital losses. The marketing materials disseminated to the investors in connection with the transactions stated that investors would not receive any material distributions of cash flow or net proceeds from a sale of the project and would not be allocated material amounts of federal income tax credits or partnership items of income, gain, loss, or deduction. Any return on investment was dependent entirely upon the allocations of the state credits and the capital loss generated upon the sale of the investors' interests.
2. In Chief Counsel Advices 200704028 and 200704030 released on January 26, 2007, the Chief Counsel advised the Service to recast the purported allocations of state credit by the Fund. The Chief Counsel determined that the partnership allocations of the state credits to investors should not be respected for federal tax purposes based on three theories. Applying the anti-abuse Regulations, the Chief Counsel determined that the partnerships involved were formed in connection with transactions, a principal purpose of which was to reduce substantially the present value of the partners' aggregate tax liability in a manner inconsistent with the intent of Subchapter K. Treas. Reg. §1.702-2. The Chief Counsel also argued that (i) no partnership existed for tax purposes because there was no joint profit motive between the developer and the investors and (ii) the



disguised sale rules under Code §707(b) applied to the transfer of the credits to the investors. Accordingly, the Chief Counsel urged the Service to disregard the partnerships or the status of the investors as partners and recast the transactions for federal tax purposes as a sale of state credits by the Fund to the investors, fully subject to gain recognition, and to disallow any capital losses on the transaction.

3. In Virginia Historic Tax Credit Fund 2001 LP, (2009) TC Memo 2009-295, after the IRS conceded that it would not ignore the Fund as a partnership, the Tax Court ruled that the investors were partners for federal income tax purposes under the principles of Commissioner v. Culbertson, 337 U.S. 733 (1949) and Commissioner v. Tower, 327 U.S. 280 (1946) and that the allocation of state credits to them were not sales of such credits, either in substance or under the disguised sale rules of Section 707(b).
4. The Court of Appeals for the Fourth Circuit reversed the Tax Court in Virginia Historic Tax Credit Fund 2001 LP et al. v. Commissioner, 639 F.3d 129 (4th Cir. 2011), recharacterizing the Fund's exchanges of state tax credits for investor contributions as "disguised sales" under Code §707.
5. The Fourth Circuit's opinion raises a number of questions.
  - a. To find a "disguised sale," the Court had to determine that the allocation of credits to investors in the Fund, was a "transfer of property" from the Fund to its investors for purposes of Section 707. Arguably this finding is contrary to the position of the IRS in ITA 200211042 (February 5, 2002), to the effect that the issuance of a state tax credit is simply a reduction in the recipient's state tax liability and is not includible in income or otherwise treated as a payment (of cash or property) from the state. See also PLR 200951024 and CCA 201147024 (November 25, 2011). ITA 200211042 further provides that the existence of a right of transferability, without more, does not change this tax treatment or cause the issuance of the credit to be treated as the receipt of "property." The Fourth Circuit does not mention this analysis or explain why the result would be different if a state credit is issued to a partnership and allocated among its partners.
  - b. The Fourth Circuit also claims not to address whether there was a disguised sale between the Fund and the operating partnerships by reason of Fund's capital contributions to the operating partnerships and the related allocation of credits from the operating partnerships to the Fund. "It bears emphasizing that we are not deciding whether tax credits always constitute "property" in the abstract. Rather, we are asked to decide only whether the





transfer of tax credits acquired by a non-developer partnership to investors in exchange for money constituted a “transfer of property” for purposes of §707.” The logical basis for a distinction between the allocations of state credits to the Fund and by the Fund is unclear. If the distinction is based on the relatively short-lived investor interests in the Fund, perhaps the Court should have said so.

6. In George H. Tempel, 136 T.C. No. 15 (2011), the Tax Court held that transferable state tax credits were capital assets, rejecting the Commissioner’s argument that the reduction of state tax liability was the equivalent of a right to ordinary income. The Tax Court further held that taxpayers had no basis in the credits and that the holding period began when the credits were granted and ended when they were sold.
7. In CCA 201147024 (November 25, 2011), the IRS determined that the sale of Massachusetts Low-Income Housing Tax Credits, as well as other state tax credits, to a third party by the original recipient is a taxable event. Accepting the conclusion of Tempel, the IRS stated that the original recipient of the Massachusetts tax credit has no tax basis in the credit and would recognize capital gain on the sale of a nonrefundable credit, unless the credit falls within a statutory exclusion in I.R.C. §1221(a). Moreover, the purchaser of the Massachusetts Low-Income Housing Credit will take a cost basis in the credit and will have to recognize gain on his or her use of the credit if he or she purchased the credit for less than its face value.
8. In Route 231, LLC, et al., TC Memo 2014-30, a state tax credit investment fund, Virginia Conservation, was admitted to Route 231, LLC, with a 1% interest and the remaining interests were held 49.5% each by John Carr, the tax matters partner, and another individual. Virginia Conservation contributed \$0.53 per \$1.00 of credit for a total of \$3,816,000 to the LLC and received an allocation of \$7,200,000 of credits, approximately 97% of the total credits. The remaining credits were allocated to Mr. Carr.

The Tax Court analyzed the transaction under the disguised sale rules of Code §707(a) and Treas. Reg. §1.707-3. It noted that the contribution of money and the allocation of credits occurred within two years of one another and thus were presumed to be a disguised sale pursuant to Treas. Reg. §1.707-3(c). The Tax Court also found that the credits would not have been allocated to Virginia Conservation “but for” the payment of \$3,816,000 by Virginia Conservation which, the Court also found, had no entrepreneurial risk with respect to the receipt of the credits.

The Tax Court rejected the argument that Route 231 did not transfer property to Virginia Conservation for purposes of Code §707(a)(2)(B)(ii)





because the Virginia tax credits “retained their character as potential reduction of taxes.” Relying on Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 at 140 (discussed in E.4 and 5, supra), the Court effectively concluded that a disproportionate allocation of credits in exchange for a contribution of money was, in substance, a disguised sale of those credits. Notably, the Court did not conclude (or apparently consider) that the allocation of credit to Mr. Carr, who made no related cash contribution, was a disguised sale.

The Tax Court’s decision in Route 231 was recently affirmed by the U.S. Court of Appeals for the Fourth Circuit. Route 231, LLC v. Commissioner, 810 F.3d 247 (4th Cir. 2016). The taxpayer in Route 231 attempted to distinguish the transaction in question from that in Virginia Historic on the basis that Route 231, LLC, the partnership that owned the property with respect to which the conservation easements were granted, was not a sham partnership that ceased to exist as soon as the state tax credits were transferred. The Court of Appeals dismissed this argument, stating that “The bona fides of Virginia Conservation’s status as a member of Route 231, or that entity’s status as a valid limited liability company (and valid partnership for tax purposes) do not matter for this inquiry. In short, the analysis under §707 goes to the bona fides of a particular transaction, not to the general status of the participants to the transaction. Contrary to Route 231’s repeated assertions, I.R.C. §707 applies by its plain terms to designated transactions between otherwise valid ongoing partnerships and their legitimate partners.” As articulated by the Court of Appeals, the disguised sale analysis does not turn on the bona fides of the partnership or the status of a partner as a partner in the partnership but rather on the bona fides of a particular transaction. In light of Virginia Historic and Route 231, a disproportionate allocation of state tax credits to a partner that is protected against loss of the credits through adjusters and a guaranty is likely to be taxed under the disguised sale rules.

9. In SWF Real Estate LLC, et al., TC Memo 2015-63, a state tax credit investment fund, Virginia Conservation, was admitted to SWF Real Estate, LLC (“SWF”) with a 1% interest and the remaining 99% interest was owned by Yellowfish Investments, Inc. Virginia Conservation contributed \$0.53 per \$1.00 of credit for a total of \$1,802,000 to SWF and received an allocation of \$3,400,000 of credit. The Tax Court rejected the argument that SWF did not transfer property to Virginia Conservation for purposes of Code §707(a)(2)(B)(ii) because the Virginia tax credits “were valuable and imbued with essential property rights because they induced Virginia Conservation to invest in SWF, and both SWF first and then Virginia Conservation had the right to use the Virginia tax credits on their State tax returns, benefit from the Virginia state tax credits through a reduction of State tax liability, and exercise control over the Virginia tax credits to sell or transfer them in the State tax credit marketplace.” Relying on Virginia Historic Tax Credit Fund



2001 LP v. Commissioner, 639 F.3d 129 at 140 (discussed in E.4 and 5, supra), the Court effectively concluded that a disproportionate allocation of credits in exchange for a contribution of money was, in substance, a disguised sale of those credits.

10. See Day, State Tax Credits Can Be a Real Drag, Bloomberg BNA Tax Management Real Estate Journal, April 6, 2016.

## F. Imputed Interest.

Below-market loans from governmental or charitable entities are generally not subject to the imputed interest rules of Code §7872, which otherwise would require recipients of such loans to recognize as income the difference between the stated principal amount of such loans and the imputed principal amount.

1. In Rev. Rul. 98-34, 1998-2 C.B. 118, the owners of a HUD-subsidized housing development did not realize income when they received a below-market HUD second mortgage made under the Multifamily Assisted Housing Reform & Affordability Act of 1997 and used the proceeds to retire a portion of an existing federally-insured first mortgage loan. The refinancing was effected to facilitate a reduction in rental assistance which would have caused the project to be unable to service the existing first mortgage loan.
2. If the project in Rev. Rul. 98-34 were a tax credit project, this refinancing would no longer cause it to become “federally subsidized,” and will not result in a reduction of credits. See I.B.3., infra.
3. Comment: When a loan is made in exchange for property, e.g., seller-financing in connection with a purchase of real property, Code §7872 does not apply and interest is imputed under Code §1274, which contains no exception for loans from governmental or charitable organizations. Thus, if a below-market note is issued to a charitable or governmental entity as the seller of property, a portion of the stated principal amount of the note will be recharacterized as interest and the cost basis of the property will be reduced accordingly. Similarly, a “significant modification” of a loan (within the meaning of Treas. Reg. §1.1001-3) from a governmental or charitable organization will result in cancellation of debt income if the modified loan does not bear interest at or above the AFR. CCA 199943037 (October 29, 1999).
4. Modification of Assumed Debt. It is not unusual in the context of a syndication for the acquirer to assume existing debt as part of the acquisition. Often, the terms of such existing debt are modified in connection with the acquisition, for example, the term of the debt may be extended or the interest rate reduced, sometimes retroactively. Note: If the interest rate is reduced retroactively (i.e., accrued interest is



effectively forgiven), the debtor will likely recognize cancellation of debt (“COD”) income. A “significant modification” of a debt instrument is treated as a deemed exchange of the original debt (“old debt”) for a new debt instrument (“new debt”) that differs materially either in kind or extent. Treas. Reg. §1.1001-3(b). Changes in yield, timing of payments, obligor or security, etc. are likely to be treated as significant for this purpose. If such an exchange is deemed to occur, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt. The issue price of the “new debt” is determined under the rules of Code Section 1274 and is equal to the present value of the amount due at maturity, discounted at the applicable federal rate. If the new debt bears interest at less than AFR, the modification is likely to result in COD income. Accordingly, most investors will require that any existing debt be modified prior to their admission to the partnership. In addition to potential COD income, the excess of the stated amount of such new debt over its issue price is taxed as original issue discount (“OID”). In other words, the imputed principal amount of the new debt is less than its face amount and interest is imputed at AFR. Since a portion of the new debt is re-characterized as interest, the cost basis of the property is accordingly reduced, i.e., acquisition basis is reduced. However, the project owner can avoid the loss of acquisition basis (and acquisition credits) by increasing the amount of the seller loan (or creating a seller loan if one is not already contemplated) by a corresponding amount.

## G. Property Taxes and Related Issues.

1. Depending on state or local law, a low-income housing project may be assessed using the capitalization of income method that takes into account restricted rents, but does not take into account federal low-income housing credits received by the project’s owner. See, e.g. Willow Bend Estates, LLC v. Humphreys County Board of Supervisors, No. 2012-IA-00575-SCT, 2013 BL 287653 (Miss. Oct. 17, 2013); Stillwater Housing Associates v. Rose, 254 P.3d 726 (Okla. Civ. App. 2011); Cottonwood Affordable Housing v. Yavapi County, et al., 72 P.3d 357 (Ariz. Tax 2003); Cascade Court Limited Partnership v. Noble, Wash. Ct. App., No. 42539-I-I (April 4, 2001). But see, Gillian Franks v. Town of Essex, 2013 V.T. 84 (Vt. Sup. Ct. 2013) (existence of a housing-subsidy covenant does not automatically reduce the property’s value for *ad valorem* tax purposes but instead should be individually considered in determining a property’s fair market value); Beechwood II, L.P. v. Clermont County Bd. of Revision, 2011 Ohio 5449 (Ohio Ct. App. 2011) (while federal low-income housing tax credits can be valued as separate from the underlying real estate, taxpayer has the burden of showing the allocation of the purchase price to assets other than the realty); Brandon Bay Ltd. Partnership v. Payette County, 2006 WL 695529 (Idaho 2006) (appraisal properly took into account both federal low-income housing



credits and restricted rents); Huron Ridge LP v. Township of Ypsilanti, 2005 WL 1798589 (Mich. Tax Tribunal 2005) (Id.); Town Square Ltd. Partnership v. Clay County Board of Equalization, 704 N.W.2d 896 (S.D. 2005) (Id.); Spring Hill, L.P. v. Tennessee State Bd. of Equalization, 2003 WL 23099679 (Tenn.Ct.App. 2003) (Id.); In Re Appeal of Green Pines Ltd., 576 S.E.2d 316 (N.C. 2003) (appraisal properly valued project using market rents because the rent restrictions were voluntarily assumed by the project in order to take advantage of available federal and state tax incentives).

- a. Note: The value of remaining federal low-income housing tax credits may be taken into account when valuing a party's secured claim in a low-income project in a bankruptcy proceeding. See, e.g., In re Lewis and Clark Apartments, LP, 479 B.R. 47 (B.A.P. 8th Cir. 2012); In re Creekside Senior Apartments, LP, et al., Debtors, 477 B.R. 40 (B.A.P. 6th Cir. 2012), aff'd In re Creekside Senior Apartments, LP, et al., Debtors, 489 B.R. 51 (B.A.P. 6th Cir. 2013). Both courts held that as the right to tax credits is not a separate asset but instead a covenant that runs with the underlying property, the value of the credits and any related rent restrictions should be taken into account in valuing the project property.
2. State courts have found that the involvement of for-profit limited partners in providing low- and moderate-income housing does not prevent property owners from qualifying for a real estate tax exemption. See In re Blue Ridge Housing of Bakersville LLC, 738 S.E.2d 802 (N.C. Ct. App. 2013) (project owned 0.01% by a 501(c)(3) nonprofit corporation qualified for an *ad valorem* property tax exemption for nonprofit organizations providing low and moderate income housing in North Carolina); McLennan County Appraisal District v. American Housing Foundation, Tex. App., No 10-08-00416-CV, 3/9/11 (providing low- and moderate-income housing is specifically considered a charitable function under Texas Tax Code, and limited partnerships that own such property may qualify for a real estate tax exemption if a charitable organization organized under Internal Revenue Code Section 501(c)(3) owns 100 percent of the general partner interest). But see, Gulf Coast Housing Partnership, Inc. v. Bureau of the Treasury of the City of New Orleans, et al., 129 So.3d 817 (La.App. 4th Cir. 11/27/2013) (Louisiana low-profit limited liability companies wholly-owned by a Delaware 501(c)(3) nonprofit corporation were subject to *ad valorem* property taxes on immovable property located in Louisiana where the property was titled to the limited liabilities companies and not clearly dedicated to public purposes).

## H. Tax-Exempt-Use Property.



1. Participation by a tax-exempt organization in a project may cause all or a portion of the property to be treated as “tax-exempt-use property” under Code §168(h). If property is treated as “tax-exempt-use property, it will have to be depreciated over a 40-year recovery period rather than over a 27.5 year recovery period. Code §470 generally limits losses with respect to tax-exempt use property, but does not apply to projects to which Code §42 applies. In general, property owned by a partnership in which a tax-exempt entity is a partner constitutes tax-exempt-use property, at least in part. The portion of such property treated as tax-exempt-use property is the highest percentage of partnership income or gain (other than Section 704(c) gain) which the tax-exempt entity may receive. For these purposes, a “tax-exempt controlled entity”, which is defined as any corporation of which tax-exempt entities own 50% or more of the stock, is treated as a tax-exempt entity, unless it elects under Code §168(h)(6) to have its tax-exempt owner treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the controlled entity. Thus, to avoid tax-exempt use property concerns, a tax-exempt organization should own its interest in a partnership indirectly through a taxable corporate subsidiary which elects under Code §168(h)(6) to have the tax-exempt parent treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the taxable subsidiary. This will ensure that no portion of the project would be treated as tax-exempt-use property. Note: The election must be made by the due date of the tax return for the first taxable year for which the election is to be effective. Treas. Reg. §301.9100-7T (a)(2)(i). See also PLR 201411009 (March 14, 2014); PLR 201340006 (October 18, 2013); PLR 201249003 (December 7, 2012); PLR 201230002 (July 27, 2012); PLR 199933043 (May 21, 1999) (noting that the IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that they acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government).
  - a. During a discussion of Tax Credit Hot Topics during the May 2016 ABA Forum held in Washington, D.C., a general consensus emerged that a for-profit subsidiary corporation formed by a housing authority cannot make a 168(h)(6)(F)(ii) election. Because its sole shareholder, the housing authority, cannot recognize UBTI, the election and the related treatment of income from the subsidiary as UBTI would be unenforceable against the housing authority. Additionally, a corporate subsidiary of a housing authority likely would not qualify as eligible to make the election under the definitions of tax-exempt entity and tax-exempt controlled entity in section 168(h)(2) and (h)(6)(F)(iii) because it would likely be treated as an instrumentality and entities that are tax-exempt without regard to their status as tax-exempt controlled entities cannot make the election. However, a housing authority

likely could create an affiliate exempt from tax under Sections 501(c)(3) or (c)(4), including a supporting organization described in Section 509(a)(3), which, in turn, could form a for-profit wholly-owned subsidiary, which for-profit subsidiary could be treated as a tax-exempt controlled entity that may make a valid election. The for-profit subsidiary of the of the 501(c)(3) or (c)(4) entity should not be treated as an instrumentality of a State or political subdivision because (1) all of its activities are subject to income tax and (2) a majority of the board of directors of the corporation are selected by the Section 501(c)(3) or (c)(4) organization, which is not a State or political subdivision thereof.

## I. Reportable Transactions: Disclosure Requirements and Excise Taxes.

1. Disclosure Requirements. Code §6011 and the regulations thereunder impose reporting requirements on certain categories of transactions and may apply to an investment in a low-income housing transaction. The disclosure requirements apply to “reportable transactions” which include, among other things, transactions in which there is “contractual protection”, that is a transaction in which a taxpayer or a related party (as defined in Code §267(b) or 707(b)) is entitled to a full or partial refund (or a reduction) of fees paid to a person who provides a statement (written or oral) about the tax consequences of the transaction (or for whose benefit a statement is made or provided to the taxpayer or related party) if all or part of the intended tax consequences from the transaction are not sustained. Treas. Reg. §6011-4(a). These transactions must be reported by any taxpayer whose income tax or informational return reflects a tax benefit from the transaction and who would be entitled to a full or partial refund of fees. There had been concern that investments in low-income housing tax credit transactions would be subject to these disclosure requirements because of the “contractual protection” often provided by tax credit adjuster and other transaction guaranties. The Service, however, has ruled that transactions in which there is a refundable or contingent fee “related to” low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, 2007-1 C.B. 517.
2. Excise Taxes. The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), enacted on May 17, 2006, created Code §4965, which designates certain transactions as prohibited tax shelter transactions and imposes excise taxes on a tax-exempt organization and its managers if the organization becomes a party to a to a “listed transaction” or a “prohibited tax-shelter transaction.” Code §4965(a)(1). Although a “prohibited tax-shelter transaction.” includes a transaction with contractual protection under Treas. Reg. §1.6011-4(b)(4), the Service has ruled that transactions in which there is a refundable or contingent fee





“related to” low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, 2007-1 C.B. 517.

3. Comment. The forgoing disclosure requirements and excise tax provisions may still apply to transactions which are eligible for both the rehabilitation credit and the low-income housing credit because there is no exception for a transaction in which there is a refundable or contingent fee related to the rehabilitation credit.

#### J. Electronic Filing and Form 8609.

In January 2004, regulations were issued to facilitate the electronic filing of Federal tax returns by eliminating the requirement that a completed copy of the Form 8609 signed by an authorized agency official be filed along with the owner’s Federal income tax return for each year of the Compliance Period. Treas. Reg. §1.42-1(h). Form 8609 has been revised and its instructions reflect the elimination of the signature requirement for electronic filings. Taxpayers filing paper returns must continue to file the signed Form 8609. The IRS has also eliminated the requirements that any carryover allocation, binding agreements, and/or elections to fix the applicable percentage be filed with the first Form 8609. Treas. Reg. §1.42-6(d)(4)(i); Treas. Reg. §1.42-8(a)(6)(i).

#### K. Hurricane and Other Disaster-Related Relief.

1. In Rev. Proc. 2014-49 (August 21, 2014) and Rev. Proc. 2014-50 (August 21, 2014), the IRS provided updated guidance about temporary relief from requirements including carryover allocations, recapture, compliance monitoring, buildings in the first year of the Credit Period, the amount of credit allowable to a building that has been restored and emergency housing for qualified rental housing developments financed by low-income housing credits or tax-exempt bonds in designated major disaster areas. Rev. Proc. 2014-49, which addresses relief under §42 of the Code, modifies and supersedes Rev. Proc. 2007-54. Rev. Proc. 2014-50 addresses relief from the requirements of §142(d) of the Code.
2. Increased Credit Authority
  - a. *Gulf Opportunity Zone* – the 2006, 2007 and 2008 state credit ceilings of states located within the so-called Gulf Opportunity Zone (which includes portions of Alabama, Mississippi and Louisiana) were increased by the lesser of (i) \$18.00 per resident within the Gulf Opportunity Zone or (ii) the credits actually allocated to projects located within the Gulf Opportunity Zone for such year. Code §1400N(c)(1). The areas of Alabama, Mississippi and Louisiana included within the Gulf Opportunity Zone were reflected in IRS Fact Sheet 2006-1 (January 2006).





- b. *Texas and Florida* – the 2006 state credit ceilings of Florida and Texas each were increased by \$3,500,000. Code §1400N(c)(2).
  - c. *Hurricane Irene and Lee and Other Disaster Areas* – Similar legislation was introduced to increase the state credit housing ceilings of states located in the Irene-Lee and other disaster areas for calendar years 2012, 2013, and 2014, however none of these bills appear to have been passed. S. 2233, 113th Congress (2014); S. 3234, 112th Congress (2012); H. R. 3769, 112th Congress (2012).
  - d. See also IV.C.1.a.(i), supra, regarding increased LIHTC allocations in qualifying disaster areas.
3. Additional Difficult Development Areas – the Gulf Opportunity Zone, the Rita GO Zone and the Wilma GO Zone are treated as difficult development areas with respect to buildings placed in service in 2006, 2007 and 2008 and receiving credit allocations in such years (or bond-financed projects in which the bonds are issued after December 31, 2005). Code §1400N(c)(3). The contours of the Rita and Wilma GO Zones are also reflected in IRS Fact Sheet 2006-1. For low-income housing credit purposes, GO Zones were considered difficult development areas through December 31, 2010 and Community Development Block Grants were not taken into account when determining whether buildings located in GO Zones are federally subsidized. In addition, the rule requiring an allocation (other than a carryover allocation) to be made no later than the close of the calendar year in which a building is placed in service was suspended for allocations made in 2006, 2007 and 2008 for buildings located in GO Zones, provided such buildings were placed in service no later than January 1, 2012.
- a. Legislation was introduced to suspend the allocation rule for an additional year with respect to allocations made in 2006, 2007 and 2008 for buildings located in GO Zones, but it does not appear to have been passed. 112 H.R. 559 (2011); 112 S. 30 (2011).
4. Special Rule for Applying Income Tests – in the case of buildings placed in service in 2006, 2007 and 2008 in nonmetropolitan areas within the Gulf Opportunity Zone, the income limits of Code §42 are applied by using “national nonmetropolitan median gross income” (determined under the rules applicable to Section 8) rather than area median gross income. Code §1400N(c)(4).
5. Special Occupancy Rules – In Notice 2005-69, 2005-2 C.B. 622 (effective August 29, 2005), the IRS granted state tax credit agencies the authority to designate “temporary housing periods” (not to extend beyond

September 30, 2006) during which, if authorized at the project-level by the agency, displaced individuals who resided in jurisdictions in Alabama, Louisiana and Mississippi designated for individual assistance by FEMA in the wake of Hurricane Katrina will be deemed (notwithstanding actual income) qualified low-income tenants for the purposes of determining a project's first-year qualified basis and satisfaction of the 40-60 and 20-50 Tests. In addition, in years following the first year of the credit period, occupancy by such individuals during a designated temporary housing period will be disregarded in (i) determining the status of a vacant unit and (ii) triggering application of the available unit rule (see III.B.6.b., supra). Building owners need not make attempts to rent to low-income individuals the low-income units occupied by displaced individuals. The rules requiring non-transient occupancy will not apply to any unit providing temporary housing to displaced individuals during a designated temporary housing period, but the rent restrictions applicable to low-income units occupied by displaced individuals will continue to apply and existing tenants may not be evicted or have their tenancy terminated as a result of efforts to provide temporary housing to displaced individuals. The Notice also imposes special recordkeeping, certification and listing requirements. Notice 2006-11, 2006-1 C.B. 457 (effective September 24, 2005) provides relief on similar terms for displaced individuals who lived in areas of Louisiana and Texas designated for individual assistance by FEMA in the wake of Hurricane Rita.

- a. Comment: The Service similarly has suspended temporarily certain income limitation requirements under Section 42 for particular qualified low-income housing projects located in jurisdictions designated for Individual Assistance by the FEMA. See Notice 2013-64, 2013-42 I.R.B. 438 (September 30, 2013); Notice 2013-40, 2013-25 I.R.B. 1254 (May 31, 2013) (as amplified by Notice 2013-47, 2013-31 I.R.B. 120 (July 10, 2013)); Notice 2012-68, 2012-48 I.R.B. 574 (November 5, 2012); Notice 2012-7, 2012-4 I.R.B. 308 (December 21, 2011); Notice 2011-83, 2011-43 I.R.B. 593 (October 7, 2011); Notice 2011-74, 2011-41 I.R.B. 496 (September 16, 2011); Notice 2011-65, 2011-34 I.R.B. 173 (August 5, 2011). After such a designation, the Service will (a) suspend certain income limitations for qualified low-income projects; (b) allow a displaced individual to be deemed a qualified low-income housing tenant for purposes of establishing the project's qualified basis and (c) suspend the non-transient use requirement of Section 42(i)(3)(B)(i) from applying to any unit providing temporary housing to any displaced individual during the established temporary housing period. To qualify for relief under such a Notice, the project owner must (i) show that the displaced individual previously resided in a jurisdiction designated for Individual Assistance by FEMA; (ii)



obtain approval from the appropriate state authority or commission for relief under the Notice; (iii) maintain and certify certain information concerning each displaced individual temporarily housed in the project; (iv) apply the same rent-restrictions to low-income units housing displaced individuals as other tenants; and (v) protect existing tenants from eviction in order to provide temporary housing for displaced individuals.

- b.** Comment: The Service similarly has suspended temporarily certain income limitations and other requirements under Section 142(d) for rental projects financed with tax-exempt bonds located in jurisdictions designated for Individual Assistance by FEMA. See Notice 2013-63, 2013-42 I.R.B. 436 (September 30, 2013) (noting that the Notice should be read in conjunction with Notice 2013-64, which suspended requirements under Section 42 for low-income housing projects affected by weather-related disasters in Colorado); Notice 2013-39, 2013-25 I.R.B. 1252 (May 31, 2013) (as amplified by Notice 2013-47, 2013-31 I.R.B. 120 (July 10, 2013)) (noting that the Notice should be read in conjunction with Notice 2013-40, which suspended requirements under Section 42 for low-income housing projects affected by severe storms and tornados in Oklahoma); Notice 2013-9, 2013-9 I.R.B. 529 (February 6, 2013) (noting that the Notice should be read in conjunction with Notice 2012-68, which suspended requirements under Section 42 for low-income housing projects affected by Hurricane Sandy).

**L. Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, and Updated §42 Audit Technique Guide.**

- 1.** Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition (“Form 8823”).
- a.** IRS Form 8823, which is used by state housing agencies to fulfill their responsibility under Section 42(m)(1)(B)(ii) to notify the IRS of noncompliance with the low-income housing tax credit provisions or any disposition of a building, was last revised in 2011. The IRS published a notice soliciting public comments regarding Form 8823 in July of 2014. 79 Fed. Reg. 41365 (July 15, 2014). Revised Form 8823 was published in September 2015.

The substance of the revised Form 8823 remains unchanged. However, the IRS made several substantive changes to the instructions:

- (i)** Added a new instruction for items 11a-11p to clarify when “out of compliance” and “noncompliance corrected” boxes



should be checked. If the issue remains uncorrected at the end of the correction period, only the “out of compliance” box should be checked. If the issue was corrected within the correction period, both boxes should be checked. If the noncompliance was previously reported to the IRS on a separate Form 8823, only the “noncompliance corrected” box should be checked.

- (ii)** Omitted instructions previously included for Item 11c that provided additional detail regarding reporting deficiencies under the UPCS for the five major areas of inspection (site, building exterior, building systems, dwelling units, and common areas) and health and safety hazards.
- (iii)** Added a new instruction for item 11k elaborating on the extended use agreement requirements of Section 42(h)(6). The new instruction includes information about the term and requires the extended use agreement include the following provisions:

  - (a) Specify that the applicable fraction for the building for each year in the extended use period will not be less than the applicable fraction specified in the extended use agreement and prohibit the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low income unit, or any increase in the gross rent with respect to such unit not otherwise permitted under section 42;
  - (b) Allow individuals (whether prospective, present, or former occupants) who meet the income limitations applicable to the building under section 42(g) the right to enforce in state court the requirements and prohibitions under section 42(h)(6)(B)(i) throughout the extended use period;
  - (c) Prohibit the disposition to any person of any portion of the building unless all of the building is disposed of to that person;
  - (d) Prohibit the refusal to lease to section 8 voucher holders because of the status of the prospective tenant as such a holder; and
  - (e) Provide that the agreement is binding on all successors of the taxpayer.





1. The Senate Finance Committee recently released reports from its five tax reform working groups. The Community Development & Infrastructure Bipartisan Tax Working Group Report included an overview of the low-income housing tax credit and estimated that the tax expenditure for the low-income housing tax credit for fiscal years 2014-2018 is \$40.5 billion. It did not include recommendations regarding the low-income housing tax credit. U.S. Senate Committee on Finance, The Community Development & Infrastructure Bipartisan Tax Working Group Report (July 2015).
2. Bipartisan legislation has been introduced in the House and the Senate to extend permanently the minimum applicable percentage for 70% Present Value Credits for new buildings placed in service after December 31, 2014. H. R.1142, 114th Congress (2015); S. 1193, 114th Congress (2015). In addition, the legislation proposed a minimum applicable percentage of 4% for non-federally subsidized existing buildings placed in service after enactment. An identical bill was introduced in the Senate and referred to the Committee on Finance on May 5, 2015. As of August 1, 2017, there does not appear to have been any further action on either bill. The 9% floor; however, was made permanent under the PATH Act. On July 21, 2015, the Senate Committee on Finance held a markup and voted to approve a bipartisan tax extenders package (“An Original Bill to Extend Certain Expired Tax Provisions”) that would extend the temporary 9% minimum applicable percentage for non-federally subsidized new buildings for which credit allocations are made before January 1, 2017. See Joint Committee on Taxation, “Description of the Chairman’s Mark of a Bill to Extend Certain Expired Tax Provisions” (JCX-101-15), July 17, 2015. The bill, as modified by Chairman Orrin Hatch prior to the Committee’s markup, would also establish a 4% minimum applicable percentage for acquisition of non-federally subsidized existing buildings placed in service after the date of enactment and for which credit allocations are made prior to January 1, 2017. The minimum applicable percentage would only apply to acquisitions of existing buildings that have received credit allocations subject to caps from state housing credit agencies; existing buildings that are also financed with tax-exempt bonds would be considered federally subsidized for this purpose and ineligible for the minimum applicable percentage. See Joint Committee on Taxation, Description of the Chairman’s Modification to the Chairman’s Mark of a Bill to Extend Certain Expired Tax Provisions (JCX-103-15), July 21, 2015. The bill would also include an extension of a provision allowing for the exclusion of the military basic housing allowance received by active military members in certain areas for purposes of calculating whether an individual qualifies as a low-income tenant.
3. Legislation has been introduced to include a full-time student who previously was a homeless child or youth (as defined by section 725(2) of





the McKinney-Vento Homeless Assistance Act) or a full-time student who previously was a homeless veteran (as defined by section 2002(1) of title 38, United States Code) in the group of students permitted to occupy a unit without disqualifying it from treatment as a low-income unit. H.R. 2721, 114th Congress (2015); S. 1412, 114th Congress (2015). The Senate bill was introduced on May 21, 2015 with bipartisan sponsorship and referred to the Committee on Finance. A bill including these provisions was introduced in the House on June 10, 2015 and referred to the House Committee on Ways and Means, among others. Similar legislation has been introduced in recent years.

4. In May 2016, Senators Maria Cantwell and Orrin Hatch introduced the Affordable Housing Credit Improvement Act of 2016. The bill included a 50% increase in per-capita and small state minimum allocations, phased in over 5 years, a new income-averaging election, and a permanent 4% rate for acquisition and bond-financed projects. S. 2962, 114<sup>th</sup> Congress (2016). In July 2016, Senators Cantwell and Hatch introduced a second comprehensive bill that builds on S. 2962. The new bill contains the same provisions as S. 2962 as well as a number of other provisions designed to provide additional resources for affordable rental housing development and increase the financial feasibility of developments. Specifically, the new bill would repeal the qualified census tract population cap, replace the 10-year rule by providing a limit on acquisition basis for LIHTC properties last placed in service during the prior 10 years, include relocation costs in Eligible Basis, eliminate basis reduction for LIHTC properties receiving energy efficiency and energy renewable tax incentives, replace the right of first refusal in favor of nonprofits with an option to acquire either the project or a partnership interest, give states discretion to provide a 30% basis boost for tax-exempt bond financed projects, and give states discretion to provide a 50% basis boost for projects targeting extremely low-income (ELI) households in buildings in which at least 20% of units are reserved for ELI households. These initiatives were reiterated in the subsequent bill Senators Cantwell and Hatch introduced in February 2017 titled the Affordable Housing Credit Improvement Act of 2017. S. 548, 115th Congress (2017). As in the 2016 bill, 2017 legislation contained an average income test, which would allow tenants with up to 80 percent of AMI to reside in projects as a means of offsetting lower rents that would be paid by households at 30 or 40 percent of AMI. A new proposal in the 2017 bill proposed allowing state housing finance agencies authority that Treasury currently possesses to make a determination that a planned foreclosure is an “arrangement” intended to terminate the extended use period. Additionally, the 2017 bill adds a provision that repeals the cap on qualified census tracts and difficult to develop areas so that a greater number of areas may receive these designations, entitling projects in their boundaries to receive a basis boost. The new bill also requires the Secretary of the Treasury to issue guidance prohibiting states’ QAPs from including local approval or local



contribution requirements. A companion bill, bearing the same title, was also introduced in the House of Representatives. See H.R. 1661, 115th Congress (2017).

5. The Bipartisan Budget Act of 2015 (BBA) was enacted into law on November 2, 2015. Pub. L. No. 114-74. It repeals the current rules governing partnership audits, which had been enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and replaces TEFRA's unified partnership audit and litigation rules with a new centralized regime that is intended to make partnership audits more efficient by avoiding multi-tier audits and determinations at the partner level. See Notice 2016-23, 2016-12 I.R.B. (March 4, 2016). The new partnership audit rules, created by Section 1101(a) of the BBA, provide that, generally, adjustments to items of income, gain, loss, deduction, or credit of a partnership shall be determined, and tax attributes attributable thereto shall be assessed and collected at the partnership level. The new rules also require a partnership to designate a partnership representative, which must be a partner with a substantial presence in the United States. §6223. Generally, a partnership may elect out of the new regime if it meets certain criteria regarding the number and nature of its partners. A partnership also may elect into the regime prior to its effective date. Generally, the new regime is effective for partnership taxable years beginning after December 31, 2017. In Notice 2016-23, the IRS has requested comments on the major elements of the new regime, and it will publish regulations following the period for comment.
6. New Treasury Regulations were issued to implement rules contained in the BBA. The proposed regulations provide procedures for partnerships to elect out of the new regime, guidance regarding filing administrative adjustment requests and determinations of amounts owed, and definitions and rules governing the existence and activity of the partnership representative. The proposed regulations also affect partnerships for taxable years beginning after December 31, 2017 and any other partnerships that elect its application for taxable years beginning between November 2, 2015 and January 1, 2018. Comments were requested and a hearing was scheduled for September 18, 2017.
7. The Common Sense Housing Investment Act of 2017 was introduced into the House of Representatives to propose that the mortgage interest deduction be replaced with a 15% nonrefundable credit for indebtedness secured by a residence. H.R. 948, 115th Congress (2017). Savings from this change are to be used to fund the Housing Trust Fund, rental assistance (including a new Renter's Tax Credit) and the Public Dousing Capital Fund.

N. GAO Report.



1. The United States General Accounting Office (GAO) issued a report on July 15, 2015, stating that Congress should designate HUD as a joint administrator of the LIHTC program. It asserted that HUD should provide oversight to HFAs, because it already relies on HFAs to implement its programs and has processes and procedures in place to conduct oversight. It also recommends that HUD analyze the effectiveness of LIHTC while the IRS continues to be responsible for monitoring taxpayer compliance and enforcing tax law. GAO argues that IRS does not have the staff or budget to properly oversee the program and joint administration would “better align program responsibilities with each agency’s mission and more efficiently address existing oversight challenges.” GAO Report, GAO-15-330, July 15, 2015.
2. GAO issued a subsequent report on May 11, 2016, reviewing oversight of the LIHTC program. The 2016 report mentions the July 2015 report and reiterates its suggestion that HUD play a larger role in oversight of LIHTC. GAO contends that the IRS has a limited ability to identify noncompliance issues and potential recapture events because it does not possess the data to do so, whereas HUD already maintains a number of databases with relevant information that it analyzes for a variety of purposes. The report concludes by recommending that (1) the IRS collaborates with allocating agencies and the Department of Treasury to clarify rules regarding reporting noncompliance, (2) the Small Business/Self-Employed Division of the IRS participates in the Rental Policy Working Group’s physical inspection alignment initiative, and (3) the IRS evaluates how it could utilize HUD’s REAC databases for reviewing noncompliance information. GAO Report, GAO-16-360, May 11, 2016.

