IRC §42, Low-Income Housing Credit - Part II Tax Issues at the Project Level

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NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Chapter 4 First Year Certification

Introduction

Under IRC §42(l) (1), taxpayers are required to complete a certification with respect to the first year of the credit period. The certification is made by completing Part II of the Form 8609 executed by the state agency to document the allocation of IRC §42 credit.

- The certification requirements apply to both low-income credits allocated under IRC §42 and buildings financed with tax-exempt bonds under IRC §142(d) that received credits associated with the volume cap under IRC §146.
- The certification must be made no later than the due date (including extensions) of the first tax return with which the taxpayer claims credit using Form 8609-A, Annual Statement for Low-Income Housing Credit.
- Taxpayers make the certification one time by filing the completed Form 8609, Low-Income Housing Credit Allocation and Certification, with the LIHC Compliance Unit.

Without a Form 8609 completed, signed, and dated by the state agency, the taxpayer cannot complete the first-year certification required under IRC §42(l) (1) and, therefore, may not be entitled to claim any IRC §42 credits. The IRC §42(l) (1) certification should be identified as an audit issue if:

- as part of the precontact analysis, the completion of the certification cannot be confirmed (see Chapter 2), or
- the taxpayer's operation of the project is inconsistent with the information and elections documented on Form 8609.

Topics

- Law
- Completing the Certification During the Audit
- Evaluating Taxpayer Compliance
- Taxpayer Arguments
- Failure to Complete Certification
- Audit Scope
- Penalties
- Administrative Requirement

- Summary

Law

IRC §42(l) (1) reads:

(1) Certification with respect to 1st year of credit period. Following the close of the 1st taxable year in the credit period with respect to any qualified low- income building, the taxpayer shall certify to the Secretary (at such time and in such form and in such manner as the Secretary prescribes)-

(A) The taxable year, and calendar year, in which such building was placed in service,

(B) The adjusted basis and eligible basis of such building as of the close of the 1st year of the credit period,

(C) The maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under subsection (h),

(D) the election made under subsection (g) with respect to the qualified low income housing project of which such building is a part, and

(E) Such other information as the Secretary may require.

The flush language following IRC §42(l) (1) (E) reads:

In the case of a failure to make the certification required by the preceding sentence on the date prescribed therefore, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable by reason of subsection (a) with respect to such building for any taxable year ending before such certification is made.

Treas. Reg. §1.42-1(h)

Treas. Reg. §1.42-1(h) addresses the filing of forms, stating that the requirements for completing and filing Form 8609 are addressed in the instructions to the form. The instructions read:

Building owner. You must make a one-time submission of Form 8609 to the Low-Income Housing Credit (LIHC) Unit at the IRS Philadelphia campus. After making a copy of the completed original Form 8609, file the original of the form with the unit no later than the due date (including extensions) of your first tax return with which you are filing Form 8609-A, Annual Statement for Low-Income Housing Credit

Form 8609-A, Part I, line C, asks whether the taxpayer has the original Form 8609 (or copy) signed and issued by the state agency. The instructions for this line read:

Item C. In order to claim the credit, you must have an original, signed Form 8609 (or copy thereof) issued by a housing credit agency assigning a BIN for the building. This applies even if no allocation is required (as in the case of a building financed with tax-exempt bonds). Check "Yes" to certify that you have the required Form 8609 in your records.

Caution: Any building owner claiming a credit without receiving a completed Form 8609 that is signed and dated by an authorized official of the housing credit agency is subject to having the credit disallowed.

Chief Counsel Advisory 200137044

CCA 200137044 provides guidance regarding the IRC §42(l) (1) certification (in a question (Q) and answer (A) format) including the following:

Q2: Once a Form 8609 is first issued by an applicable allocating authority, can the taxpayer file an amended return to claim credits for taxable years in a building's compliance period prior to the issuance of the Form 8609?

A2: Once a Form 8609 is issued by the applicable allocation authority, the taxpayer can file an amended return to claim credits for taxable years in a building's compliance period prior to the year in which the Form 8609 is issued.

Q3. If a taxpayer has claimed IRC §42 credits for any year prior to the issuance of the Form 8609, can all credits claimed prior to the issuance of the Form 8609 be disallowed?

A3. Under certain circumstances, if a taxpayer claimed IRC §42 credits for a year prior to issuance of the Form 8609 by the applicable allocating authority, all credits claimed prior to issuance of the Form 8609 can be disallowed.

The CCA includes two examples:

- If, in the case of an allocation from the state housing credit ceiling, the state agency has not completed Part 1, the form is incomplete. Since the first-year certification requirement of IRC §42(l) (1) is incorporated into Form 8609, an incomplete form would not satisfy the IRC §42(l) (1) first year certification requirement.
- If the failure to meet the IRC §42(l) (1) certification requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years (assuming no fraud) in the compliance period until this requirement is met.

The CCA also includes a qualification that "…It is not clear what the result would be for a tax-exempt bond project." At the time CCA 200137044 was written, Treas. Reg. §1.42-1T(h)(2) provided that for tax-exempt bond financed projects for which no allocation is made, an owner was to obtain a blank copy of Form 8609 and fill in (for Part 1) the address of the building and the name and address of the owner. This inconsistency between IRC §42 credit allocations and credits associated with IRC §146 was resolved when Treas. Reg. §1.42-1(h) became effective on January 27, 2004 (see discussion of regulation above).

Q4. Can a taxpayer satisfy the certification requirements of IRC §42(l) (1) during the examination process?

A4. There is no prohibition against satisfying the certification requirements of IRC §42(l) during the examination process.

Q5. If a revenue agent finds that the first year certification requirements of IRC§42(l) have not been met; can the entire credit amount for the first and all successive years be disallowed?

A5. The answer to whether the entire credit amount for the first and all successive year can be disallowed if the first-year certification requirements of IRC §42(l) have not been met is similar to that in A3.

The flush language following:

IRC §42(l) (1) (E) provides that in the case of a failure to make the certification required by IRC §42(l) (1) on the date prescribed thereof, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable under IRC §42(a) for any taxable year before such certification is made.

If the failure to meet the §42(l) (1) certification requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years (assuming no fraud) in the compliance period until this requirement is met.

Completing the Certification During the Audit

There is no prohibition against satisfying the certification requirements during the examination process. See CCA 200137044. The taxpayer should be given the opportunity to provide executed Forms 8609 (completed, signed, and dated by the state agency) and Part II completed and signed by the taxpayer. If the taxpayer presents completed Forms 8609, then the following four issues must be addressed:

Issue #1: Credit Claimed in Prior Years

Determine whether the credit claimed by the taxpayers in years before the certification is more than the credit allocated and documented on the Forms 8609. The audit should be expanded to include prior years to disallow credit in excess of the credit amount allocated by the state agency. The recapture provisions under IRC §42(j) should be applied to prior year returns closed by statute.

Issue #2: Elections and Prior Year Tax Returns are Consistent

Verify that the taxpayer's elections and past filings are consistent. Under IRC §6001, the taxpayer must provide adequate proof of consistent behavior, which can include providing prior year federal tax returns.

Example 1: Inconsistent Elections

A taxpayer placed a newly constructed low-income building in service in February of 2005 and began claiming credits the same year. The state agency provided the completed Form 8609, Part I, in March of 2009. The taxpayer elected to begin the credit period the first year after the building was placed in service, 2006, even though credits were actually claimed the year the building was placed in service.

In this case, the taxpayer has created documentation to support claiming the credit for eleven years rather than the prescribed ten year credit period under IRC §42(f)(1). The IRC §42 program analyst should be contacted if this issue is identified.

Issue #3: Verification of First Year Credit

Verify the eligible basis, the applicable fraction, and minimum set-aside for the first year of the credit period to ensure that the building was timely placed in service and that the credit has been correctly computed. Under Treas. Reg. §1.42-5(b)(2), the records for the first year of the credit period must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the 15-year compliance period of the building.

Issue #4: Reasons for Failure to Complete the Certification

Determine why the taxpayer failed to timely complete the IRC §42(l) certification.

Taxpayers commonly argue that the circumstances were beyond their control. The Forms 8609 were timely requested from the state agency after the end of the first year in the credit period (when the eligible basis is determined), but the forms were not received before filing tax returns. Factors to consider:

- When was the request for the Forms 8609 made?
- What follow-up efforts did the taxpayer make to secure the Forms 8609?
- Why did the state agency delay executing the Forms 8609?

State agencies generally attempt to timely provide the completed forms. Failure to do so is indicative of problematic projects; e.g., the cost certifications may not be complete, the state agency may have determined that the project was built using sub- standard materials, or the project was not built according to the terms of the allocation. The state agency should be contacted to determine the cause of the delay.

State agencies keep records of their contacts with project owners; determine if and why the taxpayer delayed in responded to the state agency's inquiries.

Evaluating Taxpayer Compliance

In *United State v. Boyle, Executor of the Estate of Boyle* (see Appendix F), the Court addressed a delinquency penalty for failure to timely file a return and explained that the meaning of the phrase, "...failure is due to reasonable cause and not to willful neglect..." for purposes of assessing the IRC §6651 penalty for failure to timely file a tax return.

The Court explained Congress' purpose was to ensure timely filing of tax returns to the end that tax liability will be ascertained and paid promptly. "…To escape the penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from "willful neglect," and (2) that the failure was "due to reasonable cause...Congress obviously intended to make absence of fault a prerequisite to avoidance of the late-filing penalty. A taxpayer …must therefore prove that his failure to file on time was the result neither of carelessness, reckless indifference, nor intentional failure."

Willful Neglect

As used by the Supreme Court in *United States v. Boyle*, the term "willful neglect" may be read as meaning a conscious, intentional failure or reckless indifference. Under Treas. Reg. §1.6662-3(b):

- Negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.
- A disregard of rules or regulations is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances that demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe.
- A disregard of rules or regulations is intentional if the taxpayer knows of the rule or regulation that is disregarded. Taxpayers often include a statement with their return to the effect that the Forms 8609 have been requested but have not been received from the state agency.

Reasonable Cause

The term "reasonable cause" is not defined in the Code, but Treas. Reg. §301.6651-1(c) (1) provides that, to demonstrate "reasonable cause," a taxpayer filing a late return must show that he "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time." Similarly, in *United States v. Boyle*, "reasonable cause" means that the taxpayer exercised ordinary business care and prudence in determining its tax obligations but is unable to comply with those obligations. (See IRM 20.1.1.3.1)

A determination of reasonable cause must be based on an evaluation of all the facts and circumstances on a case-by-case basis. Consider the following factors:

- How long after the end of the first year of the credit period did the taxpayer receive the Forms 8609 from the state agency? How many years has the taxpayer claimed the credit without completing the certification? How did the taxpayer answer question C on Form 8609-A filed with the tax returns to complete the IRC §42(l) (2) annual certification requirement?

- Did the taxpayer encounter other difficulties while noncompliant with the IRC §42(l) (1) certification requirement, and how were the problems resolved?
- What reason did the taxpayer give for the delay? To show reasonable cause, the dates and explanations should clearly reflect efforts to timely resolve the problems and expeditiously obtained the Forms 8609 from the state agency.
- Did the taxpayer know or make reasonable attempts to determine the IRC §42(l) (1) certification requirements? Is the general partner a professional specializing in the development and management of IRC §42 properties?
- Did the taxpayer make a mistake? How long was it before the taxpayer corrected the mistake? Generally, errors do not provide a basis for reasonable cause, but additional facts and circumstances may support such a determination. Forgetfulness, oversight, or reliance upon another person does not support a determination of reasonable cause.
- Death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause. Consider the relationship of the responsible party to the partnership; the dates, duration of the illness or absence; how the event prevented compliance; whether other business obligations were impaired; and whether the noncompliance was remedied within a reasonable period after a death or absence.

Taxpayer's Arguments

Taxpayer's Burden

The taxpayer bears the burden of demonstrating that the failure did not result from willful neglect and that there was a reasonable cause for failing to complete the IRC §42(l)(1) certification before the due date (including extensions) of the first tax return on which the credit was claimed.

State Agency Caused Delays

A taxpayer may argue that delays were caused by the state agency responsible for completing the Forms 8609.

A taxpayer is not subject credit disallowance or recapture because a state agency failed to timely provide executed Forms 8609. The evaluation should be made based on the individual facts and circumstances of the case and the taxpayer's actions. The issue is whether there is a reasonable cause for any delays caused by the taxpayer and whether the taxpayer's failure resulted from willful neglect.

Housing Policy

A taxpayer may argue that consideration should be given to the underlying policy of IRC §42, which is to encourage the construction of low-income housing by providing tax credits to taxpayers who are willing to assume substantial economic risk.

Any narrow interpretation of "reasonable cause" would operate to discourage the very activity IRC §42 was designed to promote. Therefore, the strict standard as explained in *United State v.*

Boyle is not appropriate for IRC §42(l) (1). Rather, the facts and circumstances of each case and should be evaluated to determine whether the taxpayer was exercising ordinary business care and prudence and responding to circumstances that cause delays in a prudent manner.

First, the determination should not be limited to consideration of the taxpayer's due diligence or prudence in responding to circumstances causing delays. The nature and cause of the delays must also be considered.

Second, the flush language following IRC §42(l) (1) requires consideration of both "reasonable cause" and "willful neglect" when determining whether the IRC §42 credit is allowable before completing the first year certification. *United State v. Boyle* does not set the standard, but rather reinforces and explains how the concepts should be applied under similar circumstances; i.e., the failure to file a tax return.

Finally, an argument based on housing policy suggests that taxpayers investing in IRC §42 project should be treated differently, or more leniently than other taxpayers who fail to timely comply with filing requirements. This argument is contrary to the administration of tax law and results in an unfair and inequitable treatment of taxpayers. From *United States v. Boyle*, Chief Justice Burger wrote:

"…Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. Prompt payment of taxes is imperative to the Government, which should not have to assume the burden of unnecessary ad hoc determinations."

Failure to Complete Certification

Without the completed certification, the IRS cannot determine whether the state agency has approved the completed project, the amount of credit the taxpayer is entitled to claim, or the terms of the allocation. As a result, if the taxpayer cannot complete the certification during the audit, then the entire credit should be disallowed in all years open by statute. Under IRC §42(j), a portion of credit can be recaptured in years closed by statute or otherwise not examined.

Reasonable Cause Exists

Determine whether the on-going delay in completing the IRC §42(l) (1) certification is due to reasonable cause. If reasonable cause is established, the taxpayer should be cautioned that statutes should be extended (or protective claims for refunds filed) to ensure that the taxpayer can amend returns to claim the credits at a later date.

Reasonable Cause Not Identified

If the failure to complete the certification process is not due to a reasonable cause, or is due to willful neglect, no credit is allowable for any tax year before the certification is completed. The entire credit should be disallowed in all years open by statute and under IRC §42(j), a portion of credit can be recaptured in years closed by statute or otherwise not examined

Audit Scope

Additional Audit Requirements

The examination should include verification of the eligible basis, the applicable fraction, and minimum set-aside for the first year of the credit period, as the taxpayer may be able to claim the prior year credits at a later time or claim credits beginning with the taxable year in which the Forms 8609 are received from the state agency and the certification completed. For these possible outcomes, the taxpayer will need to establish that the buildings are qualified low-income buildings under IRC §42(g) (1) and the costs includable in the buildings' eligible basis.

Penalties

Penalties should be considered if the credit is disallowed; i.e., a determination was made that the taxpayer could not establish a reasonable cause for the failure to timely complete the IRC §42(l) (1) certification or the taxpayer was willfully negligent. The responsible parties should be identified and consideration given to the penalty under IRC §6701. This penalty applies to persons who knowingly aid and abet in the understatement of the tax liability of another person.

Administrative Requirement

Securing Completed Forms 8609

Should the taxpayer be able to complete the certification during the audit, the original executed Forms 8609 (both Parts I and II completed, signed, and dated) should be secured from the taxpayer and forwarded to the LIHC Compliance Unit with a note explaining that the forms were secured during an audit. The mailing address is included with the instructions for Form 8609 for the current revision of the form.

Summary

The importance of the IRC §42(l) (1) certification cannot be overemphasized; it isn't simply "paperwork." There is a possibility that a taxpayer is fraudulently claiming the credit; i.e., the taxpayer does not have an allocation of credit from a state agency. Further, even if the taxpayer has entered into a contract with the state agency, the IRS cannot determine whether the state agency has approved the completed project, the amount of credit the taxpayer is entitled to claim, or the terms of the allocation until the taxpayer completes the IRC §42(l)(1) certification.

Chapter 5 Extended Use Agreement

Introduction

For all buildings allocated credit after 1989, IRC §42(h) (6) requires taxpayers to enter into an extended use agreement with the state agency. The requirement also applies to buildings financed with tax-exempt bonds under IRC §142(d) and receiving credits associated with the volume cap under IRC §146. Taxpayers must agree to a long-term commitment beginning on the first day of the 15-year compliance period and ending on the later of (1) the date specified by the state agency in the agreement or (2) the date which is 15 years after the close of the 15-year compliance period. In other words, the taxpayer covenants to maintain the buildings as low-income housing for at least 30 years.

Topics

- Law
- Audit Issues
- Audit Techniques
- Disallowance of Credit
- Summary

Law

Requirement

IRC §42(h) (6) (A) provides that a building is eligible for credit only if there is a minimum long-term commitment to low-income housing.

(A) In general. No credit shall be allowed by reason of this section with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year.

Content

IRC §42(h) (6) (B) identifies the terms of the agreement.

(B) Extended low-income housing commitment. For purposes of this paragraph, the term "extended low-income housing commitment" means any agreement between the taxpayer and the housing credit agency—

(i) which requires that the applicable fraction (as defined in subsection (c)(1)) for the building for each taxable year in the extended use period will not be less than the applicable fraction specified in such agreement and which prohibits the actions described in subclauses (I) and (II) of subparagraph (E)(ii),

(ii) which allows individuals who meet the income limitation applicable to the building under subsection (g) (whether prospective, present, or former occupants of the building) the right to enforce in any State court the requirement and prohibitions of clause (i),

(iii) which prohibits the disposition to any person of any portion of the building to which such agreement applies unless all of the building to which such agreement applies is disposed of to such person,

(iv) which prohibits the refusal to lease to a holder of a voucher or certificate of eligibility under section 8 of the United States Housing Act of 1937 because of the status of the prospective tenant as such a holder,

(v) which is binding on all successors of the taxpayer, and

(vi) which, with respect to the property, is recorded pursuant to State law as a restrictive covenant.

Extended Use Period

IRC §42(h) (6) (D) defines the extended use period.

(D) Extended use period. For purposes of this paragraph, the term "extended use period" means the period—(i) beginning on the 1st day in the compliance period on which such building is part of a qualified low-income housing project, and

(ii) ending on the later of--

(I) the date specified by such agency in such agreement, or

(II) the date which is 15 years after the close of the compliance period.

Tenant Protections & Exceptions

IRC §42(h)(6)(B)(i), by cross referencing IRC §42(h)(6)(E)(ii), provides tenants with protection against eviction or the termination of tenancy (other than for good cause) from any low-income unit and any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period.

IRC §42(h) (6) (E) (ii) provides that the termination of an extended use agreement under clause (i) shall not be construed to permit before the close of the 3-year period following such termination

(I) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or

(II) any increase in the gross rent with respect to such unit not otherwise permitted under this section.

Rev. Rul. 2004-82, Q&A #5 explains that under IRC §42(h) (6) (B) (i), an extended use commitment must include a specific prohibition against the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low- income unit (no-cause eviction protection) and any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period. Because the prohibition in Q&A #5 was made retroactive to existing extended use agreements, the Service established a safe harbor under which housing credit agencies and taxpayers could meet the requirements of IRC §42(h)(6)(B)(i) in lieu of an extended use agreement for agreements entered into before January 1, 2006. Under Rev. Proc. 2005-37, the safe harbor is met:

- If the agreement contains general language requiring taxpayers to comply with IRC §42 requirements (catch-all language) and the state agency notifies the taxpayer in writing on or before December 31, 2005, that consistent with the interpretation in Rev. Rul. 2004-82, Q&A-#5, the catch-all language prohibits the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) throughout the entire commitment period and prohibits the taxpayer from making an increase in the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period, or
- If the extended use agreement does not contain specific language on the IRC §42(h)(6)(B)(i) prohibition against the actions described in subclauses (I) and (II) of' IRC §42(h)(6)(E)(ii) or catch-all language, then the agreement must be amended to clearly provide for the IRC §42(h)(6)(B)(i) prohibition against the actions described in subclauses (I) and (II) of' IRC §42(h)(6)(E)(ii) by December 31, 2005.

Early Termination (Foreclosures and Qualified Contracts)

The extended used period may be terminated early if there is a foreclosure or the taxpayer requests that the state agency find a buyer and no buyer is willing to maintain the housing's low-income status under IRC §42(h)(6)(F).

(E) Exceptions if foreclosure or if no buyer willing to maintain low-income status. (i) In general. The extended use period for any building shall terminate-

(I) on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure) unless the Secretary determines that such acquisition is part of an arrangement with the taxpayer a purpose of which is to terminate such period, or

(II) on the last day of the period specified in subparagraph (I) if the housing credit agency is unable to present during such period a qualified contract for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a qualified low- income building.

Subclause (II) shall not apply to the extent more stringent requirements are provided in the agreement or in State law.

Purchase by Tenant

IRC §42(g) (6) allows a low-income tenant to pay (on a voluntary basis) a de minimis amount to be held toward the purchase of the low-income unit after the end of the 15-year compliance. The existence of such agreements, which might be recorded in the land records, does not negate the extended use agreement.

To qualify, the agreement must meet two conditions:

- All amounts paid are refunded to the tenant if the tenant ceases to occupy the unit, and
- The purchase of the unit is not permitted until after the close of the building's 15- year compliance period.

Also, in flush language to IRC §42(g) (6), the Code provides that any amount paid by the tenant is included as rent for determining whether the unit is rent-restricted. Rev. Rul. 95-49 asks, "Does an extended low-income housing commitment satisfy §42(h) (6) if its provisions may be suspended or terminated after the compliance period when a tenant exercises a right of first refusal to purchase a low-income building?"

Briefly, Chief Counsel responded that the extended use agreement ensures that a certain percentage of a low-income building's units will continue to be available for rental by low-income tenants after the close of the compliance period. Similarly, IRC §42(i) (7) provides that that no federal income tax benefit fails to be allowable to the owner of a qualified low-income building merely by reason of a right of first refusal held by the building's tenants to purchase the building after the close of the 15-year compliance period, thereby permitting low-income tenants to be home- owners instead of renters. Since the objectives of §§42(h)(6) and (i)(7) are similar in that both sections attempt to promote housing for low-income individuals beyond the compliance period, the extended use agreement satisfies IRC §42(h)(6) even if a tenant holds a right of first refusal to purchase a low-income unit after the end of the 15-year credit period. See PLR 200703024 for an example.

Correction Period

IRC §42(h) (6) (J) provides a correction period should there be a determination that an extended use agreement is not in effect.

(J) Effect of noncompliance. If, during a taxable year, there is a determination that an extended low-income housing agreement was not in effect as of the beginning of such year, such determination shall not apply to any period before such year and IRC §42(h) (6) (A) shall be applied without regard to such determination if the failure is corrected within 1 year from the date of the determination.

Foreclosure or Instrument in Lieu of Foreclosure

Under IRC §42(h)(6)(E)(i)(I), the extended use agreement terminates on the date the building is acquired by foreclosure (or instrument in lieu of foreclosure) unless the Secretary determines that such acquisition is part of an arrangement with the tax- payer a purpose of which is to terminate such period. No credit is allowable for the taxable year if the taxpayer is subject to the IRC

§42(j) credit recapture provisions as a result of the disposition by foreclosure or instrument in lieu of foreclosure.

Additional Discussion

Refer to Chapter 16, 23, and 26 of the Guide for Completing Form 8823 for additional discussion.

Audit Issues

- Whether an extended use agreement was in effect at the end of the tax year under audit.
- Whether an extended use agreement meets the IRC §42(h) (6) (B) requirements.
- If a determination was made that an extended use agreement was not in effect, whether the taxpayer corrected the failure within one year of the determination.

Audit Techniques

Confirm that the extended use agreement is recorded by reviewing the land records. Depending on the location of the project, the agreement should be recorded by the county or other similar local government entity according to state law. Also review mortgages and other restrictive covenants recorded against the property; these agreements may include conditions that are inconsistent with IRC §42 requirements.

The extended use agreement is a contract between the state agency allocating the IRC §42 credit and the taxpayer owning the IRC §42 project. Make sure the extended use agreement is executed by the taxpayer and reflects agreement between the taxpayer and the housing credit agency.

Evaluate whether the extended use agreement meets the IRC §42(h) (6) (B) requirements. Under IRC §42(m)(1)(B) and (C), state agencies can impose additional conditions upon the credit allocation to serve the lowest income tenants for the longest periods in specified locations. For example, the state agency may require a taxpayer to set-aside a percentage of low-income units for occupancy by households with income less than 30% of the area's median gross income, even though the taxpayer elects the 40-60 minimum set-aside under IRC §42(g)(1). These additional requirements will also be reflected in the extended use agreement, but are not enforced under IRC §42. Rather, it is the state agency's responsibility to address noncompliance under state law.

For extended use agreements executed before January 1, 2006, that include catch-all language requiring compliance with IRC §42 requirements, ask the taxpayer to provide the state agency's notification that the catch-all language prohibits the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period. If the original extended use agreement did not contain catch-all language or specific language on the IRC §42(h) (6) (B) (i) prohibitions, then the agreement should have been amended by December 31, 2005.

For extended use agreements executed after December 31, 2005, the agreement should include specific language prohibiting the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period.

If the state agency identified noncompliance, a Form 8823 should have been filed with the IRS. The report should have included an explanation and copy of the notification letter beginning the one-year correction period. Contact the state agency to determine whether the noncompliance issue was timely resolved.

Disallowance of Credit

Disallowance of Current Year Credit

Noncompliance occurs if:

- The extended use agreement does not meet the IRC §42(h)(6) requirements, is not properly executed, or is not recorded according to state law, and
- The taxpayer failed to correct noncompliance within the one-year correction period provided by IRC §42(h) (6) (J).

If noncompliance occurs, no IRC §42 credit is allowable for any building governed by the agreement until the taxable year in which the extended use agreement is in effect. If noncompliance is identified, the IRC §42 program analyst should be contacted.

IRC §42(j), Recapture Amount

While noncompliance with the requirements under IRC §42(h) (6) results in the loss of credit, the noncompliance does not result in a decrease in qualified basis. As a result, the credit recapture provisions under IRC §42(j) are not applicable when a taxpayer fails to meet the IRC §42(h) (6) requirements or fails to correct noncompliance within the 1-year correction period. See Chapters 13 and 16.

Summary

For all buildings allocated tax credits after 1989, IRC §42(h) (6) requires taxpayers owning IRC §42 buildings to enter into an extended use agreement with the state agency that allocated the credits to the buildings. The requirement also applies to buildings financed with tax-exempt bonds under IRC §142(d) and receiving credits associated with the volume cap under IRC §146.

The extended use agreement must be in effect for at least 30 years beginning on the first day of the building's 15-year compliance period and ending on the later of the date specified by the state agency in the agreement or 15 years after the close of the 15-year compliance period.

The extended use agreement is a contract between the taxpayer and state agency which can be enforced by low-income individuals (prospective, present or former occupants of the buildings) in state court and prohibits the refusal to lease to a holder of a voucher or certificate of eligibility under section 8 because of the status of the prospective tenant as such a holder.

The extended use agreement provides tenants with protection against eviction or the termination of tenancy (other than for good cause) from any low-income unit and any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42 throughout the entire extended use period. However, there is an exception if there is a foreclosure or no buyer is willing to maintain the housing's low-income status, in which case tenants have these protections for three years following the termination of the extended use agreement.

The extended use agreement prohibits the disposition of any portion of a low- income building to which the agreement applies unless all of the buildings are disposed of to such person, and is binding on all successor owners of the project.

The extended use agreement must be recorded pursuant to State law as a restrictive covenant.

Noncompliance occurs if the extended use agreement does not meet the IRC §42(h) (6) requirements, is not properly executed, or is not recorded according to state law. However, if a taxpayer corrects the noncompliance within the one-year correction period, there is no disallowance of IRC §42 credit.

If noncompliance occurs, no IRC §42 credit is allowable for any building governed by the agreement until the taxable year in which the extended use agreement is in effect. The IRC §42(j) credit recapture provisions, however, are not applicable.

Chapter 6 Nonprofit Set-Aside

Introduction

Congress, aware of the important role played by nonprofit organizations in the development of affordable housing, provided additional tax incentives for these entities to be involved in the development and management of IRC §42 projects.

Topics

- Law
- Audit Issues
- Audit Techniques
- Audit Adjustments
- Related Issues
- Summary

Law

IRC §42(h) (5) provides that a portion of each state's annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations. Specifically, IRC §42(h) (5) provides:

Nonprofit Set-Aside

(A) In general. Not more than 90% of the State housing credit ceiling for any State for any calendar year shall be allocated to projects other than qualified low- income housing projects described in subparagraph (B).

Qualified Low-Income Housing Projects

(B) Projects involving qualified nonprofit organizations. For purposes of subparagraph (A), a qualified low-income housing project is described in this subparagraph if a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.

Qualified Nonprofit Organizations

(C) Qualified nonprofit organization. For purposes of IRC §42(h) (5), the term "qualified nonprofit organization" means any organization if-

(i) such organization is described in paragraph (3) or (4) of IRC §501(c) and is exempt from tax under IRC §501(a),

(ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and

(iii) one of the exempt purposes of such organization includes the fostering of low-income housing.

(D) Treatment of certain subsidiaries.

(i) In general. For purposes of IRC §42(h)(5), a qualified nonprofit organization shall be treated as satisfying the ownership and material participation test of subparagraph (B) if any qualified corporation in which such organization holds stock satisfies such test.

(ii) Qualified corporation. For purposes of clause (i), the term "qualified corporation" means any corporation if 100% of the stock of such corporation is held by one or more qualified nonprofit organizations at all times during the period such corporation is in existence.

Additional Discussion

Refer to Chapter 22 of the Guide for Completing Form 8823 for additional discussion.

Audit Issues

- Whether the taxpayer received an allocation from the nonprofit set-aside.
- Whether the nonprofit is a qualifying nonprofit organization and satisfies the requirements for its tax exempt purpose.
- Whether the nonprofit has maintained an ownership interest in the project.
- Whether the nonprofit materially participated (within the meaning of IRC §469(h)) in both the project development and operation of the project throughout the building's 15-year compliance period.

Audit Techniques

Step 1: Identify Credit Allocations from Nonprofit Set-Aside

Allocations from the nonprofit set-aside are identified on Line 6g of Form 8609, Low-Income Housing Credit Allocation and Certification, starting with the November 2003 revision of the form. If an earlier revision was used, contact the state agency that made the allocation. Confirmation from the state agency is needed because:

- Even though a nonprofit may be a partner in the partnership under audit, the taxpayer is not subject to the IRC §42(h) (5) requirements unless the taxpayer received the credit allocation from the nonprofit set-aside.
- Although a nonprofit is not currently a partner in the partnership under audit, the taxpayer may have originally included a qualifying tax-exempt entity and received a credit allocation from the nonprofit set-aside.

If a determination is made that the taxpayer did not receive its credit allocation from the nonprofit set-aside, no further action is required.

Step 2: Confirm Nonprofit's Status as a Qualified Tax- Exempt Organization

IRC §42(h) (5) (C) defines a qualified nonprofit organization as any organization meeting the tax-exempt requirements of IRC §§ 501(c) (3) or 501(c) (4), and for which one of the exempt purposes includes the fostering of low-income housing. As low-income housing projects are typically owned by partnerships, allocations under the nonprofit set-aside are frequently made to partnerships for which the general partner is a qualifying nonprofit organization.

- Ask the taxpayer for a copy of the IRS determination letter to confirm that the nonprofit was granted tax-exempt status.
- Confirm that the nonprofit has filed required Forms 990, Return of Organization Exempt From Income Tax.
- In the case of an IRC §501(c) (3) organization, determine whether the nonprofit is a tax exempt entity in good standing by using the IRS website (www.irs.gov). Enter "78" into the "Search IRS site for" feature; the response will be "Most likely you are looking for "Publication 78, Search for Exempt Organizations." Clicking on the underline portion will provide an alphabetical listing of exempt organizations.

- Determine whether one of the nonprofit's exempt purposes includes the fostering of low-income housing. IRC §501(c)(3) provides, in part, that an organization may be considered exempt if it is organized and operated exclusively for one or more of the following purposes; religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals. IRC §501(c)(4) provides, in part, that civic leagues or organizations satisfying certain criteria may be considered exempt if their net earnings are devoted exclusively to charitable, educational, or recreational purposes. Nonprofits participating in the IRC §42 program are usually designated as "charitable."

Treas. Reg. §1.501(c)(3)-1(d)(2) defines the term "charitable," as it relates to an organization's exempt purpose and provides that the term should be construed liberally. Notwithstanding, IRC §42(h) (C) (iii) requires that one of the exempt purposes of the organization must include the fostering of low-income housing. IRC §42(h)(5)(C)(i) also references IRC §501(c)(4), which relates to nonprofit civic leagues or organizations operated exclusively to promote social welfare, or local associations of employees, the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes. As is the case with an organization described in IRC §501(c) (3), one of the exempt purposes of such a league, organization, or association must include the fostering of low-income housing.

Rev. Proc. 96-32 provides guidance (including a safe harbor) for determining whether a qualified nonprofit organization under IRC §501(c) (3) involved in low- income housing is pursuing a charitable purpose by fostering low-income housing. The safe harbor determination is based on the percentage of low-income units provided and the income level of the tenants. These guidelines are applicable continuously throughout the 15-year compliance period. Under the safe harbor, a qualified nonprofit organization must establish (for each project) that at least 75% of the units are occupied by residents whose incomes are 80% or less of the area's median income, and either:

1. 40% of the units are occupied by residents whose incomes are 60% or less of the area median income, or
2. 20% of the units are occupied by residents whose incomes are 50% or less of the area median income.

To coincide with IRC §42 requirements, this determination can be made based on the residents' income at the time the household moves into the low-income unit.

If the taxpayer does not satisfy the safe harbor requirements, the assistance of an Exempt Organization specialist should be requested. See IRM 4.10.2.6.5 for instructions.

See also Step 5 and Related Issues (below) for additional considerations impacting the exempt status of the nonprofit.

Step 3: Ownership Test

The nonprofit must have an ownership interest in the low-income housing project throughout the 15-year compliance period. A qualified nonprofit organization can own an interest directly, or through a partnership, or own stock in a qualified corporation that owns directly, or through a partnership, a low-income housing project. A qualified corporation must be a corporation that is 100% owned at all times during its existence by one or more qualified nonprofit organizations.

Step 4: Material Participation

A qualified nonprofit organization must materially participate (within the meaning of IRC §469(h)) in both the development and operation of the project throughout the 15-year compliance period. IRC §469(h) defines material participation as activity that is regular, continuous, and substantial. Treas. Reg. §1.469-5T provides rules for determining the material participation for individuals and Treas. Reg. §1.469-5T (g) (3) provides rules for determining the material participation of certain corporations. Because neither of these provisions applies to nonprofit organizations, they should be reviewed for illustrative purposes only. The general facts and circumstances test of IRC §469(h) (1) is the test applicable to nonprofit organizations. The legislative history suggests the following guidelines in defining material participation in a business activity:

- Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer,
- 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.
- Participation must be maintained throughout the year. Periodic consultation is not sufficient.
- Regular on-site presence at operations is indicative of material participation.
- Providing services as an independent contractor is not sufficient.

Accordingly, a nonprofit entity will be considered to materially participate where it is regularly, continuously, and substantially involved in providing services integral to the development and operations of a project.

Nonprofits play an important role in the IRC §42 program. With their expertise, nonprofits can focus on the on-going performance of the housing project and the provision of services. For-profit entities may also have an interest in promoting low- income housing, but are also interested in the financial aspects of a project and have the funds to make capital contributions to the project. The motivations of both, enhanced by the ability of the nonprofit entity to access the nonprofit set-aside credit, often results in the creation of a partnership that includes both a nonprofit entity and a for-profit entity.

The partnership is often structured so that the nonprofit is a general partner with a 1% or less interest in the partnership and the for-profit investor(s) are limited partners with a combined ownership interest of 99% or more. This structure allows the nonprofit to participate in the project to achieve its special housing objectives of the credit, while providing the financial benefit of the credit to the for-profit investor partners.

If the partnership has one or more for-profit general partners, the nonprofit partner may have less participation in the partnership, which raises the issue of whether the nonprofit's participation in the project is substantial (and thus material).

Step 5: Exempt Status and Private Inurement

The nonprofit and for-profit general partner should not be related parties; i.e., share officers or board of directors. Such relationships may indicate that that the primary purpose of the nonprofit organization is to access credit from the nonprofit set-aside. More importantly, such associations may call into question the exempt status of the nonprofit entity. The issue being - whether the nonprofit entity acts exclusively in furtherance of a charitable purpose or to further the interests of private investors. Although there is no all-inclusive list, some indicators that the nonprofit entity is not acting exclusively to further a charitable purpose are identified here.

- The nonprofit is not the only general partner,
- The nonprofit's minority partnership interest provides for minimal participation in the IRC §42 project's operation,
- The nonprofit makes guarantees to the limited partners against loss of low-income housing credits, and
- Excessive private benefits result from real property sales, development fees, or management contracts.

If there are indicators that the nonprofit entity is being unduly influenced by a for- profit entity, then assistance of an Exempt Organization specialist should be requested for further development of this issue. See IRM 4.10.2.6.5 for instructions.

Audit Adjustments

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h) (5) (B) requirements. Failure to comply with IRC §42(h) (5) (B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c) (1). Therefore, the IRC §42(j) credit recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA 201352009.

Step 1: Determination "as of the Close of the Taxable Year"

Determine whether the noncompliance was corrected before the close of the taxable year in which the noncompliance originally occurred. As explained by CCA 201352009, and consistent with IRC §42(c) (1) (A), compliance should be determined "as of the close of the taxable year." If a taxpayer is found to be compliant "as of the close of the taxable year" in which the noncompliance first occurred, then no disallowance of credit is required.

Step 2: Noncompliance Corrected within a Reasonable Period

If the noncompliance is not corrected "as of the end of the taxable year in which the noncompliance occurred," then determine whether responsibility for the non-compliance rests solely with the qualified nonprofit organization.

- If responsibility does not rest solely with the qualified nonprofit organization, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).
- If responsibility rests solely with the qualified nonprofit organization, then the agent should determine whether the noncompliance was corrected within a "reasonable period."

"Reasonable Period" Quantified

Under IRC §42(j)(4)(E), taxpayers are provided relief from the credit recapture provisions in the event of a casualty loss if the loss is restored within "a reasonable period established by the Secretary." In CCA 200134006, Chief Counsel concurred that a reasonable period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties under IRC §165.

Therefore, to ensure fair and equitable treatment of taxpayers in comparable situations, the "reasonable period" provided in IRC §42(j) (4) (E) to restore a casualty loss should be used to determine whether a taxpayer corrected the IRC §42(h) (5) (B) noncompliance within a reasonable period of time when the cause of the noncompliance rests solely with the qualified nonprofit organization. That is, the reasonable period of time for correcting noncompliance with IRC §42(h) (5) (B) is no longer than 2 years following the end of the tax year in which the noncompliance first occurred.

- If the noncompliance was corrected within a reasonable period, then no disallowance of credit is required.
- If the noncompliance was not corrected within a reasonable period, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).

Related Issues

Federal Financing

Nonprofit organizations usually have access to federal funding sources, including federal grants and below-market rate loans. Typically, nonprofit organizations will secure the federal financing and then loan the proceeds to the taxpayer. Depending on the facts and repayment terms, the loans may not be bona fide debt or will be subject to limitations. See Chapter 10 for additional discussion.

Developer Fee

In addition to sponsoring the development of the low-income housing, a nonprofit entity may act as the project's developer and earn a developer's fee. The issue is whether the nonprofit entity had the expertise needed to develop an IRC §42 project and, in fact, did develop the project. See Chapter 8 for additional discussion.

Tax-Exempt Status (Private Inurement & Taxable Income)

If the nonprofit entity is earning a development fee, there are two issues that may affect the tax-exempt status of the entity.

- Private Inurement. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) provides that an exempt entity must be organized and operated exclusively for an exempt purpose specified in IRC §501(c)(3). Because these purposes serve public rather than private interests, an exempt entity must establish that it is not organized for the benefit of private interests. A developer fee paid to a nonprofit entity that may be ascribed, in whole or in part, to the benefit of private persons may call into question whether the entity is being operated "exclusively" for an exempt purpose, which in turn, may jeopardize the tax-exempt status of the entity.
- Unrelated Business Taxable Income. Nonprofit entities may generate income through activities not directly related to their tax-exempt purposes. The developer fee may be subject to taxation under IRC §512 and if the nonprofit entity has an excess of taxable income, the entities tax-exempt status could be jeopardized.

In *Housing Pioneers, Inc. v. Commissioner*, the Tax Court determined that private inurement existed where the founders of the nonprofit organization operated it to privately benefit an existing housing partnership. See Appendix J.

The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.

Summary

IRC §42(h) (5) provides that a portion of each state's annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations.

The qualified nonprofit organization must own an interest in the project and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.

Once it has been determined that a taxpayer received a credit allocation from the nonprofit set-aside, audit issues include determining whether the nonprofit is a qualifying nonprofit entity and satisfies the requirements for its tax exempt purpose, whether the nonprofit has maintained an ownership interest, whether the nonprofit materially participated in the project development and is participating in the on-going operation of the project.

The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.

The taxpayer may be subject to disallowance of the entire annual credit if noncompliance with the IRC §42(h) (5) (B) occurs. However, the IRC §42(j) credit recapture provisions are not applicable.

Chapter 7 No Longer Participating in the IRC §42 Program

Introduction

IRC §42(c) (2) defines a "qualified low-income building" to mean any building which is part of a qualified low-income housing project at all times during the period beginning on the first day in the compliance period on which such building is part of such a project, and ending on the last day of the compliance period with respect to such building. However, a low-income building may not remain a qualified low- income building throughout the entire 15-year compliance period. In this chapter, audit issues resulting from a state agency's determination that a building is entirely out of compliance and is no longer participating in the IRC §42 program are discussed.

Topics

- Law
- Audit Issues
- Audit Techniques
- Building Reinstated in Program
- Summary

Law

State Agency's Authority

Treas. Reg. §1.42-5(e) (3) provides authority for the state agency to report to the IRS that a building is "no longer in compliance nor participating in the IRC §42 program" on Form 8823 line 11p. Treas. Reg. §1.42-5(e) (3(i) reads:

> Notice to Internal Revenue Service -- (i) In general. The Agency must be required to file Form 8823, "Low-Income Housing Credit Agencies Report of Noncompliance," with the Service… If an Agency reports on Form 8823 that a building is entirely out of compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building's noncompliance…"

As noted in the Form 8823 Guide (Chapter 21), when a state agency notifies the IRS that a building is no longer in compliance nor participating in the IRC §42 program, the state agency may cease compliance monitoring. Also note that Form 8823, line 11p, does not include a box for reporting "noncompliance corrected" when a state agency reports that a building is no longer participating in the IRC §42 program.

Returned Credits

Under certain circumstances, previously allocated low-income housing credits may be returned to the state agency. Under Treas. Reg. §1.42-14(d)(2)(ii), these credits may be returned up to 180 days following the close of the first tax year of the credit period for the building that received the allocation. These credits are returned to the state's credit ceiling and can be reallocated to another qualified low-income project. In the event the entire credit is returned and the Forms 8609, Low-Income Housing Credit Allocation and Certification, have been issued, Form 8823 is used to notify the IRS that the credit has been returned. Treas. Reg. §1.42-14(d) (2) (iv) specifies the reasons for the return of the entire amount of allocated credit:

- The building is not placed in service within the required time period or fails to meet the minimum set-aside requirements of IRC §42(g) (1) by the close of the first year of the credit period.
- The building does not comply with the terms of its credit allocation. The terms of an allocation are the written conditions agreed to by the state agency and the allocation recipient in the allocation document.
- The owner and state agency mutually agree to cancel an allocation of credit by mutual consent.

Note: Treas. Reg. §1.42-14(d)(2)(iv) also provides that a state agency may determine under IRC §42(m)(2) that an amount of credit allocated to a project is not necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.

Noncompliance During the 15-Year Compliance Period

Typical issues that may justify a state agency's determination that a taxpayer is no longer participating in the program include:

- The taxpayer's noncompliance is egregious; i.e., conspicuous, flagrant, and systemic in nature and includes the failure to make reasonable attempts to comply with the requirements of the program, or careless, reckless, or intentional disregard of program requirements.
- The taxpayer has, during the 15-year compliance period, voluntarily withdrawn a low-income building from the IRC §42 program, but retained ownership. For example, all the rental units may have been converted to market-rate units or used for another purpose.
- The taxpayer fails to respond to repeated notices for monitoring reviews. Under Treas. Reg. §1.42-5(c) (2) (ii) (B), at least once every three years, the state agency must conduct on-site inspections of all buildings in the project and, for at least 20% of the project's low-income units, inspect the units and review the low- income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.

- The taxpayer repeatedly fails to submit annual reports and owner certifications required under Treas. Reg. §1.42-5(c) (1) and (3). See Chapter 7 of the Guide for Completing Form 8823 for additional discussion.

Additional Discussion

Refer to Chapter 21 of the Guide for Completing Form 8823 for additional discussion.

Audit Issues

There are two primary issues:

- Whether the taxpayer claimed credit for the taxable year in which the taxpayer ceased to participate in the IRC §42 program, or for any subsequent tax year of the credit period, and
- Whether the taxpayer correctly recaptured credit as required under IRC §42(j).

Audit Techniques

Step 1: Identify Issue

The first step is to determine whether the taxpayer claimed credit for the taxable year in which participation in the IRC §42 program ceased or any subsequent tax year. Also determine whether the taxpayer recaptured credit under IRC §42(j); i.e., Form 8611 should be completed and filed with the tax return. If the taxpayer ceased claiming credit and correctly applied the IRC §42(j) credit recapture provisions, then no further action is needed.

Step 2: Disallow Credit in the Year of Determination and All Subsequent Tax years

If credit was claimed for the taxable year in which the taxpayer ceased to participate in the program, then the credit associated with the low-income buildings that are no longer in compliance is disallowed. If necessary, subsequent year tax returns should also be audited to disallow any credit taken in those years.

Step 3: Determine the Amount of Credit Claimed in Prior Years

A determination that a low-income building is no longer in compliance and is no longer participating in the IRC §42 program is also a credit recapture event under IRC §42(j). The amount of credit claimed for each taxable year prior to the year of the determination should be verified with the taxpayer.

- The credit for the first year of the credit period is usually less than the total allowable credit because the applicable fraction is determined using the special rule under IRC §42(f) (2). Under this rule, credit not allowable in the first year is allowable in the eleventh year.

- A portion of the credit claimed may be associated with increases in qualified basis after the end of the first year of the credit period. This credit is accounted for on Form 8609-A, Line 11. This portion of the credit is not subject to recapture.

In the event the taxpayer cannot verify that a lesser amount was claimed, the maximum allowable credit should be used to compute the recapture amount. See Chapter 16 for additional discussion and computation of the recapture amount.

Building Reinstated in the Program

Only the state agency that allocated the credit to the taxpayer can reinstate a low- income building in the IRC §42 program and, as a result, resume compliance monitoring activities. For example:

- A taxpayer may be able to bring the building back in compliance. No credit is allowable while the building is not in compliance and not participating in the program, but the taxpayer may resume claiming credit if the noncompliance is corrected and the credit is otherwise allowable.
- The low-income building may be sold to a new owner who can bring the building back into compliance and wishes to participate in the program. Under IRC §42(d) (7), if a low-income building (or interest therein) is acquired before the end of the 15-year compliance period, then the credit allowable to the new owner is equal to the amount that would have been allowable to the prior owner.

Audit Issues and Techniques

If a building has been reinstated in the program, the taxpayer needs to provide documentation indicating the date the building was reinstated. The date of reinstatement is important for determining whether credit should be disallowed and/or recaptured. Further, the taxpayer should demonstrate that:

- The original noncompliance issues that resulted in the state agency's determination have been resolved.
- The extended use agreement required under IRC §42(h) (6) is in effect and recorded pursuant to State law as a restrictive covenant. See Chapter 5 for additional discussion.
- The taxpayer has timely filed certifications with the state agency for each taxable year beginning with the year the building was reinstated. The taxpayer should provide copies of the certifications, which can be verified with the state agency if necessary. See Treas. Reg. §1.42-5(c) (1).
- The state agency has resumed compliance monitoring activities. State agencies are required to provide taxpayers with written notice if the state agency discovers by inspection, review, or some other manner that the project is not in compliance with IRC §42 requirements. Many state agencies will also provide a taxpayer with a notification letter if, as a result of a physical inspection or tenant file review, no noncompliance issues were identified. See Treas. Reg. §1.42-5(e) (2). These reports are clear evidence that the state agency has resumed responsibility for compliance monitoring. If the taxpayer

cannot provide documentation that the project is subject to the state agency's compliance monitoring activities, the state agency should be contacted for confirmation.

Summary

A state agency may determine that a low-income building is no longer in compliance nor participating in the IRC §42 program and report the noncompliance event to the IRS on Form 8823. A state agency is not required to continue compliance monitoring activities after reporting the noncompliance to the IRS.

Under certain circumstances, as identified in Treas. Reg. §1.42-14(d) (2) (ii), credits may be returned to the state agency.

A state agency may report that a low-income building ceased to be part of qualifying low-income project at any time during the 15-year compliance period.

The audit can be limited to determining if the taxpayer claimed credits for the taxable year in which the taxpayer ceased to participate in the IRC program, or for any subsequent year of the credit period, and whether the taxpayer correctly recaptured credit as required under IRC §42(j).

A state agency may reinstate a building in the IRC §42 program if a taxpayer (or successor owner of the property) is able to bring the building back into compliance. The taxpayer may resume claiming credit if the noncompliance is corrected and the credit is otherwise allowable, but no credit would be allowable during the period the building is not in compliance.