IRC §42, Low-Income Housing Credit - Part III Eligible Basis

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- Chapter 8 Eligible Basis: Includable Costs
  - Introduction
  - Topics.
  - Defining Eligible Basis
    - Residential Rental Project
    - Depreciable Residential Rental Property
    - IRC §179, Election to Expense Assets
    - IRC 263A: Indirect Costs
    - Residential Rental Unit Defined
    - Common Areas
    - Community Service Facilities
    - Transitional Housing & Supportive Services for the Homeless
    - Functionally Related Facilities
    - Landscaping and Land Improvements
    - Date of Determination
  - Reconciling Eligible Basis & Identifying Large, Unusual, or Questionable Items
    - Step 1: Reconciliation of Eligible Basis
    - Step 2: Review Taxpayer's Final Cost Certification
    - Step 3: Identify Large, Unusual, or Questionable Items (LUQs)
  - Verifying Assets Included in Eligible Basis
    - Issue 1: Character of Asset
    - Issue 2: Cost of Asset
    - Issue 3: When Paid or Incurred
    - Issue 4: Reasonable Method of Allocation
    - Issue 5: Continuous Service
  - Common Areas, Required Facilities, and Providing Services
    - Common Area
    - Reasonably Required Facilities
    - Facilities Used to Provide Services
  - Development Fees
    - Developer Fee Defined
    - Related Parties
    - Audit Issues & Techniques
    - Issue 1: Character of the Services to be Provided
    - Issue 2: Services Actually Provided

        - Issue 3: Reasonable Fee
        - Issue 4: Method of Payment
        - Analysis of Debt
        - Court Case: Substantiation of Services Performed
        - Summary
    - Partnership Costs
        - Organizing Costs
        - Syndication Costs
    - IRC §42 Credit Allocation Costs
    - Cost of Securing Financing
        - Cost of Issuing Tax-Exempt Bonds
    - Computing Adjustments to Eligible Basis
        - Nonqualifying Costs
        - Reductions and Limitations
    - Summary
- Chapter 9 Eligible Basis: Acquisition and Rehabilitation of Existing Buildings
    - Introduction
    - Topics.
    - Acquisition of Existing Buildings
        - IRC §42(d)(2): Existing Buildings
        - Requirement 1: Acquisition by Purchase
        - Requirement 2: Last Placed in Service
        - Requirement 3: Previously Placed in Service by the Taxpayer
        - Requirement 4: Substantial Rehabilitation
        - Audit Issue: Artificially Inflated Purchase Price
    - Substantially Rehabilitated Buildings
        - Rehabilitation Expenditures Defined
        - Substantial Improvements: Minimum Expenditures to Qualify
        - Buildings Acquired from a Government Unit
        - Placed in Service Date
        - Costs Included in Eligible Basis
        - Audit Issues and Techniques
    - Acquiring a Low-Income Building Before the End of the Compliance Period
        - Placed in Service
        - Allocation of Credit
        - Allocation of Recapture Amount
        - Audit Issues and Techniques
    - Acquiring a Low-Income Building During the First Year of the Credit Period
        - Application of IRC §42(d)(7)
        - Audit Issues and Techniques
    - Acquiring a Low-Income Building Before the Placed in Service Date
        - Eligible Basis
        - Audit Issues and Techniques
    - Summary
- Chapter 10 Eligible Basis: Analysis of Financial Resources
    - Introduction

    - Topics.
    - Federal Grants
        - IRC §42(d)(5)(A) Federal Grants
    - Low-Income Buildings Financed with Tax-Exempt Bonds
    - Below Market Federal Loans
    - Nonrecourse Financing and IRC §42(k)(1), At-Risk Rules
        - "At Risk" and Nonrecourse Financing
        - Audit Techniques
        - Adjusting Qualified Basis
    - Nonrecourse Financing from an Qualified Nonprofit Organization
        - Qualified Nonprofit Organization Defined
        - Financing Secured by Property
        - Limited to 60% of Eligible Basis
        - Repayment of Principal and Interest
        - Two Additional Requirements
    - Right of First Refusal to Purchase
        - Minimum Purchase Price
        - Purchase by Tenants
        - Impact on Federal Income Tax Benefits
    - Qualified Contracts
        - Audit Issues
    - Bona Fide Debt
        - Good Faith Intent
        - Impact on Eligible Basis
    - "Not-For-Profit" Rules and Economic Substance
        - IRC §183
        - Treas. Reg. §1.42-4
        - IRC §7701(o), Clarification of Economic Substance Doctrine
        - Economic Substance Doctrine Implementation Procedures
        - Impact on Eligible Basis
    - IRC §45D, New Markets Tax Credit
        - Investment In IRC §42 Projects Not Allowed
        - Audit Issue: Loans from CDEs
        - Step 1: Identify CDE
        - Step 2: Capital or Equity Investments
    - Audit Techniques
        - Step 1: Identify Financial Sources
        - Step 2: Review Loan Documents
    - Summary
- Chapter 11 Eligible Basis: Limitations and Adjustments
    - Introduction
    - Topics.
    - Disproportionate Standards
        - IRC §42(d)(3): Disproportionate Standards for Units
    - Federal Grants
        - IRC §42(d)(5)(A): Federal Grants

        - Building Placed in Service Before July 31, 2008
        - Buildings Placed in Service After July 30, 2008
        - Federal Grants
        - Federal Rental Assistance Payments
        - Funds Not Considered Federal Grants
        - Section 1602 Grants
        - Tax Credit Assistance Program
        - Reporting Federal Grants
        - Audit Issues
        - Audit Techniques
        - Conclusion
    - IRC §47, Rehabilitation Credit
        - Law
        - Reduction of Adjusted Basis
        - Example
    - IRC §48, Energy Credit
        - Law
        - Reduction of Depreciable Basis Includible in Eligible Basis
        - Section 1603 Grant Funds
    - Supportive Services for the Homeless
    - Low-Income Buildings Financed with Tax-Exempt Bonds
        - Documentation of Bond Financing
        - Coordinating IRC §42 and IRC §142(d) Requirements
        - Eligible Basis Limitation
        - Allocating Bond Proceeds
        - Audit Techniques
    - Community Service Facilities
        - IRC §42(d)(4)(C): Community Service Facility
        - Adjusted Basis Limitation
        - Example
    - Low-Income Buildings in High Cost Areas
        - Qualified Census Tracts
        - Difficult to Develop Areas (DDA)
        - Gulf Opportunity Zone
        - State Agency Designation
        - Coordination with 40-50 Rule under Former IRC §42(i)(2)(E)
        - Audit Techniques
        - Example
    - Summary

Chapter 8 Eligible Basis: Includable Costs

Introduction

The examination of eligible basis begins with an analysis of the actual qualifying costs incurred by the taxpayer. This chapter provides guidelines for determining the dollar value of assets includable in eligible basis.

Topics

- Defining Eligible Basis
- Reconciling Eligible Basis & Identifying Large, Unusual, or Questionable Items
- Verifying Assets Included in Eligible Basis
- Common Areas, Required Facilities, and Providing Services
- Development Fees
- Partnership Costs
- IRC §42 Credit Allocation Costs
- Cost of Securing Financing
- Computing Adjustments to Eligible Basis
- Summary

Defining Eligible Basis

Eligible Basis is defined primarily by reference to IRC §§103 and 168. IRC §42 provides supplemental definitions and requirements.

Residential Rental Project

Under IRC §42(d) (4) (A), the adjusted basis of any building is determined without regard to the adjusted basis of any property which is not residential rental property. The legislative history for IRC §42 explains that residential rental property, for purposes of the low-income housing credit, has the same meaning as residential rental property within IRC §103. Treas. Reg. §1.103-8(b)(4)(i) constructed units…" that meet certain requirements states, in part, that "a residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly

Treas. Reg. §1.103-8(b) (8) (IV) defines a "building or structure" to mean, generally, a "discrete edifice or other man-made construction consisting of an independent foundation, outer walls, and roof. A single unit which is not an entire building but is merely a part of a building is not a building or structure within the meaning of this section. As such, while single townhouses are not buildings if their foundation, outer walls, and roof are not independent, detached houses and row houses are buildings."

Notice 88-91 explains, however, that the term "qualified low-income building" for IRC §42 purposes includes residential rental property that is either an apartment building, a single family dwelling, a townhouse, a rowhouse, a duplex, or a condominium. A qualified low-income building does not include residential rental property owned or leased by a cooperative housing corporation or a tenant - stockholder, as those terms are defined under IRC § 216(b)(1)(and (2).

Under IRC §42, the buildings qualifying for the credit are:

- new buildings, the original use of which begins with the taxpayer (IRC §42(i)(4));
- existing buildings, which means any buildings that are not new buildings (IRC §42(i)(5)); and
- Rehabilitated buildings; i.e., the expenditures connected with rehabilitating an existing building are treated as a separate new building and do not include the cost of acquiring the building (IRC §42(e) (1) and (2)).

Depreciable Residential Rental Property

IRC §42(c)(2)(B) refers to low-income buildings as any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply; e.g., costs includable in eligible basis must be depreciable property under IRC §168.

IRC §168(e) (2) (A) defines "residential rental property" to mean any building or structure if 80% or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. The term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment if more than one-half of the units are used on a transient basis. Also, if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

IRC §179, Election to Expense Assets

Under IRC §179(d) (9), no credit is allowed under IRC §38 with respect to any amount for which a deduction is allowed under IRC §179(a). The IRC §42 credit is a general business credit under IRC §38(b) (5). Consequently, depreciable residential rental property expensed under IRC §179 is not includable in eligible basis.

IRC 263A: Indirect Costs

IRC §263A generally requires direct costs and an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer to be capitalized to the property produced. IRC §263A(g)(1) defines "produce" as including constructing, building, installing, manufacturing, developing, or improving. However, as explained in Treas. Reg. §1.263A-2(a)(1)(ii), a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. Under IRC §263A(g)(2), a taxpayer is treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying IRC §263A(a).

Indirect costs are defined in Treas. Reg. §1.263A-1(e) (3) (i) as "…all costs other than direct material costs and direct labor costs (in the case of property produced)…. Indirect costs are properly allocable to property produced…when the costs directly benefit or are incurred by reason of the performance of production…"

Residential Rental Unit Defined

A "unit" is defined in Treas. Reg. §1.103-8(b) (8) (i) to mean "any accommodation containing separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Such accommodations may be served by centrally located equipment, such as air conditioning or heating. Thus, for example, an apartment containing a living area, a sleeping area, bathing and sanitation facilities, and cooking facilities equipped with a cooking range, refrigerator, and sink, all of which are separate and distinct from other apartments, would constitute a unit.

IRC §42(i) (3) (B) (IV) provides that certain single-room occupancy units also qualify as residential rental units even though such housing may provide eating, cooking and sanitation facilities on a shared basis. (See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.)

Common Areas

IRC §42(d)(4)(B) provides that eligible basis includes the adjusted basis of property subject to the allowance for depreciation, used in common areas or provided as comparable amenities to all residential rental units in such building. As explained in the legislative history for the original enactment of IRC §42, residential rental property includes…facilities for use by the tenants, and other facilities reasonably required by the project.

Community Service Facilities

Under IRC §42(d) (4) (C), eligible basis of any building located in a qualified census tract includes the adjusted basis of any property used to provide services for certain nontenants. A "community service facility" is any facility (1) located in a qualified census tract (see IRC §42(d) (5) (C)), (2) designed to serve primarily individuals whose income is 60% or less of area median income (see IRC §42(g) (1) (B) and (3)) used throughout the taxable year as a community service facility. The increase in the eligible basis of any building attributable to a community service facility is capped under IRC §42(d) (4) (C) (ii). See Chapter 11.

Rev. Rul. 2003-77 provides a description of a facility qualifying as a community service facility because the requirements of IRC §42(d) (4) (C) are met.

> "A qualified low-income building (the Building) received a housing credit allocation on October 1, 2002, and was placed in service in 2003. The Building is located in a qualified census tract (as defined in IRC §42(d) (5) (B) (ii)). A portion of the Building (the Facility) is used throughout the year to provide services to residents of the Building as well as nonresidents. The Facility consists of a meeting room, an administrative office, a storage room, and several multi-purpose rooms. The services provided at the Facility include daycare, career counseling, literacy training, education (including tutorial services), recreation, and outpatient clinical health care. The services are provided free of charge or for a fee that is affordable to individuals whose income is 60% or less of area median income (within the meaning of in IRC §42(g) (1) (B)). The adjusted basis of the property comprising the Facility (of a character subject to the allowance for depreciation and not otherwise taken into account in the adjusted basis of the Building) does not exceed 10% of the eligible basis of the Building.

> As required by IRC §42(m)(1)(A)(iii), prior to the allocation of housing credit to the Building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by the Building. The study found, among other things, that providing day care, career counseling, literacy training, education (including tutorial services), recreation, and outpatient clinical health care services would be appropriate and helpful to individuals in the area of the Building whose income is 60% or less of area median income."

Transitional Housing & Supportive Services for the Homeless

IRC §42(c)(1)(E) provides that if the taxpayer is providing transitional housing for the homeless under IRC §42(i)(3)(iii), then the qualified basis of a building providing such housing includes the portion of the building used to provide supportive services designed to assist tenants in locating and retaining permanent housing. To qualify as transitional housing:

- the building must be used exclusively to facilitate the transition of homeless individuals (within the meaning of section 103 of the Stewart B. McKinney Homeless Assistance Act [McKinney-Vento Homeless Assistance Act (42 U.S.C. 11302), as in effect on Nov. 5, 1990) to independent living within 24 months, and
- A governmental entity or qualified nonprofit organization (as defined in IRC §42(h) (5)) provides such individuals with temporary housing and supportive services designed to assist such individuals in locating and retaining permanent housing.

IRC §42(c)(1)(E) also limits the portion of the building used to provide supportive services that can be included in qualified basis to the lesser of:

- so much of the eligible basis of such building as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
- 20% of the qualified basis of such building, determined without regard to the portion of the building used to provide supported services. See Chapter 13 for additional discussion.

If the building is 100% occupied by low-income tenants, then qualified basis equals eligible basis and costs of facilities used to provide supportive services is limited to 20% of the building's eligible basis, determined without regard to the portion of the building used to provide the services. If the building is not 100% low-income, then further consideration should be given to whether the building is being used exclusively to facilitate the transition of homeless individuals to independent living.

Functionally Related Facilities

Under Treas. Reg. §1.103-8(b) (4) (iii), facilities that are functionally related and subordinate to residential rental projects are also considered residential rental property and include facilities for use by the tenants, such as swimming pools and other recreational facilities, parking areas, and other facilities reasonably required for the project; e.g. heating and cooling equipment, trash disposal equipment, or units for resident managers or maintenance personnel.

Landscaping and Land Improvements

IRC §167(a) provides, as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business of a taxpayer, or of property held for the production of income.

Rev. Rul. 74-265 held that land preparation costs may be subject to a depreciation allowance if such costs are so closely associated with a depreciable asset so that it is possible to establish a determinable period over which the preparation will be useful in a particular trade or business. A useful life for land preparation is established if it will be replaced contemporaneously with the related depreciable asset, which is a question of fact, but if the replacement of the depreciable asset will require the physical destruction of the land preparation, this test is considered satisfied. The balance of the landscaping that will be unaffected by the replacement of the depreciable asset is considered inextricably associated with the land and is not includable in eligible basis under IRC §42(d) (1).

A taxpayer may argue that all land preparation and improvement costs should be depreciable property because without construction of the buildings and other infrastructure for the project, none of these expenses would have been incurred. However, the court in *Eastwood Mall v. U.S.*, 95-1 USTC paragraph 50,236 (N.D. Ohio 1995), aff'd by unpublished disposition, 59 F.3d 170 (6th Cir. 1995), specifically denounced this argument as being incorrect. The Court noted that in almost every instance, some costs will be incurred in preparing the land for the construction of a building. The court further noted that under the taxpayer's argument, all costs incurred in preparing a site are depreciable and that the only situation where land preparation costs would not be depreciable is where nothing is constructed on the land. The court stated that "[t]his interpretation is illogical and contrary to the law."

Date of Determination

For a new building, under IRC §42(d) (1), the eligible basis is its adjusted basis as of the close of the first taxable year of the credit period. Under IRC §42(d) (2), the same rule applies for existing (i.e., acquired) buildings, but additional requirements must also be met. And for rehabilitation expenses treated as a separate new building under IRC §42(h) (3) (C), the same rule applies, but only if criteria for minimum expenditure amounts have been met. See Chapter 9.

Reconciling Eligible Basis & Identifying Large, Unusual, or Questionable Items

The scope of the examination is determined after reviewing the tax return, the Forms 8609, and the taxpayer's final cost certification.

Step 1: Reconciliation of Eligible Basis

The eligible basis reported on Form 8609, line 7, and Form 8609-A, line 1, should match. Any differences should be explained by the taxpayer.

Under IRC §42(m)(2), the credit allocated by a state agency to a project must not exceed the amount the agency determines is necessary for the financial feasibility of the project and viability as a qualified low-income housing project throughout the credit period. To make sure only the credit necessary is allocated, the state agency evaluates the sources and uses of funds at three critical points of the development process: (1) when the taxpayer applies for the credit, (2) when the credit allocation is made, and (3) when the building is placed in service. See IRC §42(m) (2) (B) and (C).

The final evaluation for when a building is placed in service must be made no later than the date the state agency issues the Form(s) 8609. As described in Treas. Reg. §1.42-17(a) (5), the taxpayer must submit a schedule of project costs. This schedule is commonly referred to as the final cost certification because it is to be prepared under the method of accounting used by the taxpayer for federal income tax purposes, and must detail the project's total costs as well as those costs that may qualify for inclusion in eligible basis under IRC §42(d). In addition:

- 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. The CPA's audit must be conducted in accordance with generally accepted auditing standards and the auditor's report must be unqualified.
- For projects with less than 11 units, the state agency may require an audited schedule of project costs.

A copy of the schedule of costs and (if required) the auditor's report should be secured from the taxpayer or, if not available, from the state agency. The eligible basis reported on this final cost certification should be compared to the eligible basis reported on Form 8609 and Form 8609-A and any differences reconciled.

Step 2: Review Taxpayer's Final Cost Certification

The taxpayer's final cost certification should be reviewed for completeness. Treas. Reg. §1.42-17(a)(3)(i) lists the minimum information that should be included; i.e., the schedule should sufficiently detail the costs, whether or not includible in eligible basis, and should include (but not be limited to): site acquisition costs, construction contingency, general contractor's overhead and profit, architect's and engineer's fees, permits and survey fees, insurance premiums, real estate taxes during construction, title and recording fees, construction period interest, financing fees, organizational costs, rent-up and marketing costs, accounting and auditing costs, working capital and operating deficit reserves, syndication and legal fees, and developer fees. State agencies may require additional information and prescribe a format.

Generally, the schedule of costs is a one-page summary of total costs presented in a columnar format. The left column lists high-level categories, the second identifies the total costs incurred for that category, and the third column includes costs qualifying for eligible basis. If the taxpayer acquired and rehabilitated an existing building, then the acquisition costs for the building are stated separately from the rehabilitation costs, and are distinguished from the cost of the land.

Step 3: Identify Large, Unusual, or Questionable Items (LUQs)

Based on the review of the final cost certification, the audit scope for examining the dollar value of eligible basis can be determined. Specific costs should be identified as large, usual or questionable items. (See IRM 4.10.2.3.1.)

- Consider the inherent character of the cost categories. Categories that are not includable in eligible basis can be eliminated from further consideration if the taxpayer did not include the costs in eligible basis. For example, the costs associated with the acquisition of land.
- Consider the beneficial effects of how an item is reported. For example, there are some costs which should be allocated and only a portion of the cost included in eligible basis. A taxpayer may have purchased land with an existing building that the taxpayer then rehabilitated and now qualifies as low-income housing. In this case, there should be an allocation of the purchase price between the land and existing building. Another typical fact pattern is the allocation of costs when there is more than one low-income building. If actual costs associated with each building are not tracked during the developmental process, the total eligible basis for the entire low-income development should be allocated among the buildings based on square footage.
- Consider costs that should be identified in the final cost certification, but are missing, such as such partnership organizational costs, rent-up and marketing costs, and syndication fees. These costs need to be accounted for, even though they are not includable in eligible basis, to ensure they have not been accumulated with other costs for a line item on the certification.
- Consider line items on the cost certification that are an accumulation of a larger number of separate costs. At a minimum, the taxpayer should explain what the underlying costs are.

It may be possible to exclude costs because the costs are not, by character, includable in eligible basis. For the remaining categories identified on the cost certification, two additional criteria should be used to identify large, unusual, or questionable items for audit consideration.

- Consider the comparative size of the cost to total eligible basis. Small dollar values for line items that appear to be includable in eligible basis by character need not be further examined.
- Consider the absolute size of the cost, even if comparably small, if the dollar value does not appear commensurate with the character of the cost.

At this point, identify those cost that the taxpayer has included in eligible basis which are:

- possibly not includable in eligible basis,
- allocated costs for which the method of allocation should be reviewed,
- costs which should be, but are not, clearly identified in the cost certification and which might not be includable in eligible basis,
- an accumulation of costs, for which the underlying individual costs might not be includable in eligible basis, or
- Individual line items selected because of their comparative or absolute size.

Verifying Assets Included in Eligible Basis

Verifying the assets included in eligible basis requires consideration of five issues.

- Character of the assets,
- Cost of the assets,
- When the cost was paid or incurred,
- Whether costs were reasonably allocated among the assets, and
- Whether the assets are in continuous use during the entire 15-year compliance period.

Issue 1: Character of Asset

The first issue is whether an asset is residential rental property qualifying for the credit. Consider the following:

- IRC §§ 103 and 168 are the primary references for the definition of depreciable residential rental property. Depreciable basis includes costs capitalized to the property under IRC §§ 263(a) and 263A.
- Under IRC §42, eligible basis includes not only the cost of residential rental units, but can also include common areas, community service facilities, facilities used to provide supportive services for the homeless, and functionally related facilities.
- Eligible basis also includes the cost of some land improvements and preparation, but is generally limited to costs so closely associated with a depreciable asset includable in eligible basis that it is possible to establish a determinable period over which the land improvement or preparation will be useful. A useful life for land improvements or preparation is established if it will be replaced contemporaneously with the related depreciable asset.

Refer to Appendix C for a summary of specific costs and treatment.

Issue 2: Cost of Asset

The second issue is whether the dollar amount of the qualifying assets is accurately reported. Under IRC §42(d)(1), the eligible basis of a newly constructed building is the building's adjusted basis as of the close of the first taxable year of the building's ten-year credit period, without regard to any depreciation. See IRC §42(d) (4) (D).

The final cost certification provided to the state agency is insufficient evidence of the assets included in eligible basis. Documents available to support the computation of eligible basis include:

- Closing Documents and Settlement Sheets - These documents specify such items as the purchase price and terms, various transfer and real estate taxes, professional fees, and other related expenses. These documents were not prepared to identify assets includable eligible basis and further analysis is needed to determine which assets have been, or should be, included in eligible basis.

- American Institute of Architects (AIA) Statements or Construction Vouchers - These documents can provide details regarding the work done for specific addresses and units, the types and amounts of costs, and the related percentages of completion. These documents are helpful for reviewing eligible basis and identifying disproportionate standards. They provide a unit-to-unit comparison for construction and amenities.
- Development Agreements – These agreements may provide detail for the intended eligible basis figure and its components.
- Certificate of Occupancy – This document provides a description of the building and identifies when it was placed in service. In some areas it also describes zoning and the type of units offered, and whether commercial areas exist.
- Local Property Records – These records can provide information such as a description of the real estate, mortgage information, recording of the extended use agreement, existence of any covenants, various sale terms, and the names of prior owners.

Issue 3: When Paid or Incurred

The third issue is determining when the cost was paid or incurred. Only those qualifying costs paid or incurred by the end of the first year of the credit period are includable in eligible basis.

Costs Paid or Incurred

Notice 88-116 explains that construction, reconstruction, or rehabilitation costs are incurred for purposes of IRC §42 on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer incurring the costs with respect to other items of income and expense; i.e., the amount must be fixed and determinable.

Beginning of the Credit Period

Under IRC §42(f) (1), the credit period starts with the taxable year in which the building is placed in service, or at the election of the taxpayer, the succeeding taxable year. The election is documented on Form 8609, line 10a.

Notice 88-116 defines the term "placed in service" for IRC §42 purposes.

- The placed-in-service date for a new or existing building used as residential rental property is the date on which the building is ready and available for its specifically assigned function, 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. In general, a transfer of the building results in a new placed-in-service date if, on the date of the transfer, the building is occupied or ready for occupancy.
- The placed-in-service date under IRC §42(e)(4)(A) for rehabilitation expenditures that are treated as a separate new building is the close of any 24-month period, over which the taxpayer has aggregated expenses for purposes of determining whether the minimum costs have been incurred to qualify for the credit. This calculated placed-in-service date applies even if the building is occupied during the habilitation period. At this point, the

taxpayer should document compliance with the requirement for the selected 24-month period to establish when the rehabilitation costs were placed in service. See Chapter 9 for more detailed discussion.

Under IRC §42(f) (5) (A), the credit period for an existing building cannot begin before the first taxable year of the credit period for rehabilitation expenditures with respect to the building.

Documentation

Generally, certificates of occupancy issued by a local government agency after physically inspecting the buildings are used to document when a building was placed in service. The documented placed-in-service date should match the date identified on Form 8609, line 5.

Issue 4: Reasonable Method of Allocation

The fourth issue is whether the costs have been reasonably allocated among the assets.

Land and Depreciable Residential Rental Property

The cost of the land upon which the IRC §42 project is located should be identified and reconciled to the amount reported on the balance sheet. If the taxpayer purchased land with improvements, then the purchase price should be allocated among the assets purchased. This is necessary because the cost of the land is not includable in eligible basis while the cost of the land improvement might be includable.

The taxpayer should document how the purchase price was allocated. In addition, a review of the local property records can provide information such as a description of the real estate and sales transactions.

A review of records from the tax assessor's office may provide a ratio of the value of the land to existing improvements, which can serve as a preliminary standard against which the land valuation by the taxpayer can be measured. However, while the ratio may be helpful, the actual tax assessment value may not provide the current market values.

There are instances where the land value is nominal or zero. For example:

- The taxpayer may construct low-income housing as leasehold improvements on leased land. The lease period must be at least at least 30 years starting with the beginning of the credit period.
- Ownership of existing housing may have transferred to the taxpayer from a city or local government entity for little or no cost based on an agreement for the taxpayer to construct and operate low-income housing.

If necessary, a referral should be made to request an engineer's assistance when determining land valuations. See IRM 4.10.2.6.5 for instructions.

Acquisition and Rehabilitation of Existing Buildings

When a building is acquired and rehabilitated as low-income housing, certain costs must be allocated among the acquisition of the land, the existing building, and the new rehabilitation. Under IRC §42(e)(5), rehabilitation expenditures may, at the election of the taxpayer, be taken into account either as an rehabilitation costs or as costs associated with the existing building under IRC §42(d)(2)(A)(i), but not under both.

Multiple Low-Income Buildings

Eligible basis is determined on a building-by-building basis. There are three additional considerations when determining eligible basis for projects with more than one low-income building.

- Determine whether eligible basis is reasonably allocated among the low-income buildings.
- Determine how the costs of common areas and facilities includable in eligible basis, but not directly associated with a specific low-income building, are allocated among the low-income buildings.
- Determine how landscaping costs includable in eligible basis are allocated among the low-income buildings.

Mixed Low-Income Residential Units and Commercial Property

Mixed-use buildings, which contain commercial space as well as residential rental space, are not precluded from qualifying for the IRC §42 credit. However, the cost of the commercial portion of the building is not includible in eligible basis.

Example 1: Excluding Costs of Commercial Property

A taxpayer purchases a seven-story apartment house in an urban area for $110,000, of which $40,000 is allocated to land and $70,000 to the building. The bottom floor consists of commercial space occupied by a convenience store and a dry cleaner. The taxpayer wants to develop the six upper stories as low-income residential rental units.

The commercial space does not preclude the building from being used for low-income housing. Based on square footage, only $60,000 can be included in eligible basis (6/7 x $70,000) of the acquired building.

Direct and Indirect Costs

As explained in Treas. Reg. § 1.263A-1(e) (3) (i), "…indirect costs are properly allocable to property produced…when the costs directly benefit or are incurred by reason of the performance of production… Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to IRC §263A. Taxpayers subject to IRC §263A must make a reasonable allocation of indirect costs between production, resale, and other activities."

Treas. Reg. §1.263A-1(f) discusses various cost allocation methods that can be used to allocate direct and indirect costs to produced property. For example, a taxpayer may use the specific identification method (Treas. Reg. §1.263A-1(f) (2)), the burden rate and standard cost methods (Treas. Reg. §1.263A-1(f) (3) (i) and (ii)) and any other reasonable method (Treas. Reg. §1.263A-1(f) (4)). Taxpayers may also allocate indirect costs using the simplified production method (Treas. Reg. §1.263A-2(b)) and allocate mixed service costs using the simplified service cost method (Treas. Reg. §1.263A-1(h)). If the taxpayer uses a burden rate method, standard cost method, or other reasonable method, the allocation method must be reasonable. An allocation method is reasonable if, with respect to the taxpayer's production activities taken as a whole:

- the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in Treas. Reg. §§ 1.263A-1(f), 1.263A-2 or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;
- the allocation method is applied consistently by the taxpayer; and
- the allocation method is not used to circumvent the requirements of the simplified methods in Treas. Reg. §§ 1.263A-1, 1.263A-2, 1.263A-3, or the principles of IRC §263A.

Issue 5: Continuous Service

The fifth issue is whether the asset continues to be in service during the tax year under audit. While the eligible basis is initially determined at the end of the first year of the building's credit period, the asset must remain in service continuously throughout the entire 15-year compliance period. As a practical matter, assets will need maintenance, repairs, and even replacement over time. However, any asset that is no longer in service or that no longer exists will result in a reduction in eligible basis. The determination is made as of the last day of the taxable year.

Assets included in eligible basis should be observed when conducting the tour of the low-income project. Any differences between the assets observed and the assets included in eligible basis should be reconciled. See Chapter 3 for additional discussion.

Common Areas, Required Facilities, and Providing Services

IRC §42(d) (4) (B), Basis of property in common areas, and etc., included, reads:

The adjusted basis of any building shall be determined by taking into account the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in such building.

Common Area

Common areas are facilities expected to be used by the tenants and can be reasonably associated with residential rental property; e.g., a parking garage or swimming pool. To qualify, the facility must meet two requirements:

- The common area must be made available on a comparable basis to the tenants of all residential rental units (not only low-income tenants) and,
- No separate fee is required for the use of these facilities. As explained in the legislative history for the original enactment of IRC §42, "…the allocable cost of tenant facilities, such as swimming pools, other recreational facilities and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project."

Alternatively, a taxpayer may decide to exclude an allowable cost from eligible basis. In which case, IRC §42 does not control the taxpayer's use of the common area.

Reasonably Required Facilities

A facility reasonably required by the project is, under Treas. Reg. §1.103-8(b) (4) (iii), residential rental property that is functionally related and subordinate to the residential rental units.

For example, under Treas. Reg. §1.103-8(b)(4)(iii), units for resident managers or maintenance personnel are not classified as residential rental units, but rather as facilities reasonably required by a project that are functionally related and subordinate to residential rental units. As a result, the adjusted basis of a unit occupied by a full-time resident manager is included in the eligible basis of a qualified low-income building, but is not considered a rental unit included in the computation of the applicable fraction. See Chapter 12 and Rev. Rul. 92-61 for additional discussion.

Rev. Rul. 2004-82, Q&A #1 explains that units occupied by security officers are also treated as reasonably required facilities.

Q-1. A new qualified low-income building is located in an area in which owners of apartment buildings typically employ security officers due to the level of crime in the area. If a unit in a building is occupied by a full-time security officer for that building and the building's owner requires the security officer to live in the unit, is the adjusted basis of that unit includable in the building's eligible basis?

A-1. Yes. "…The unit occupied by a full-time security officer is similar to the units described in the examples contained in Treas. Reg. §1.103-8(b) (4) (iii), and is reasonably required by the project because of the level of crime in the area. Thus, the unit is functionally related and subordinate to the building. As a result, the unit is residential rental property for purposes of IRC §42 and its adjusted basis is includable in Building's eligible basis under IRC §42(d) (1)…"

Facilities Used to Provide Services

Eligible basis also includes facilities used by the taxpayer to provide tenants with services not normally associated with the leasing of residential rental property. See also Chapter 12.

Rev. Rul. 98-47 provides an example.

FACTS:

Complex M provides housing units on a non-transient basis for individuals who are of retirement age or older. All of the units in Complex M, which is comprised of Building X, Building Y, and Building Z, each of which is composed of similarly constructed housing units that have separate and complete facilities for living, sleeping, eating, cooking, bathing, and sanitation. The cooking and eating area contains a small refrigerator, a sink, a pull-down table, and a two-burner stove with an oven. Each unit is designed so that the stove can be replaced with a full-sized microwave oven if the physical or mental frailties of the resident make it imprudent to provide a functioning cooking stove.

Each resident enters into a lease arrangement with Complex M. The amount of the monthly payment under the lease varies according to the level of care provided in the building in which the resident resides, with Building Z commanding the largest payment and Building X the smallest payment. The monthly payment is made in exchange for use of an individual unit, basic services and, with respect to Buildings Y and Z, other services. Under a lifetime lease payment option, residents of Complex M may pay a fixed monthly amount for the time they reside in Complex M. The lifetime lease option guarantees a resident the right to move to a unit in Buildings Y or Z if the resident requires additional care.

The basic services available to the residents in all three buildings include: laundry; housekeeping; regular daily meals in the common dining areas; 24 hour monitored emergency call service using call buttons and two-way communication devices located in each room of a unit; planned social activities; and scheduled transportation to various sites in the vicinity including commercial areas, shopping centers, hospitals, and doctor's offices.

Building X, Building Y, and Building Z each contain a separate common dining area. The dining area in each building will be used exclusively by residents of Complex M and visitors of those residents. The size of the dining area in any building does not exceed that necessary to serve the residents of the building and their guests. The dining area serves the special needs of the residents and provides the staff of Complex M an opportunity to monitor the overall wellbeing, nutrition, and health of the residents.

Only the basic services are made available to residents of Building X. No other services are included in the monthly payment. Continual or frequent nursing, medical, or psychiatric services are not made available in Building X.

The basic services and the Building Y support services are made available to residents of Building Y. The Building Y support services are as follows: assistance by medication management technicians in medication management and intake; maintenance of detailed medication records; consultation with a nurse as needed about health concerns and medication

plans; assistance by nonmedically certified aides each day during waking hours in activities of daily living that include getting in and out of bed and chairs, walking, using the toilet, dressing, eating, and bathing; and routine checks by staff members of Building Y to insure the residents' general well-being. Some residents of Building Y have incapacitating infirmities that require continual assistance, but do not require continual or frequent nursing, medical, or psychiatric services. Continual or frequent nursing, medical, or psychiatric services are not made available in Building Y.

The basic services and the Building Y support services are made available to residents of Building Z. In addition, Building Z is staffed in the following manner: registered nurses are on duty for 12 hours each day; licensed practical nurses are on duty for 24 hours each day; and licensed nurses' aides are available 24 hours each day. The nurses and nurses' aides are available to provide nursing care for residents' medical or psychiatric needs. Thus, continual or frequent nursing, medical, or psychiatric services are made available in Building Z.

Residents in Building X are required to move into Buildings Y or Z or another facility outside of Complex M if, because of physical or mental disability, they require additional care beyond that offered by Building X. Residents in Buildings X and Y are required to move into Building Z or another facility outside of Complex M if they require continual or frequent nursing, medical, or psychiatric services.

ANALYSIS

As set forth in the facts above, Building X, Building Y, and Building Z each contains complete living units within the meaning of Treas. Reg. §1.103-8(b)(8), all of the living units within the respective buildings are available to the general public, and all of the living units are used on a non-transient basis.

Since Complex M also provides significant non-housing services to residents of the three buildings (including continual or frequent nursing, medical, or psychiatric services to the residents of Building Z), the analysis must consider the nature and extent of the non-housing services. In the case of Complex M, the analysis must examine whether the buildings of Complex M are hospitals, nursing homes, sanitariums, or rest homes rather than residential rental property. …The labels are not determinative. The focus is whether the facilities are, in substance, residences or health care facilities and therefore, the nature and degree of the services provided by the facility controls.

Significant non-housing services are made available to residents of Building X and Building Y, including meals and various support services. The services available to residents of Building X and Building Y do not include continual or frequent nursing, medical, or psychiatric services although, under the lifetime lease option, certain residents are assured that they will receive continual or frequent nursing, medical, or psychiatric services in Building Z if required.

HOLDING

Thus, under the principles set forth above, Buildings X and Y would be residential rental property [and qualified as residential rental units under IRC §42(d)]. Continual or frequent nursing, medical, or psychiatric services are made available to residents of Building Z in addition to the same non-housing services that are made available to residents of Building X and Building Y. Thus, under the principles set forth above, Building Z would not be a residential rental property.

Development Fees

Developer Fee Defined

Generally, a developer fee represents payment for the developer's services and is (at least in part) includable in eligible basis. There are three basic types of developer fees.

Turnkey Project Fee

The taxpayer (usually a partnership) enters into a development agreement with a developer to pay an amount that includes all hard construction costs and the developer's fee. For example, the development agreement requires a payment of $2 million with the estimated hard costs of the project budgeted at $1,200,000. If the actual costs are consistent with the budgeted amounts, then the developer will have earned a fee of $800,000. If the actual costs exceed the budget, the development fee would decrease.

Fixed Amount Development Fee

A fixed amount developer fee occurs when the "hard costs" and the developer fee are separately stated line items in the contract. For example, $1 million of estimated hard costs with a developer fee added in a fixed amount of $150,000. Unlike a turnkey agreement, the developer fee does not decrease if the hard costs exceed the budgeted amount.

Completed Project Developer Fee

A completed project developer fee is passed on to the ultimate purchaser of the building as a component of the purchase price. The purchase price includes all the components (land, new construction, acquisition of and existing building, rehabilitation costs, and development fee), but the individual components may not be separately stated.

Related Parties

Typically, the developer will be the general partner (or managing general partner) of the partnership owning the project. The developer may also be related to the entity that actually constructed the project or the property management company operating the project. The inter-relationships need to be identified and understood, as these relationships will affect how transactions are conducted and documented.

While there are specific relationships noted throughout IRC §42, taxpayers are considered related for audit purposes if:

- an adjustment made to one return requires corresponding adjustments to the other return to ensure consistent treatment (see also IRC §§ 1313(c) and 267), or
- tax returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

Audit Issues & Techniques

There are four basic issues to consider when examining the developer fee.

- Character of the services to be provided,
- Services actually provided,
- Reasonableness of the fee amount, and
- Method of payment.

To address these issues:

- Review the development agreement or contract. Generally, the contract will outline all the anticipated responsibilities and remedies if the developer fails to perform according to the agreement. It should also disclose the payment terms. Typically, there will be payments at specific times during development and when development is completed. The developer may also have agreed to defer payment of a portion of the fee.
- If the developer agreed to defer payment, review the developer fee note and/or other applicable documents(s) evidencing the debt. The note and/or applicable document(s) will outline the terms (amount, interest, payment schedule, etc.) for payment of the deferred fee.
- Review the taxpayer's book and records to identify payment of the fee. If the developer agreed to defer a portion of the fee, determine whether payments been made and/or interest accrued according to the terms of the agreement.

Issue 1: Character of the Services to be Provided

The development services to be provided will be identified in the agreement entered into by the taxpayer and the developer. This contract, as well as any supporting documentation, should be reviewed to determine what services the developer expected to perform. Typically, the developer agrees to provide (or may have previously provided) services related to the acquisition, construction, and initial operating phases of development.

Development Costs Includable in Eligible Basis

Examples of services typically includable in eligible basis include, but are not limited to:

- Negotiating agreements for architectural, engineering, and consulting services, the construction of the low-income housing (including interiors) or improvements includable

in eligible basis, and the furnishing of the associated supplies, materials, machinery or equipment.
- Applying for and maintaining all government permits and approvals necessary for the construction of the project and securing the certificates of occupancy (or other equivalent documents) when completed.
- Complying with the requirements imposed by insurance providers during construction.
- Providing oversight, including inspections during the course of construction and approving eventual payment for the services rendered.
- Implementing the taxpayer's decisions made in connection with the design, development, and construction of the project.

See Appendix C for the treatment of specific costs not identified here.

Developmental Costs Not Includable in Eligible Basis

Development of a low-income project involves services that are not associated with the low-income buildings and, therefore, the costs are not includable in eligible basis. Typical services include (but are not limited to):

- Acquiring the project site. Specific activities may include locating suitable sites, performing economic and feasibility studies, market studies, and negotiating the purchase price. The developer may be involved in the purchase (settlement and closing) for a selected site and be responsible for holding and maintaining the site until construction begins. Note: a portion of the purchase price may be included in eligible basis if the purchase included the acquisition of a building that is subsequently rehabilitated for use as low-income residential rental property.
- Maintaining contracts, books and records sufficient to establish the value of the completed project.

Negotiating Financing

A developer may advise the taxpayer regarding available sources of financing, such as federal, state or local subsidy programs, as well as commercial financing. The developer may also negotiate the terms of the financing with lenders or secure financing. See "Cost of Securing Financing" on page 8-27.

Partnership Costs

Services associated with the partnership's organization, syndicating partnership interests, or securing an allocation of IRC §42 credit, are not includable in eligible basis. These costs are discussed in detailed later in this chapter.

Initial Lease-Up Costs

Because of the developer's expertise, the taxpayer may contract with the developer to complete the initial leasing of the rental units. Typical costs include (but are not limited to) hiring on-site

managers and trained staff, advertising, and maintaining model units. These costs are not includable in eligible basis. Instead, the costs should be amortized over the life of the lease if long term. If the lease is for a short term, typically at least six months but no more than one year for low-income rental units, then the costs should be amortized over the period necessary for completing the initial leasing of all the rental units.

On-Going Management Costs

The developer may also contract to provide on-going management of the day-to-day operations of the project after the initial lease-up. Typical services include providing qualified on-site project managers, physically maintaining the project site, resolving tenant issues, renewing leasing and securing new tenants, including the completion of income certifications for low-income households. The manager will have authority to collect rents, make deposits, and pay expenses below specified dollar criteria without the taxpayer's approval. The management services may also provide for the creation of books and records sufficient to accurately report rental income and period expenses on the taxpayer's federal income tax return. These costs should be expensed and matched against current rental income.

Issue 2: Services Actually Provided

The second issue to consider is whether the developer actually performed the services. While it is generally expected that one developer will initiate development and then provide services throughout the development process until the project is completed, there are instances where more than one developer is involved.

Concurrent Developers

Multiple developers may be involved at the same time. For example, a for-profit developer may work with a qualified nonprofit organization to develop a low-income project qualifying for a credit allocation under IRC §42(h) (5). When there are multiple developers, there are two basic questions:

- How were developmental responsibilities divided among the developers? For example, responsibilities may be assigned based on the developers' areas of expertise.
- Did the developer have the skills and expertise needed to provide developmental services and complete the project?

Consecutive Developers

A developer may not be able to complete a project and the taxpayer will hire a new developer. Under these circumstances, it is important to understand why the developer could not complete the project, what services each developer performed, and how the developers were paid.

Issue 3: Reasonable Fee

While the absolute value of the fee can be large, the developer bears the equally large financial risk of failure. As a best practice, the state agencies have limited the developer fee amount that can be supported by the credit. While the methodologies differ, the state agencies generally limit the fee to a percentage of total costs. The IRS is not compelled to accept the developer fee amount allowed by the state agency and may raise issues involving the reasonableness of the fee amount if the facts and circumstances warrant doing so.

Issue 4: Method of Payment

Developer fee payments made during development, or at the time development is completed, and which are identified in the taxpayer's books as payments of developer fees are (generally) not challenged. Deferred fees, however, require further consideration.

Performance of Additional Services

- Because the developer may be (or is related to) the general partner, consider whether the payment is contingent upon providing services usually associated with the duties of a general partner.
- Because the developer may be (or is related to) the entity operating the low - income project, consider whether payment of the developer fee is contingent on successfully operating the project, or maintaining the project in compliance with IRC §42.

If the above fact patterns exist, separately or in combination, then the deferred portion of the developer fee is not includable in eligible basis because the developer is being paid for services unrelated to the development of the low-income building.

Intent to Pay Deferred Developer Fee

In some cases, the terms and conditions of the deferred developer fee note and/or other documents may suggest that the taxpayer does not intend to pay the deferred fee. This issue is particularly important to address if the parties to the transaction are related. Consider whether:

- the note and/or other documentation bears no interest rate or no payment is required for extended periods of time, suggesting that the agreement is not an arm's length transaction,
- payment is contingent on events unlikely to occur,
- payment is subordinate to payment of other debt, and it is unclear that payment would ever be financially possible,
- the developer holds a right of first refusal to purchase the property for a price equal to the outstanding debt, or
- the general partner, who is (or is related to) the developer, is required to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date.

If the above fact patterns exist, separately or in combination, the deferred developer fee note may not be bona fide debt.

Analysis of Debt

An extended discussion of bona fide debt is included here. See also Chapter 10.

Recourse or Nonrecourse Debt

Generally, debt, whether recourse or nonrecourse, is includable in the basis of property. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1, 11 (1947). However, the obligation must represent genuine, noncontingent debt. Nonrecourse debt is not includable if the property securing the debt does not reasonably approximate the principal amount of the debt, or if the value of the underlying collateral is so uncertain or elusive that the purported indebtedness must be considered too contingent to be includable in basis.

Recourse liabilities are generally includible in basis because they represent a fixed, unconditional obligation to pay, with interest, a specified sum of money. However, the mere fact that a note is recourse on its face is not determinative. For example, an obligation, whether recourse or nonrecourse will not be treated as a true debt where payment, according to its terms, is too contingent or repayment is otherwise unlikely. A liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.

Genuine Indebtedness

When considering whether transactions characterized as "loans" constitute genuine indebtedness for federal tax purposes, the courts have isolated a number of criteria from which to judge the true nature of an arrangement which in form appears to be debt. In *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3rd Cir. 1968), the court enumerated the following sixteen nonexclusive factors that bear on whether an instrument should be treated as debt for tax purposes:

- The intent of the parties;
- the identity between creditors and shareholders;
- the extent of participation in management by the holder of the instrument;
- the ability of the debtor to obtain funds from outside sources;
- thinness of capital structure in relation to debt;
- the risk involved;
- the formal indicia of the arrangement;
- the relative position of the obligees as to other creditors regarding the payment of interest and principal;
- the voting power of the holder of the instrument;
- the provision of a fixed rate of interest;
- a contingency on the obligation to repay:
- the source of the interest payments;
- the presence or absence of a fixed maturity date;
- a provision for redemption by the corporation;
- a provision for redemption at the option of the holder; and
- the timing of the advance with reference to when the taxpayer was organized.

As the *Fin Hay* court noted, "Neither any single criterion nor any particular series of criteria can provide an exclusive answer in the kaleidoscopic circumstances which individual cases present." The Sixth Circuit cited *Fin Hay* with approval in *Indmar Products Co., Inc. v. Commissioner*, 444 F.3d 771, (6th Cir. 2006), confirming that "[t]he various factors…are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." The Tax Court has also held that the case-enumerated factors are merely aids to determining whether a given transaction represents genuine debt. *Nestle Holdings, Inc., v. Commissioner*, T.C. Memo, 1995-441.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that may be considered when making such a determination are:

- whether there is an unconditional promise on the part of the taxpayer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonable foreseeable future,
- whether the lender has the right to enforce the payment of principal and interest,
- whether the lender's rights are subordinate to rights of general creditors,
- whether the instruments give the lender the right to participate in the management of the issuer (in this case, the IRC §42 project),
- whether the taxpayer is thinly capitalized,
- whether the lender (stockholders or partners) is related to the taxpayer,
- the label placed upon the instrument by the parties, and
- whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in Goldstein v. Commissioner, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

- a note or other evidence of indebtedness exists,
- interest is charged,
- there is a fixed schedule for repayments,
- any security or collateral is requested,
- there is any written loan agreement,
- a demand for repayment has been made,
- the parties' records, if any, reflect the transaction as a loan any repayments have been made, and
- the borrower was solvent at the time of the loan.

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction to be a loan.

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. See *Fisher v. Commissioner*, 54 TC 905 (1970).

In *Story v. Commissioner*, 38 TC 936 (1962) the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligation. However, the Commissioner, in C.B. 1965-1, 4, limited his acquiescence in this case to the factual nature of that particular case. See Rev. Proc. 65-4, C.B. 1965-1, 720.

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner*,

42 TC 936 (1964), in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will "continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor…where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received…" Action on Decision, 1976 A.O.D. LEXIS 364.

Related Party Transactions

In the typical fact pattern for IRC §42 projects, both the general partner of the taxpayer (the purported debtor) and the developer (the purported creditor) are controlled by the same entity (or may be the same entity). Where borrowing transactions occur between related entities rather than as arm's length, they are "subject to particular scrutiny because the control element suggests the opportunity to contrive a fictional debt." *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998). Stated another way, where "the same persons occupy both sides of the bargaining table," the form of a transaction "does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will" in order "to create whatever appearance might be of…benefit to them despite the economic reality of the transaction." *Geftman*, 54 F.3d 61 at 75, citing *Fin Hay Reality v. United States*, 398 F.2d 694, 697 (3d Cir. 1968). Accord, *Anchor Natl. Life Ins. Co. v. Commissioner*, 93 T.C. 382, 407 (1989).

As the *Geftman* Court explained, "[t]he rule in *Fin Hay* accords with the general principle that tax consequences must be determined not from the "form of the transaction," but from its "true substance." *Geftman*, 154 F.3d at 75. Thus, "a transaction must be measured against an objective test of economic reality and characterized as a bona fide loan only if its intrinsic economic nature is that of a genuine indebtedness." Where the transaction is not the project of an arm's length relationship, much less weight is accorded to the factors relating to the form of the transaction than to those factors that go to the substance of the arrangement. See *Laidlaw v. Commissioner*, T.C. Memo. 1998-232; 75 TCM (CCH) 2598, 2617.

Intrinsic Economic Nature

In form, the deferred developer fee will be structured as a promissory note or other debt instrument. However, given the relationship between the parties, a court may accord little weight to the form of the transaction. Instead, the essential question is whether the instrument's "intrinsic economic nature is that of a genuine indebtedness."

1. Independent Creditor Test

Consider the substantive terms of the alleged debt. For example, the note does not provide for installment payments; rather, the note is due and payable only after a extended period of time. It is only payable after all the taxpayer's operating expenses and all other sums due are paid. The debt is nonrecourse and unsecured. In the event of default, the note holder's sole remedy is a judgment against the taxpayer, to be collected against whatever assets (if any) the taxpayer has at the time of default. Despite these unusually generous terms, the debt is interest-free.

The acid test of the economic reality of a purported debt is whether an unrelated outside party would have advanced funds to the borrower under like circumstances. *Fischer v. U.S.*, 441 F.Supp. 32, 28 (1977). It is highly unlikely that an outside lender would have advanced funds to a taxpayer under the terms described above. Generally, creditors avoid subjecting funds to the risk of the borrower's business as much as possible and seek a reliable return. See *Laidlaw*, T.C. Memo 1998-232. Commercial lenders thus impose borrowing terms that ameliorate risks and charge interest rates that are reasonably calculated to compensate for those risks and provide a reasonable return on the lender's investment. As described above, none of the note terms suggest any effort to limit risks. The note is due and payable far in the future. There are no installment payments due in the interim. The note is subordinated to other debt and is only payable after all the taxpayer's operating expenses have been paid. The note is unsecured and nonrecourse. An economically motivated lender would charge significant interest to account for these risks, but the deferred developer fee note considered here is interest-free. Altogether, these features indicate that the debt instrument's "intrinsic economic nature" is not that of genuine debt.

2. Debt-Equity Ratios

Another factor that can indicate an absence of substance to purported debt is thinness of the taxpayer's capital structure relative to accumulated debt. *Fin Hay*, 398 F.2d 694, 696; *Laidlaw*, 75 TCM (CCH) at 2620. Courts generally consider a borrower's debt to equity ratio and other financial data in deciding if it is thinly capitalized. *Tyler .v Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969). A taxpayer's thin capitalization adds to the evidence that a deferred developer fee is not genuine debt. However, even if the taxpayer's capital structure were more robust, that alone, especially in light of the highly favorable terms of the debt, would not necessarily tip the balance in favor of treating a deferred developer fee as described above as genuine debt.

3. Potential Sources of Repayments

A related factor when considering the substance of the transaction is the taxpayer's ability to repay the advance and the reasonable expectation of the repayment. *Laidlaw*, 75 TCM (CCH) at

2624. Normally, there are four such possible sources: (1) liquidation of business assets, (2) profits, (3) cash flow, and (4) refinancing with another lender. "The burden is on the taxpayer to establish this, of course, and such a conclusion must be based on concrete facts and sound assumptions about the [taxpayer's] future." *Fischer v. United States*, 441 F.Supp 32, 39 (1977).

Consider the taxpayer described in TAM 200044004, which was a partnership formed to construct, develop, and operate a low-income housing tax credit property. The taxpayer's managing partner was related to other parties, including the developer. The other general partner was a nonprofit corporation. At completion of the construction, the taxpayer did not have sufficient funds to pay the entire development fee so it issued a note for the balance owing. The note was payable at maturity, 13 years from completion of the project. The note was unsecured and source-of-payment restrictions were in effect during the term of the note. Payment was subordinate to other debts. The note bore interest which was compounded annually and added to the unpaid principal during the term of the note. The taxpayer was obligated to pay off the note in full at maturity and the general partners were obligated to make additional capital contributions necessary to pay off the note at maturity. Financial statements also indicated that payments had been made on the note.

The TAM concluded that the amount of the developer fee note was includable in the building's eligible basis. The note was an obligation on the part of the taxpayer to pay a fixed amount, with interest, at maturity. Although payments were contingent on cash flow or receipts from capital transactions prior to maturity, all remaining principal and accrued interest were payable at maturity. Also, although sources of payment were contingent, and the developer could not foreclose on any security interest in any specific asset, the general partners were obligated, at maturity, to contribute an amount sufficient to pay off the note in full. Repayment of the note was also backed by the equity the taxpayer had in the assets beyond the general partners' guarantee. In other words, it appeared the taxpayer has sufficient equity and assets to repay the note.

Critical to the determination in the TAM was the fact that the note bore interest to compensate the lender for the various financial risks posed by the note. The TAM cites an excerpt from *Gibson Products v. United States*, 637 F.2d 1041 (5th Cir 1981), in which the court stated that, "the single most important factor dictating that the transaction…was not a true loan is the fact that the total combined assets….were not sufficient to pay the note on or before the maturity date…absent production from any of the leases." 637 F.2d at 1047.

Court Case: Substantiation of Services Performed

In *Carp & Zuckerman v. Commissioner*, the Tax Court concluded that the taxpayers failed to prove that they performed the development services specified in the agreement. The Court explained that the taxpayer bears the burden of proving that the developer fee constituted a qualified expenditure and that it was inappropriate to apply the rule found in *Cohan v. Commissioner*. See Appendix I.

Summary

Ultimately, the burden is on the taxpayer to demonstrate that the developer fee was earned and is includable in eligible basis. If the taxpayer has deferred payment, the taxpayer will also need to demonstrate the deferred fee is bona fide debt. For related party transactions, when a court may accord little weight to the form of the transaction, the intrinsic economic nature of the transaction must be considered; i.e., would an unrelated outside lender advanced funds to the taxpayer under like circumstances? Particularly when the absence of interest provisions (or very low interest rates), unsecured, nonrecourse, subordinated, balloon payment would normally dictate a significant interest rate in a commercial setting to compensate the lender for the associated risks.

Partnership Costs

Partnership costs are not includable in eligible basis. Because the taxpayer may have included partnership costs in the development costs, the taxpayer's books and records should be reviewed.

Organizing Costs

Generally, IRC §42 projects are owned by partnerships. The cost of organizing a partnership is amortized over a period of time not less than 60 months under IRC §709(b) and is not includable in eligible basis. Organizational costs include associated legal and accounting fees for preparing legal documents and contracts, making required regulatory filings, etc.

Syndication Costs

Syndication costs are incurred for the marketing and selling of partnership interests. Expenses include the preparation of offering memorandums and promotional materials, broker fees and commissions, legal fees, and due diligence costs. None of these costs are includable in eligible basis. Under IRC §709, these costs are capital costs that are not currently expensed or amortized, nor includable in the basis of the property for purposes of depreciation.

IRC §42 Credit Allocation Costs

Credit allocation costs are incurred to secure an allocation of IRC §42 credit. These costs are not capitalized to the low-income buildings' adjusted basis and, therefore, are not includable in eligible basis. Activities related to credit allocation costs include (but are not limited to):

- Reviewing the state agency's qualified allocation plan, which identifies the state's housing priorities (IRC §42(m) (1) (B) and (C)) and locating qualifying sites.
- Conducting a comprehensive market study of the housing needs of low-income individuals in the area to be served by the project. IRC §42(m)(1)(A)(iii) specifies that the market study is to be conducted before the credit allocation is made and at the developer's expense by a disinterested party approved by the state agency.
- Notifying the chief executive officer (or the equivalent) of the local jurisdiction where the project is to be located and providing the individual with a reasonable opportunity to comment on the project. The notification may also include town meetings with the community. IRC §42(m) (1) (A) (ii) requires state agencies to make this notification, but the requirement is often delegated to the developer.

- Preparing and submitting a detailed proposal to the state agency describing the project, estimating costs, and identifying sources of financing (including federal, state and local subsidies). The amount of equity expected to be generated by reason of the IRC §42 credit must also be disclosed. See IRC §42(m) (2). In addition, the proposal will include information required by the state agency.
- Paying application and/or allocation fees to the state agency. See Rev. Rul. 2004-82, Q&A #3.

Depending on the facts, all or a portion of these costs may be required to be capitalized as amounts paid to create an intangible asset. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections.

Cost of Securing Financing

The IRC §42 project will most likely need additional funding in addition to the equity investment by limited partners. The sources may vary, but generally the cost of securing the funding is not includable in eligible basis. Instead, the cost is amortized over the life of the funding as an amortizable IRC §167 intangible. See TAM 200043015, which cites *Enoch v. Commissioner,* 57 T.C. 781, 794-5 (1972), acq. on this issue, 1974-2 C.B. 2. See also Rev. Rul. 70-360, 1970-2 C.B. 103, Rev. Rul. 75-172, 1975-1 C.B. 145, and Rev. Rul. 81-160, 1981-1 C.B. 312.

Common costs include:

- Interest on bridge or construction loans,
- Permanent loan credit enhancement,
- Permanent loan origination fees and closing costs,
- Recording and title insurance costs, and
- Reserves required by lender.

Under IRC §263A, however, the allocable portion of indirect costs of real or tangible personal property produced by a taxpayer during the construction period are generally capitalized to the property produced; i.e., costs that directly benefit or are incurred by reason of the performance of production activities. To the extent the costs are allocated and capitalized under IRC §263A to property produced that qualifies for eligible basis, these capitalized costs are includable in eligible basis. For example, while the interest on a bridge or construction loan is generally not includable in eligible basis, the interest incurred during the construction period that is capitalized as an indirect cost under IRC §263A is includable in eligible basis.

Cost of Issuing Tax-Exempt Bonds

The costs associated with issuing tax-exempt bonds (bond issuance costs) are not includable in eligible basis, even if the same costs are capitalized under IRC §263A.

Bond costs include:

- fees assessed by the state agency,
- state board fees,
- rating agency fees,
- trustee fees,
- underwriter fees,
- investment fees,
- legal counsel fees,
- bank inspector fees, and
- costs for photos, prints, and renderings.

TAM 200043015 provides the rationale for excluding all bond issuance costs from eligible basis. As explained in the TAM, Congress determined that bond issuance costs are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the bond offering. Characterizing a certain portion of bond issuance costs under IRC §263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Further, permitting an IRC §263A characterization of bond issuance costs to control for purposes of IRC §42 would result in the disparate treatment of the term "residential rental property" between IRC §§ 42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42 that requires that residential rental property have the same meaning for purposes of both IRC §§ 42 and 142.

Computing Adjustments to Eligible Basis

Nonqualifying Costs

The examination of eligible basis fundamentally requires consideration of five issues:

- character of the assets,
- cost of the assets,
- when the cost was paid or incurred,
- whether costs were reasonably allocated among the assets, and
- whether the assets are in continuous use during the entire 15-year compliance period.

Based on the examination results, the dollar value of assets included in eligible basis should be adjusted.

Example 1: Impermissible Costs Included in Eligible Basis

A taxpayer claimed IRC §42 credit based on qualifying costs of $10,000,000. The examiner made the following adjustments:

- $75,000 - the expense was paid to an accountant to prepare the application submitted to the state agency to secure an allocation of credit. The $75,000 included the cost of the market study required under IRC §42(m) (1) (A) (iii) and preparing the three cost certifications required under IRC §42(m) (2) (A).

- $100,000 – the expense was a contingency fee included in the construction contract that was not paid during the period prescribed in the contract.
- $450,000 – the taxpayer included the entire $1,500,000 developer fee in eligible basis. The adjustment was made to account for services provided by the developer to find and purchase the land, organize the partnership, and secure the allocation of credit.
- $35,000 – the expense was for the construction of a swimming pool, considered common area that was timely placed in service, but later proved to be too expensive to operate. The taxpayer filled in the pool.
- $40,000 – the taxpayer could not document that costs were associated with qualifying assets or that the expenses were actually incurred.

The total adjustment is $700,000. The actual eligible basis is $10,000,000 - $700,000 = $9,300,000.

Reductions and Limitations

Once the actual costs includable in eligible basis are determined, specific reductions and limitation are considered. If the taxpayer acquired and rehabilitated an existing building, refer to Chapter 9. Otherwise, the next step in the examination of eligible basis is an analysis of the taxpayer's financial resources. See Chapter 10.

Summary

This chapter focused on determining the dollar value of assets includable in eligible basis.

Eligible basis is defined, generally, as depreciable residential rental property. IRC §§ 103 and 168 are the primary Code references, as well as specific criteria provided by IRC §42. Depreciable basis includes costs capitalized to the property under IRC §§ 263(a) and 263A.

Eligible basis includes the costs associated with the residential rental units, common areas provided as amenities, functionally related facilities, community service facilities, facilities used to provide supportive services for the homeless, and land improvements (under limited circumstances).

A low-income building's eligible basis is its adjusted basis at the end of the first year of the building's credit period, not at the time the building is placed in service.

Eligible basis does not include costs expensed under IRC §179.

The analysis of eligible basis begins by reconciling the eligible basis reported on Forms 8609 and 8609-A, followed by a review of the final cost certification presented to the state agency. Based on this review, specific costs can be identified as large, unusual, or questionable items and the audit scope established.

Verification of the costs included in eligible basis includes consideration of the character and cost of the asset, as well as when the cost was paid or incurred. Consideration should also be

given to whether costs were reasonably allocated among the qualifying assets and whether the assets were continuously in service during the building's 15-year compliance period.

The developer fee represents the developer's profit and may be includable in eligible basis. The four primary issues to consider are the character of the services provided, services actually provided, reasonableness of the fee amount, and the method of payment.

Certain costs are not includable in eligible basis; e.g., the cost of organizing a partnership and syndicating partnership interests. The cost of securing an allocation of IRC §42 credit is also excluded.

The costs of securing financing generally do not qualify as eligible basis; these costs are amortized over the life of the funding under IRC §167. To the extent these amortized costs are allocable to property produced during the construction period under IRC §263A, the allocable costs are includable in eligible basis. However, costs associated with issuing tax-exempt bonds are not includable in eligible basis, even if the same costs are capitalized under IRC §263A.

Chapter 9 Eligible Basis: Acquisition and Rehabilitation of Existing Buildings

Introduction

If the taxpayer acquired an existing building and rehabilitated it for use as low-income housing, then additional criteria must be met to qualify for the IRC §42 credit. New buildings are defined in IRC §42(i) (4) as buildings for which the original use begins with the taxpayer. Existing buildings are defined in IRC §42(i) (5) as buildings that are not new buildings.
Under specific conditions, credit can be allocated for both the acquisition and rehabilitation of an existing building. Two separate allocations of credit will be made and documented on separate Forms 8609, Low-Income Housing Credit Allocation and Certification. The type of allocation will be identified on line 6.

Topics

- Acquisitions of Existing Buildings
- Substantially Rehabilitated Buildings
- Acquiring a Low-Income Building Before the End of the Compliance Period
- Acquiring a Low-Income Building During the First Year of the Credit Period
- Acquiring a Low-Income Building Before the Place in Service Date Summary

Acquisition of Existing Buildings

IRC §42(d) (2): Existing Buildings

Generally, the eligible basis of an existing building is its adjusted basis as of the close of the first taxable year of the building's credit period if the taxpayer's acquisition of the building meets all

four requirements explained in this section. See IRC §42(d) (2) (B). If the acquisition does not meet all four requirements, then the eligible basis is zero. See IRC §42(d) (2) (A) (ii). The adjusted basis of an existing building does not include the basis of the building as determined by reference to the basis of other property held at any time by the person acquiring the building. See IRC §42(d) (2) (C).

Requirement 1: Acquisition by Purchase

The building is acquired by purchase as defined in IRC §179(d)(2), which defines the term "purchase" as any acquisition of property, but only if:

- The property is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under IRC §§ 267 or 707(b). However, when applying IRC §267(b) and (c) for purposes of IRC §179(d), IRC §267(c)(4) is treated as providing that the family of an individual shall include only his/her spouse, ancestors, and lineal descendants,
- The property is not acquired by one component member of a controlled group from another component member of the same controlled group, and
- The basis of the property in the hands of the person acquiring it is not determined (1) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (2) under IRC §1014(a) (relating to property acquired from a decedent).

For buildings acquired before July 31, 2008, IRC §179(d) is applied by substituting "10 percent" for "50 percent" in IRC §§179(d) (7), 267(b), and 707(b).

Requirement 2: Last Placed in Service

For buildings placed in service before July 31, 2008, there is a period of at least 10 years between the date of its acquisition by the taxpayer and the later of (1) the date the building was last placed in service, or (2) the date of the most recent nonqualified substantial improvement of the building

A "substantial" improvement is an improvement added to the capital account of a building during any 24-month period, but only if the sum of the amounts added to the account during this period equals or exceeds 25% of the adjusted basis of the building (determined without regard to IRC §1016(a) (2) and (3)) as of the first day of such period. The date of a substantial improvement is the last day of the 24-month period.

A "nonqualified substantial improvement" is any substantial improvement if IRC §167(k), as in effect on November 4, 1990, the day before the date of enactment of the Revenue Reconciliation Act of 1990, was elected for the improvement or IRC §168, as in effect on October 22, 1986, the day before the enactment of the Tax Reform Act of 1986, applied to such improvement.

Consideration of the building's most recent nonqualified substantial improvement was removed when IRC §42(d) (2) (B) was amended as part of the Housing Assistance Act of 2008. As a

result, for buildings placed in service after July 30, 2008, the determination is limited to whether there is a period of at least 10 years between the date of its acquisition by the taxpayer and the date the building was last placed in service.

When determining when a building was last placed in service for purposes of the 10- year requirement, certain placed in service events taking place within the 10-year period are ignored. These include a placement in service:

- in connection with the acquisition of a building in a transaction in which the basis of the building in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such building in the hands of the person from whom acquired;
- of a building by a person whose basis in the building is determined under IRC §1014(a) (relating to property acquired from a decedent);
- of a building by any governmental unit or qualified nonprofit organization (as defined in IRC §42(h)(5)) if the requirements of IRC §42(d)(2)(B)(ii) are met with respect to the placement in service by such unit or organization and all the income from such property is exempt from Federal income taxation;
- of a building by any person who acquired the building by foreclosure (or by instrument in lieu of foreclosure) of any purchase-money security interest held by such person if the requirements of IRC §42(d)(2)(B)(ii) are met with respect to the placement in service by such person and such building is resold within 12 months after the date such building is placed in service by such person after such foreclosure; or
- of a single-family residence by any individual who owned and used such residence for no other purpose than as the individual's principal residence.

In addition to the rules described above, IRC §42(d) (6) provides a special exception that makes the 10-year requirement under IRC §42(d) (2) (B) (ii) inapplicable. Qualifying buildings include:

- Any "federally-assisted building" or "state-assisted building" placed in service after July 30, 2008. A federally-assisted building is any building substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d) (3), 221(d) (4), or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture. A state-assisted building is any building substantially assisted, financed, or operated under any state law similar in purposes to any of the laws referred to above for federally-assisted buildings.
- Buildings acquired from insured depository institutions in default. On application by the taxpayer, the IRS may wave the requirement for any building acquired from an insured depository institution in default, as defined in section 3 of the Federal Deposit Insurance Act [12 USCS §1813], or from a receiver or conservator of such an institution.

Requirement 3: Previously Placed in Service by the Taxpayer

The building was not previously placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer as of the time previously placed in service. A person (the "related person" for purposes of this sentence) is related to any person if the related person bears a relationship to such person specified in IRC §§ 267(b) or 707(b) (1), or the related person and such person are engaged in trades or businesses under common control (within the meaning of IRC §52(a) and (b)). See IRC §42(d) (2) (D) (ii). For buildings placed in service on or before July 30, 2008, "10%" is substituted for "50%" when applying IRC §§ 267(b) or 707(b) (1).

Requirement 4: Substantial Rehabilitation

IRC §42 credit is allowable under IRC §42(e) for costs associated with the substantial rehabilitation of a building; i.e., the taxpayer acquired and substantially rehabilitated an existing building. Substantial rehabilitations are discussed in the next section.

Audit Issue: Artificially Inflated Purchase Price

In an attempt to secure a larger allocation of credit, a taxpayer may attempt to artificially increase the adjusted basis of an acquired building. Consider the case of *Corbin West Limited Partnership*, in which the Tax Court reasoned that because there was no reasonable likelihood that Corbin West would pay off the note, the note lacked economic substance and was not includable in the property's basis. The taxpayer was not entitled to depreciation deductions or low-income housing credits related to the note. See Appendix G.

Substantially Rehabilitated Buildings

Under IRC §42(e)(1), the costs paid or incurred by the taxpayer for rehabilitating a building are treated as a new building separate from the cost of acquiring the building.

Rehabilitation Expenditures Defined

Under IRC §42(e) (2), "rehabilitation expenditures" are:

- amounts chargeable to a capital account, and
- incurred for property (or additions or improvements to property) that is depreciable, and
- incurred in connection with the rehabilitation of a building. Rehabilitation expenditures do not include the cost of acquisition.

Substantial Improvements: Minimum Expenditures to Qualify

Under IRC §42(e) (3), a minimum amount of rehabilitation expenses must be incurred to be treated as a new building under IRC §42(e) (1).

First, the rehabilitation expenses must be allocable to one or more rental units, or substantially benefit the rental units; e.g., the common area or a facility necessary for the operation of the project.

Second, the rehabilitation expenditures incurred during any 24-month period must meet the greater amount of either:

- Not less than 20% of the adjusted basis of the acquired building (determined as of the first day of the 24-month period), without regard to IRC §1016(a)(2) or (3), or
- The qualified basis (applicable fraction x eligible basis) attributable to the rehabilitation costs, when divided by the number of low-income units in the building, is $6,000 or more. In other words, the average rehabilitation cost associated with each low-income unit must be at least $6,000.

The above expenditure values used to determine whether the minimum rehabilitation expenditure requirement is met were added by the Housing Assistance Tax Act of 2008. Substitute 10% for 20% and $3,000 for $6,000 if:

- The taxpayer received the allocation of credit before July 31, 2008 (as documented on Form 8609, line 1a), or
- The building was financed by tax-exempt bonds issued before July 31, 2008. Buildings financed with tax-exempt bonds are identified on Form 8609, line 4. Further documentation from the taxpayer is needed to determine when the bonds were issued.

The $6,000 average rehabilitation cost is also adjusted for inflation if the 24-month period ends during any calendar year after 2009. Under IRC §42(e)(3)(D), the $6,000 amount is increased by an amount equal to $6,000 multiplied by the cost-of-living adjustment under IRC §1(f)(3) for the calendar year by substituting "calendar year 2008" for "calendar year 1992" in IRC §1(f)(3)(B). Any increase which is not a multiple of $100 is rounded to the nearest multiple of $100.

Buildings Acquired from a Government Unit

Under IRC §42(e) (3) (B), there is an exception to the minimum rehabilitation expenditure requirement when the building is acquired from a government unit. The taxpayer can elect to satisfy the minimum rehabilitation requirement solely by reference to IRC §42(e) (3) (A) (ii) (II); i.e., the taxpayer must incur an average $6,000 rehabilitation cost per low-income unit (subject to inflation). However, use of this exception requires that the 30% applicable percentage under IRC §42(b) (1) (B) (ii) be used to compute the credit for the rehabilitation expenditures.

Placed in Service Date

Under IRC §42(e) (4) (A), expenditure qualifying as "substantial rehabilitation" are treated as placed in service at the close of the 24-month period. The 24-month period is determined by the taxpayer.

Costs Included in Eligible Basis

Once a determination has been made that the taxpayer substantially rehabilitated an existing building, the taxpayer can treat all the rehabilitation costs as a separate new building. Under IRC

§42(d) (1), the eligible basis for a new building is its adjusted basis as of the close of the first year of the credit period.

Audit Issues and Techniques

Compliance with the minimum expenditures requirement is determined on a building-by-building basis.

- The taxpayer should be asked to demonstrate that the test was met for the 24- month selected by the taxpayer, and
- After accounting for any adjustments to eligible basis, compliance with the minimum expenditure requirement should again be determined, using the same 24-month period selected by the taxpayer.

Acquiring a Low-Income Building Before the End of the Compliance Period

Under IRC §42(d) (7), a taxpayer acquiring an existing IRC §42 low-income building (or interest therein) during the 15-year compliance period steps into the place of the prior owner. As a result, the building is not eligible for a new allocation of credit for acquisition costs and the taxpayer is expected to maintain the building as an IRC §42 low-income building for the remainder of the compliance period. The taxpayer may, however, receive an allocation of credit to rehabilitate the building.

Placed in Service

In general, a transfer of the property results in a new placed in service date if, on the date of the transfer, the property is ready and available for its intended purpose. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4) C.B. 91. However, if IRC §42(d)(7) applies, the fact that the transfer results in a new placed in service date does not jeopardize the purchaser's eligibility to claim the low-income housing credit.

Allocation of Credit

Under IRC §42(f) (4), if a building is disposed of during the 10-year credit period and the new owner continues to operate the building as a qualified low-income building under IRC §42(c) (2), the credit is allocated between the prior owner and the new owner on the basis of the number of days during the year the building (or interest) therein was held by each. Note, however, that the parties may allocate the credit according to the number of months each party held the property as provided in Rev. Rul. 91-38, Q&A #5.

Allocation of Recapture Amount

An acquisition of a low-income building during the credit period also requires allocation of the recapture amount should there be a recapture event under IRC §42(j) after the change in ownership.

Audit Issues and Techniques

The eligible basis remains the same, regardless of changes in ownership. One difficulty encountered when auditing the eligible basis of a building acquired during the compliance period is the taxpayer's inability to provide original documentation of the costs incurred by the original owner. See Appendix E for discussion of documentation and record retention requirements.

Acquiring a Low-Income Building During the First Year of the Credit Period

A taxpayer may prefer to acquire an interest in a completed low-income building to avoid the risks of development. It is not uncommon for an equity investor to postpone acquiring a limited partnership interest until after the low-income building is placed in service but before the end of the first year of the credit period.

Application of IRC §42(d) (7)

The credit need not actually have been claimed by a prior owner in order for a subsequent owner to claim the credit under IRC §42(d) (7). If a taxpayer transfers a qualified low-income building (or an interest therein) before actually claiming a credit, but after having received an allocation from a state agency or having qualified for the credit without an allocation (i.e., low-income buildings financed with tax exempt bonds), the credit will be considered allowed to the prior owner.

In the case of buildings financed with tax-exempt bonds under IRC §42(h) (4) (B), therefore not requiring a credit allocation, the credit is considered allowed to the prior owner for purposes of IRC §42(d) (7) (B) (i) when the following conditions are met:

- the tax-exempt obligations have been issued;
- the building has met the requirements for allocation of a housing credit dollar amount under the state agency's qualified allocation plan;
- the governmental unit issuing the bonds has determined the credit dollar amount necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period; and
- the state agency has assigned a building identification number to the building as is done when an allocation of credit is made by the state agency.

For further information, see Rev. Rul. 91-38.

Example

On March 1, 2007, Developer D, a calendar year taxpayer, placed in service a low income building that had received a $20,000 allocation of IRC §42 credit in 2006. The building consisted of 10 low-income units and 2007 is the first year of the credit period. On July 20, 2007, D sold a 99% of its interest in the building to T. At the time of sale, D had not yet claimed any credit with respect to the building for the period before the sale.

Although D had not claimed any IRC §42 credit prior to the sale, the building had received an allocation of IRC §42 credit before the sale of D's interest to T and D would have been allowed to claim credit on the 99% portion of its interest sold if D had retained 100% ownership of the property and had otherwise complied with the requirements of IRC §42. Therefore, under IRC §42(d) (7), T "steps into the shoes" of D to the extent of the acquired 99% interest and may claim the IRC §42 credit that would have been allowable to D on that interest for the period after the acquisition, provided that T complies with the IRC §42 requirements.

For D, the credit is computed as:

[(200/365) x $20,000 x 100%] + [(165/365) x $20,000 x 1%] = $11,049.31

T's share of the credit is computed as:

(165/365) x $20,000 x 99% = $8,950.69

Audit Issues and Techniques

Since eligible basis is not determined until the end of the first year of the credit period, the acquisition of an interest in the building does not, of itself, affect the analysis of eligible basis. However, a transfer under IRC §42(d)(7) should be reviewed to ensure that the allowable credit reflects the period of time the seller and the buyer held an interest in the building and the amount of credit attributable to their respective interests.

Acquiring a Low-Income Building Before the Placed in Service Date

Under certain circumstances, a taxpayer willing to bear the risks of development will invest in a building before the building has been placed in service, but after the building has received an allocation of credit. For example, a developer receives a "carry-over" allocation of credit under IRC §42(h) (1) (E) and begins construction. When partially completed, the developer transfers the building to the partnership intended to own the building and for which the developer is the general partner. Later, at an agreed upon percentage of completion before the building is placed in service, an investor will secure a partnership interest.

Eligible Basis

When ownership of a newly constructed building is transferred before the building is placed in service, the purchaser's eligible basis in the building is equal to the transferor's eligible basis in the building at the time of transfer, regardless of the purchase price. When ownership of a rehabilitated building is transferred before the rehabilitation expenditures are placed in service, the purchaser's eligible basis in the rehabilitation expenditures is equal to the lesser of the rehabilitation expenditures at the time of transfer, or the purchaser's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before that date. See Rev. Rul. 91-38, Q&A #7.

Furthermore, should the purchaser incur additional qualifying costs after the date of transfer, the costs would be added to the purchaser's eligible basis. As a result, when the eligible basis is determined at the end of the first year of the credit period, the eligible basis will consists of the transferor's eligible basis at the time of transfer and any additional qualifying costs incurred by the purchaser after the transfer.

Audit Issues and Techniques

The transferor may have provided a summary of costs qualifying for eligible basis without providing supporting documentation. See Appendix E for discussion of documentation and record retention requirements.

Summary

The eligible basis of an acquired building is its adjusted basis as of the close of the first taxable year of the credit period if; the acquisition of the building meets four requirements:

- The building is acquired by purchase,
- For buildings placed in service before July 31, 2008, there is a period of at least 10 years between the date of its acquisition and the later of (1) the date the building was last placed in service, or (2) the date of the most recent nonqualified substantial improvement of the building. If placed in service after July 30, 2008, the determination is limited to whether there is a period of at least 10 years between the date the building was acquired and the date the building was last placed in service.
- The building was not previously placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer as of the time previously placed in service, and
- the taxpayer substantially rehabilitated the acquired building.

To qualify as "substantially rehabilitated" and have the related expenditures be treated as a separate new building, rehabilitation expenses must meet the greater of:

- Not less than 20% of the adjusted basis of the acquired building (determined as of the first day of the identified 24-month period), or
- The qualified basis attributable to the rehabilitation costs, when divided by the number of low-income units in the building, is $6,000 or more. The required average rehabilitation cost is adjusted for inflation if the 24-month period ends during any calendar year after 2009.

A taxpayer acquiring an IRC §42 low-income building (or interest therein) during the 15-year compliance period steps into the shoes of the prior owner. The eligible basis remains the same, regardless of changes in ownership.

A taxpayer may prefer to acquire an interest in a completed low-income building during the first year of the credit period to avoid the risks of development. The credit need not actually have

been claimed by a prior owner in order for a subsequent owner to claim the credit under IRC §42(d) (7).

When ownership of a newly constructed building is transferred before the building is placed in service, the purchaser's eligible basis in the building is equal to the transferor's eligible basis in the building at the time of transfer, regardless of the purchase price, plus any qualifying costs incurred by the purchaser.

When ownership of a rehabilitated building is transferred before the rehabilitation expenditures are placed in service, the purchaser's eligible basis in the rehabilitation expenditures is equal to the lesser of the rehabilitation expenditures at the time of transfer, or the purchaser's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before that date.

Chapter 10 Eligible Basis: Analysis of Financial Resources

Introduction

The amount of credit allocated to a low-income building is not to exceed the amount necessary to assure the low-income project's financial feasibility throughout the credit period. However, the capital investment generated by the credit is seldom sufficient to cover all the costs of development, including costs not includable in eligible basis and anticipated operational costs.

To determine the amount of credit needed, the state agency will evaluate the taxpayer's financial resources at three critical points in the development of the project:

- When the taxpayer applies for the credit,
- When the credit is allocated (or when the taxpayer received a carryover allocation of credit under IRC §42(h)(1)(E) or (F)), and
- When the low-income buildings are placed in service. This final analysis is usually conducted immediately after the end of the first year of the credit period, when the building's eligible basis is fixed.

For each of these determinations, the taxpayer is required to certify to the state agency the full extent of all federal, state, and local subsidies, and all other sources of funds and development costs that apply (or which the taxpayer expects to apply) with respect to the building.

The final cost certification, which describes all financial resources and federal/state/ local subsidies, should be reviewed as part of the audit of eligible basis. This review is necessary because some financing sources impose specific requirements or restrictions on the credit.

Topics

The following topics are discussed in this chapter:

- Federal Grants

- Low-Income Buildings Financed with Tax-Exempt Bonds
- Below Market Federal Loans
- Nonrecourse Financing and IRC §42(k)(1), At-Risk Rules
- Nonrecourse Financing from a Qualified Nonprofit Organization
- Right of First Refusal to Purchase
- Qualified Contracts
- Bona Fide Debt
- "Not-For-Profit" Rules and Economic Substance
- IRC §45D, New Markets Tax Credit
- Audit Techniques
- Summary

Federal Grants

IRC §42(d) (5) (A) Federal Grants

Under IRC §42(d) (5) (A), a building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant.

- For buildings placed in service before July 31, 2008, all federal grants made to the building (including for the operation of the building) require a dollar-for-dollar reduction of eligible basis.
- If the building was placed in service after July 30, 2008, eligible basis cannot include any costs financed with the proceeds of a federally funded grant.

See Chapter 11 for a detailed discussion.

Low-Income Buildings Financed with Tax-Exempt Bonds

IRC §42(i)(2) provides that a new building is treated as "federally subsidized" if the proceeds of a tax-exempt bond are used (directly or indirectly) with respect to the building or its operation. Federally subsidized buildings are identified on Line 6a or 6d of Form 8609, Low-Income Housing Credit Allocation and Certification. The applicable percentage for these buildings is limited to the 30% applicable percentage under IRC §42(b) (1) (B) (ii).

The percentage of the aggregate basis financed with tax-exempt bonds is identified on Form 8609, Line 4. Under IRC §42(h) (4) (B):

- If 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds that are subject to the IRC §146 volume cap, then the allowable credit is based on the entire eligible basis.
- If less than 50% of the aggregate basis of the building and land on which the building is located is financed with tax-exempt bonds that are subject to the IRC §146 volume cap, then the allowable credit is based on the eligible basis financed with the tax-exempt bonds.

See Chapter 14 for in-depth discussion of the Applicable Percentage.

Below Market Federal Loans

New buildings placed in service before July 31, 2008, are also considered "federally subsidized" under former IRC §42(i) (2) (A) if the proceeds of a below market federal loan, are (or were) used (directly or indirectly) with respect to the building or its operation. Under former IRC §42(i)(2)(D), the term "below market federal loan" is defined as any loan funded in whole or in part with federal funds if the interest rate payable on the loan is less than the applicable federal rate in effect under IRC §1274(d)(1) as of the date that the loan was made. If it can be established that:

- funds loaned to the taxpayer are federally sourced and the interest rate is below the applicable Federal rate at the time the loan is made, and
- costs included in eligible basis are financed with the loan proceeds, then the tax treatment of the funds will be determined based on whether the future value of the IRC §42 project approximates the face value of the loan plus stated interest at the time the loan comes due.

- If the value of the IRC §42 project is equal to, or greater than, the face value of the loan, plus stated interest on the loan, then the funds will be treated as a federal subsidy included in eligible basis and, under IRC §42(b) (1) (B) (ii), the applicable percentage will be reduced from the 70% value to the 30% value. See Chapter 14.
- If the value of the IRC §42 project is less than the face value of the loan, plus stated interest on the loan, then the funds, to the extent they are less than the value of the project, will be treated as a federal grant. As a result, under former IRC §42(d) (5) (A), the eligible basis of the building will be reduced to the extent of the funds that is treated as a grant.

Nonrecourse Financing and IRC §42(k) (1), At-Risk Rules

Under IRC §42(k)(1), "…rules similar to the rules of IRC §49(a)(1), other than subparagraphs (D)(ii)(II) and (D)(iv)(I), IRC §49(a)(2), and IRC §49(b)(1*)* shall apply in determining the qualified basis of any building in the same manner as such sections apply in determining the credit base of property." When applying IRC §49 to the IRC §42(k) at-risk rules, it is important to note that:

- IRC §42 is not specifically referenced in IRC §49, and
- the credit at-risk rules under IRC §42(k) (1) are "similar to," but not exactly the same as, the IRC §49 rules.

Generally, under IRC §49(a) (1), the "credit base" of property is reduced by the nonqualified nonrecourse financing, but the rules are applied differently for purposes of IRC §42(k).

- Under IRC §49(a)(1)(E), if the taxpayer is a partnership, then the determination of whether a partner's allocable share of any financing is nonqualified nonrecourse financing

is made at the partner level and in the same manner as the credit is allowable under IRC §38.
- Under IRC §42(k) (1), the IRC §42 building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing on the building. See Chapter 13 for complete discussion of Qualified Basis.

"At Risk" and Nonrecourse Financing

In general, IRC §465(b) provides that a taxpayer is considered "at risk" for the following:

- capital contributions (money and the adjusted basis of any property contributed), and
- amounts borrowed with respect to the activity for which the taxpayer has a personal liability or has pledged property as security (recourse financing).

IRC §49(a) (1) (D) (i) provides that nonqualified nonrecourse financing is any nonrecourse financing that is not "qualified commercial financing." IRC §49(a)(1)(D)(ii) defines qualified commercial financing, as financing with respect to any property if (1) such property is acquired by the taxpayer from a person who is not a related person, (2) the amount of nonrecourse financing does not exceed 80% of the credit base of the property being financed, and (3) the financing is borrowed from a "qualified person" or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government.

IRC §49(a)(1)(D)(iv) defines a qualified person as any person which is actively and regularly engaged in the business of lending money and which is not (1) a person related to the taxpayer, (2) a person from which the taxpayer acquired the property (or a related person to such person), or (3) a person who receives a fee relating to the taxpayer's investment in the property (or a related person to such person).

IRC §49(a)(1)(D)(iii) provides that "nonrecourse financing" includes (1) any amount by which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and (2) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to a person (other than the taxpayer) having such an interest.

IRC §49(a) (1) (D) (v) provides that the term "related person" has the same meaning as provided in IRC §465(b) (3) (C) and is determined as of the close of the taxable year in which the property is placed in service, unless regulations provide otherwise.

IRC §465(b) (3) (C) provides that a person is related to any person if:

- the related person bears a relationship to such person specified in IRC §267(b) or IRC §707(b)(1), and substituting "10 percent" for "50 percent," or
- the related person and such person are engaged in trades or business under common control (within the meaning of IRC §52(a) and (b)).

IRC §§ 49(a) (2) and (b) (1) provide rules concerning net decreases and increases in nonqualified nonrecourse financing after the end of the taxable year in which the property is placed in service. As noted earlier, however, any reduction in the "credit basis" for IRC §49 purposes is equivalent to a reduction in the qualified basis of the IRC §42 low-income building.

Audit Techniques

The application of the at-risk rules under IRC §42(k) (1) may result in a reductions of a low-income building's qualified basis. Therefore, the identification of any nonrecourse debt to which the at-risk rules apply must be made at the ownership level.

- All documents, agreements, and debt instruments should be reviewed for debt associated with the financing of assets included in eligible basis. Regardless of how the taxpayer has classified the debt, consider whether the liability for repayment of the debt has been limited; e.g., guarantees, etc.
- Review the partnership agreement to determine whether the agreement includes any guarantees that would limit liability for debt.

Adjusting Qualified Basis

Any reduction of qualified basis for nonqualified nonrecourse debt is made at the ownership level (usually a partnership) and will reduce the allowable IRC §42 credit allocable to the partners. See Chapter 13.

Nonrecourse Financing from an Qualified Nonprofit Organization

There is one exception to the general at-risk rules under IRC §42(k) (1) for nonrecourse financing from a qualified nonprofit organization if certain criteria are met. If these requirements are met, the determination of whether such nonrecourse financing is qualified commercial financing with respect to any qualified low-income building is made without regard to whether such organization-

- Is actively and regularly engaged in the business of lending money, or
- Is a person described in IRC §49(a) (1) (D) (iv) (II); i.e., a person from which the taxpayer acquired the property (or a related person to such person).

Qualified Nonprofit Organization Defined

Under IRC §42(k) (2), the financing must be borrowed from a qualified nonprofit organization as defined in IRC §42(h) (5) (C):

- the organization is described in IRC §501(c)(3) or (4) and is exempt from tax under IRC §501(a),
- the organization is not affiliated with or controlled by a for-profit organization, and
- one of its exempt purposes is the fostering of low-income housing.

This requirement is also met if the loan is made by a subsidiary (corporation) of a qualified nonprofit organization 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.

Financing Secured by Property

Under IRC §42(k) (2) (B), the financing must be secured by the qualified low-income building. This requirement does not apply, however, if the building is a federally assisted building as defined in IRC §42(d) (6) (B), and if:

- a security interest in the building is not permitted by a federal agency holding or insuring the mortgage secured by the building, and
- the proceeds from the financing (if any) are applied to acquire or improve the building.

Former IRC §42(d)(6)(B), which applies to buildings placed in service before July 31, 2008, defines a "federally-assisted building" as any building which is substantially assisted, financed, or operated under-

- section 8 of the United States Housing Act of 1937,
- section 221(d)(3) or 236 of the National Housing Act, or
- section 515 of the Housing Act of 1949.

For buildings placed in service after July 30, 2008, the Code section defining federally assisted buildings was moved to IRC §42(d) (6) (C) (i) and includes buildings substantially assisted, financed, or operated under the programs identified in former IRC §42(d) (6) (B), as well as "any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture."

Limited to 60% of Eligible Basis

The requirement under IRC §42(k)(2)(C) is met if not more than 60% of the eligible basis of the qualified low-income building is attributable to such nonrecourse financing from the nonprofit organization at the end of any taxable year in the 15- year compliance period. The principal and interest of any governmental financing which is part of a wrap-around mortgage involving such financing is not included in the 60% limit.

Repayment of Principal and Interest

The requirement under IRC §42(k) (2) (D) is met if the financing is fully repaid on or before the earliest of:

- the date on which the financing matures,
- the 90th day after the close of the building's 15-year compliance period, or
- the date the building is refinanced or the building (to which such financing relates) is sold.

Two Additional Requirements

Interest Rate

Under IRC §42(k) (3), if the interest rate on the financing is less than the rate which is 1 percentage point below the applicable federal rate as of the time such financing is incurred, then the qualified basis (to which such financing relates) of the qualified low-income building shall be the present value of the amount of such financing, using as the discount rate such applicable federal rate.

For purposes of the preceding sentence, the rate of interest on any financing shall be determined by treating interest to the extent of government subsidies as not payable.

Failure to Fully Repay

Under IRC §42(k) (4), if the taxpayer fails to fully repay the financing as outlined in IRC §42(k) (2) (D), then the taxpayer's tax for the year of such failure is increased by an amount defined as the "applicable portion of the credit."

Under IRC §42(k)(4)(B) the applicable portion is the aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if the eligible basis of the building were reduced by the amount of financing that does not meet the requirements of IRC §42(k)(2)(D).

In addition, under IRC §42(k) (4) (A), interest on the applicable portion is assessed for the period beginning with the due date for the filing of the tax return for the first taxable year for which such credit was allowable, and ending with the due date for the taxable year in which such failure occurs, determined by using the underpayment rate and method under IRC §6621.

IRC §42(k) (4) (C) makes rules similar to the rules of IRC §42(j) (4) (A) and (D) applicable for purposes of IRC §42(k) (4). The IRC §42(j) credit recapture rules are discussed in Chapter 16.

Right of First Refusal to Purchase

Under IRC §42(i) (7) (A), tenants (in cooperative form or otherwise), a resident management corporation of a building, a qualified nonprofit organization as defined in IRC §42(h) (5) (C), or government agency may hold a right to purchase the building after the close of the building's 15-year compliance period for a price which is not less than the minimum purchase price.

Minimum Purchase Price

Under IRC §42(i) (7) (B) the minimum purchase price is an amount equal to the sum of:

- the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants), and

- All federal, state, and local taxes attributable to the sale.

Purchase by Tenants

Tenants may individually hold a right of first refusal to purchase their individual rental units.

For example, in PLR 200703024, the taxpayer owning the IRC §42 project wanted to amend the extended use agreement to provide tenants with a right of first refusal to purchase their units at the end of the compliance period. Under the right of first refusal, the purchase price for each unit would be affordable to the tenants because it would be based on the maximum applicable rents and would include a purchase discount. The IRS concluded that the right of first refusal granted to tenants as part of a condominium home ownership plan to purchase their units after the close of the compliance period applicable to each unit satisfied the IRC §42(i)(7)(A) requirements.

Impact on Federal Income Tax Benefits

Under IRC §42(i)(7)(A), no federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal to purchase the building.

Qualified Contracts

Under IRC §42(h) (6), a taxpayer must enter into a long-term agreement with the housing agency to provide housing for an "extended" time period after the end of the building's 15-year compliance period. Under IRC §42(h) (6) (E), the agreement terminates at any time if the building is acquired by foreclosure (or instrument in lieu of foreclosure) or, beginning after the 14th year of the building's compliance period, the housing agency is unable to present a "qualified contract" for the purchase of the low-income building by a person willing to maintain the building's low-income status. The state agency has one year beginning on the date the taxpayer submits a written request to the housing agency to find a person to acquire the taxpayer's interest in the low-income portion of the building.

In summary, under IRC §42(h) (6) (F), a qualified contract is a bona fide contract to acquire (within a reasonable period after the contract is entered into) the non low-income portion of the building for fair market value and the low-income portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing agreement) of the sum of:

- the outstanding indebtedness secured by, or with respect to, the building,
- the adjusted investor equity in the building, plus
- other capital contributions not reflected in the amounts described in (1) or (2) above, reduced by cash distributions from (or available for distribution from) the project.

A detailed description of the qualified contract is presented in Treas. Reg. §1.42-18. However, since the disposition of low-income buildings is anticipated to be after the end of the 15-year compliance period, the existence of a qualified contract does not impose any limit on any

allowable credit during the 15-year compliance period or impose the credit recapture rules under IRC §42(j). See Chapter 16.

Audit Issues

There are two considerations as the taxpayer nears the end of the 15-year compliance period:

- Is the taxpayer physically maintaining the IRC §42 project in a manner suitable for occupancy? See Chapter 12.
- Is the taxpayer continuing to market and rent vacant low-income units to new low-income tenants? See Chapter 12.

If the answer to (1) or (2) above is "no," then the taxpayer is subject to credit disallowance if the taxpayer is claiming credit for additions to qualified basis (see Chapter 15) and credit recapture under IRC §42(j). See Chapter 16.

Bona Fide Debt

A bona fide debt is one which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. See Treas. Reg. §1.166-1(c). To be a valid debt, the advance had to be made with a bona fide expectation that such amount would be repaid. In determining if there is a debtor-creditor relationship, the facts and circumstances pertinent to the advances is looked at along with the subjective intent of the parties.

Loan documents should be reviewed to determine whether the loans are bona fide debt. Supporting documents also include, but are not limited to, appraisal reports, historical and forecasted statements of operations and cash flows, guarantee agreements and balance sheets for guarantors.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument as debt or equity for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that may be considered when making such a determination are the following:

- whether there is an unconditional promise on the part of the issuer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonably foreseeable future,
- whether the holder has the right to enforce the payment of principal and interest,
- whether the holder's rights are subordinate to rights of general creditors,
- whether the instruments give the holder the right to participate in the management of the issuer,
- whether the issuer is thinly capitalized,
- whether the holder of the instrument is related to the equity holder of the issuer,
- the label placed upon the instrument by the parties, and
- whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in Goldstein v. Commissioner, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

- a note or other evidence of indebtedness exists,
- interest is charged,
- there is a fixed schedule for repayments,
- any security or collateral is requested to ensure payment,
- there is any written loan agreement,
- a demand for repayment has been made,
- the parties' records, if any, reflect the transaction as a loan
- any repayments have been made, and
- the borrower was solvent at the time of the loan.

Good Faith Intent

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction to be a loan.

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. See *Fisher v. Commissioner*, 54 TC 905 (1970).

In *Story v. Commissioner*, 38 TC 936 (1962) acq., 1965-1 C.B. 5, the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligations. However, the Commissioner limited his acquiescence in this case to the factual nature of that particular case. Furthermore, the Commissioner stated that such acquiescence would not be considered the basis for issuing rulings in advance of the consummation of the transaction. See Rev. Proc. 65-4, 1965-1, C.B. 720.

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner*, 42 TC 936 (1964) in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will "continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor…..where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received…" Action on Decision, 1976 A.O.D. LEXIS 364

See Chapter 8 for additional discussion of bona fide debt.

Impact on Eligible Basis

Costs financed with debt which is not bona fide debt are excluded from eligible basis.

"Not-For-Profit" Rules and Economic Substance

IRC §183

IRC §183 addresses activities not engaged in for profit. Under IRC §183(a), if an activity by an individual or S Corporation is not engaged in for profit, no deduction attributable to such activity shall be allowed except as otherwise provided in IRC §183.

IRC §183(c) defines an "activity not engaged in for profit" as any activity other than one with respect to which deductions are allowable for the taxable year under IRC §162 or under paragraph (1) or (2) of IRC §212.

Treas. Reg. §1.42-4

Treas. Reg. §1.42-4(a) specifically exempts ownership and operation of qualified low-income buildings under IRC §42 from the IRC §183 limitations. The regulation reads:

(a) Inapplicability to IRC §42. In the case of a qualified low-income building with respect to which the low-income housing credit under IRC §42 is allowable, IRC §183 does not apply to disallow losses, deductions, or credits attributable to the ownership and operation of the building.

The regulation, however, provides the following limitation.

(b) Limitation. Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under IRC §42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. See, e.g., IRC §§38(c), 163(d), 465, 469; *Knetsch v. United States*, 364 U.S. 361 (1960), 1961-1 C.B. 34 ("sham" or "economic substance" analysis); and *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978), 1978-1 C.B. 46 ("ownership" analysis).

IRC §7701(o), Clarification of Economic Substance Doctrine

Consistent with IRC §7701(o), a taxpayer's investment in an IRC §42 project should not be challenged merely because the investment was made based on a tax incentive; i.e., the taxpayer made an investment (in form and substance) that the credit was intended to encourage. That does not mean, however, that all the transactions associated with the development and operation of IRC §42 projects are automatically safeguarded from the consideration of the economic substance doctrine.

IRC §7701(o) applies to transactions entered into after March 30, 2010, the date of enactment.

Economic Substance Doctrine Implementation Procedures

The decision to raise the codified economic substance doctrine must be made on a case-by-case basis and based on all the facts available. It is advisable that the factors outlined in LB&I Directive, LB&I-4-0711-015, be considered and analyzed in making this decision. Note that than individual transaction within an IRC §42 project, and not the entire project, may be considered to lack economic substance. Therefore, when determining whether to raise the codified economic substance doctrine in an IRC §42 project, all steps or transactions of the project must be considered.

Impact on Eligible Basis

Costs financed with debt which lacks economic substance and/or does not reflect a profit motive are excluded from eligible basis.

IRC §45D, New Markets Tax Credit

The IRC §45D, New Markets Tax Credit, provides a credit against federal income taxes for Qualified Equity Investments (QEIs) made in qualified community development entities (CDEs), which in turn invest the cash in one or more of the following "qualified low-income community investments" under IRC §45D(d)(1):

- Any capital or equity investment in, or loan to, any qualified active low-income community business, the definition of which is dependent on the type of entity, the entity's business activity, whether the entity is engaged in active conduct of the business and whether the entity's income, activities, and assets qualify.
- A loan purchased by a CDE from another CDE which is a qualified low-income community investment.
- Financial counseling and other services to any qualified active low-income community business located in, or to any residents of, low-income communities.
- Any equity investment in, or loan to, any CDEs.

The credit is 39% of the QEI and is claimed over the 7-year credit period. Under IRC §45D (a)(2), the applicable percentage is 5% for the first three years and 6% for the last four years. The IRC §45D credit is subject to recapture if, at any time during the 7-year credit period, there is a recapture event with respect to the investment.

Similar to IRC §42 investors, funds for investment as QEIs are often accumulated in "syndicated" partnerships, which then make QEIs in CDEs.

Investment In IRC §42 Projects Not Allowed

If a CDE makes a capital or equity investment or a loan with respect to a qualified low-income building under IRC §42, the investment or loan is not a qualified low-income community investment to the extent the building's eligible basis is financed by the proceeds of the investment or loan. See Treas. Reg. §1.45D-1(g) (3) (ii).

Audit Issue: Loans from CDEs

Since IRC §42 projects may be located in communities qualifying for IRC §45D investments, consideration should be given to whether:

- A CDE made a direct equity or capital investment in the IRC §42 project; i.e., the CDE is a partner (directly or indirectly) in the taxpayer owning the IRC §42 project, or
- Loan proceeds supporting assets in eligible basis are from a CDE,

And, if either (1) or (2) above is true, check to see if whether the investment or loan is treated as a qualified low-income community investment for purposes of IRC §45D.

Step 1: Identify CDE

To qualify as a CDE, an entity must be a domestic corporation or partnership that has a primary mission of serving, or providing investment capital for, low-income com-munities or low-income persons. Confirmation that an entity has current CDE status can be obtained at www.cdfifund.gov.

Step 2: Capital or Equity Investments

Determining whether a CDE's investment in, or loan to, the IRC §42 project was treated as a qualified low-income community investment is beyond the scope of an audit of the IRC §42 credit. The IRC §45D program analyst should be contacted, as the IRC §45D credit may be subject to disallowance and/or recapture. Regardless of the outcome, the low-income building's eligible basis will not be affected.

Audit Techniques

In addition to the capital investment by members of a partnership, financing may include temporary construction loans, permanent commercial debt, and federal subsidies such as tax-exempt bonds under IRC §146, federally-sourced below-market rate loans, and federal grants. Financing may also include "soft debt," which is generally thought of as nonrecourse debt with favorable repayment terms. In addition, the deferred payment of costs included in eligible basis, such as a developer's fee, should be examined to determine whether it is an indirect form of financing.

Step 1: Identify Financial Sources

- The taxpayer's final cost certification should be reviewed to identify sources of financing the taxpayer disclosed to the state agency.
- Analyze the liabilities disclosed on the balance sheet filed with the tax return.
- Review the land records to determine whether debt instruments have been recorded as liens against the property.

Step 2: Review Loan Documents

Loan documents and repayment histories should be reviewed in detail.

- What is the relationship between the taxpayer and the lender?
- What are the terms of the debt instrument? Consider whether the debt reflects an arm's length transaction, particularly if the parties are related or one party is in a position to manipulate or camouflage a transaction.
- What is the source of the funds? Are the funds federally sourced?
- Is the debt bona fide debt?
- Does the debt transaction have economic substance?

Summary

Federally sourced financing will limit the amount of credit that can be allocated to the building by either reducing eligible basis or restricting the applicable percentage to a 30% present value. Federal sourced financing includes tax-exempt bonds, federally sourced below-market rate loan (if the building was placed in service before July 31, 2008), and federal grants.

Nonrecourse financing is subject to at-risk rules, but there is an exception for financing from a qualified nonprofit entity under certain circumstances.

Neither a right of first refusal to purchase the low-income buildings nor the existence of a qualified contract to purchase the buildings affects whether the credit is allowable or the amount of the allowable credit.

A taxpayer's investment in an IRC §42 project is not subject to the IRC §183 limitations. However, consideration should be giving to whether debt is bona fide debt and whether a transaction reflects economic substance.

Costs financed with debt which is not bona fide debt are excluded from eligible basis.

Taxpayers owning IRC §42 projects are exempted from IRC §183 limitations. However, losses, deductions, or credits associated with the ownership and operation of a qualified low-income building under IRC §42 may be limited or disallowed under other provisions of the Code or principles of tax law.

For purposes of the IRC §45D, New Markets Tax Credit, if a CDE makes a capital or equity investments or a loan with respect to a qualified low-income building under IRC §42, the investment or loan is not a qualified low-income community investment to the extent the building's eligible basis is financed with the proceeds of the investment of loan.

Chapter 11 Eligible Basis: Limitations and Adjustments

Introduction

Chapter 8 provided guidelines for analyzing the costs treated as eligible basis by the taxpayer. Chapter 9 addressed requirements specific to acquiring and/or rehabilitating an existing building.

In Chapter 10, the taxpayer's financial resources were analyzed. Once the correct eligible basis is determined, adjustments are needed to account for limitations placed on the eligible basis. In this chapter, the following topics are addressed:

Topics

- Disproportionate Standards
- Federal Grants
- IRC §47, Rehabilitation Credit
- IRC §48, Energy Credit
- Supportive Services for the Homeless
- Low-Income Buildings Financed with Tax-Exempt Bonds
- Community Service Facilities
- Low-Income Buildings in High Cost Areas
- Summary

Disproportionate Standards

IRC §42(d) (3): Disproportionate Standards for Units

A low-income building's eligible basis is reduced by the portion attributed to market-rate units and that are above the average quality standard of the low-income units. However, this basis reduction for disproportionate standards can be avoided to the extent the excess cost of the market-rate unit is not greater than 15% of the average cost per square foot of all the low-income units in the building and the taxpayer elects to exclude the excess cost of the market-rate unit from eligible basis. IRC §42(d)(3)(B)(ii) defines "excess" as the excess of the cost of a market-rate unit over the amount which would be the cost of the market-rate unit if the average cost per square foot of all low-income units in the building were substituted for the cost per square foot of the market-rate unit.

The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 9b.

Example 1: Disproportionate Standards

A mixed-use low-income building consists of 100 residential rental units. The 60 low-income units are 1,000 square feet on average and have an average cost of $120,000 or $120/sq. ft. The 40 market-rate units are also 1,000 square feet on average, but include upgraded appliances, granite counter tops, and hardwood floors which are not included in the low-income units. The cost of each market rate unit is $156,000 or $156/sq. ft. The taxpayer elected to exclude the excess cost of each market-rate unit from eligible basis and calculated eligible basis to be $12,000,000 (100 units x $120,000). Assuming the applicable percentage is 9%, the taxpayer computed the allowable credit as follows:

$12,000,000 x .60 x .0900 = $648,000

15% of the average cost per square foot for the low-income units is $18/sq. ft. To be eligible for the IRC §42(d) (3) (B) (ii) election, the average cost of a market-rate unit cannot exceed ($120 + $18)/sq. ft. or $138/sq. ft. Although the taxpayer made the election to reduce eligible basis on line 9b of Form 8609, the taxpayer does not qualify for the election for any of the market-rate units because the excess costs of these units is more the 15% of the average cost for the low-income units. The eligible basis is limited to the cost of the low-income units, which is $7,200,000, calculated as 60 units x $120,000. The applicable fraction, however, remains 60%. Therefore, the allowable credit is computed as:

$7,200,000 x .60 x .0900 = $388,800

Federal Grants

IRC §42(d) (5) (A): Federal Grants

Under IRC §42(d) (5) (A), a building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant. The legislative history to the Tax Reform Act of 1986, which first implemented IRC §42 reads:

"Federal grants and other subsidies-Eligible basis may not include in any taxable year the amount of any Federal grant, regardless of whether such grant is included in gross income. A Federal grant includes any grant funded in whole or in part by the Federal government, to the extent funded with Federal funds. Examples of grants which may not be included in eligible basis include grants funded by Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants."

Building Placed in Service Before July 31, 2008

Originally, IRC §42(d) (5) (A) considered all federal grants funding the development of a low-income building or used to operate the building once placed in service. The statute read:

"Eligible basis reduced by federal grants. If, during any taxable year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of such grant is funded with Federal funds (whether or not includible in gross income), the eligible basis of such building for such taxable year and all succeeding taxable years shall be reduced by the portion of such grant which is so funded."

Issues to consider include:

- Did the taxpayer receive federal grants before the beginning of the compliance period which (1) funded costs included in eligible basis, and (2) were outstanding at any time during the compliance period?
- Did the taxpayer receive federal grants during the compliance period? If so, were the funds used for the building or its operation?

Buildings Placed in Service After July 30, 2008

IRC §42(d)(5)(A) was amended by section 3003(d) of the Housing Assistance Tax Act of 2008 to eliminate consideration of federal grants made to fund the operation of the low-income building. The Code now reads:

"Federal grants not taken into account in determining eligible basis. The eligible basis of a building shall not include any costs financed with the proceeds of a federally funded grant."

Federal Grants

The following illustrate the types of federal grants, which, if used to fund costs otherwise allowable for eligible basis, prevent these costs from being included in eligible basis:

- Housing Development Action Grants (HDAG) under the Housing and Urban-Rural Recovery Act of 1983.
- Community Development Block Grants (CDBG) under Title I of the Housing and Community Development Act of 1974.
- Urban Development Action Grants (UDAG) under Section 119 of the Housing and Community Development Act of 1974.
- Rental Rehabilitation Grants under Section 17 of the U.S. Housing Act of 1937.
- Grants made under the HOME program.

The above list is not intended to be all inclusive. Additional considerations involving federal grants include:

- Grants may be received directly or indirectly from the Federal government. For example, a state or local government entity (or private source, such as a nonprofit entity) may receive federal grant funds directly from the Federal government and then make a grant of these funds to the project.
    - If the building was placed in service before July 31, 2008, the building's eligible basis would be reduced by the amount of the grant.
    - If the building was placed in service after July 30, 2008, any costs funded by the grant cannot be included in the building's eligible basis.
- Eligible basis is reduced by the amount of the federally-sourced grant, regardless of whether the taxpayer includes the grant in gross income.
- If the proceeds of a loan funded by a federal grant are used for a building and the loan is not reasonably expected to be repaid, then it is considered a federal grant.
- If a federally-sourced grant is designated by the federal source for a specific purpose, then no portion of the funds can be redesignated for a different purpose.

Federal Rental Assistance Payments

Eligible basis is not reduced if the proceeds of a federal grant are used as a rental assistance payment under sections 8 or 9 of the United States Housing Act of 1937, or any rental assistance program designated by the IRS. See Treas. Reg. §1.42-16.

Funds Not Considered Federal Grants

As identified in the explanation of the Housing Assistance Tax Act of 2008 prepared by the Joint Committee on Taxation, none of the following is considered a grant made with respect to a building (eligible basis) or its operation:

- Rental assistance under section 521 of the Housing Act of 1949,
- Assistance under section 538(f)(5) of the Housing Act of 1949,
- Interest reduction payments under section 236 of the National Housing Act,
- Rental assistance under section 202 of the Housing Act of 1959,
- Rental assistance under section 811 of the Cranston-Gonzalez National Affordable Housing Act,
- Modernization, operating and rental assistance pursuant to section 202 of the Native American Housing Assistance and Self-Determination Action of 1996,
- Assistance under title IV of the Stewart B. McKinney Homeless Assistance Act,
- Tenant-based rental assistance under section 212 of the Cranston-Gonzalez National Affordable Housing Act,
- Assistance under the AIDS Housing Opportunity Act,
- Per diem payments under section 2012 of title 38, United State Code,
- Rent supplements under section 101 of the Housing and Urban Development Act of 1965,
- Assistance under section 542 of the Housing Act of 1949, and
- Any other ongoing payment used to enable the property to be rented to low-income tenants.

Section 1602 Grants

Section 1602(a) of the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5) provides that the Department of the Treasury shall make a grant to the housing credit agency in an amount equal to the state's low-income housing grant election amount, which was limited to a percentage of the state's 2009 credit ceiling. The funds received by the agency in exchange for the credit were then used by the agency to make subawards to projects being developed.

Notice 2010-18 clarifies that the subawards are not federal grants. Specifically:

- subawards are excluded from the gross income of recipients and are exempt from taxation, and
- subawards used in a qualified low-income building are not federal grants for purposes of IRC §42(d) (5) (A) and do not otherwise reduce the depreciable or eligible basis of the building. See IRC §42(i) (9) (B).

Tax Credit Assistance Program

Enacted as part of the American Recovery and Reinvestment Tax Act of 2009, the Tax Credit Assistance Program (TCAP) administered by the Department of Housing and Urban Development (HUD) provides grant funding for capital investment in IRC §42 housing projects using a formula-based allocation of funds to state housing credit allocation agencies. The state housing agencies then distribute these funds through a competitive process according to their

state's qualified allocation plan. Taxpayers receiving an allocation of IRC §42 credits in 2007, 2008, or 2009 are eligible for TCAP funding.

A taxpayer that received TCAP grants cannot include in eligible basis any costs financed with the proceeds of the grant. In addition, as clarified in CCA 201106008, taxpayers other than nonprofit or governmental entities generally include governmental grants in gross income under IRC §61(a) absent a specific exclusion. In this case, ARRA does not specifically exclude TCAP grants from gross income, and the Code does not contain any specific exclusion for such grants. Accordingly, TCAP grants are includible in a recipient's gross income for federal income tax purposes.

If the state agency distributed the grant funds as a bona fide loan, then it is a federal loan and is treated similarly to other federal loans.

Reporting Federal Grants

Buildings Placed in Service Before July 31, 2008

Taxpayer should reduce the total eligible basis of the building by the amount of any federal grants made to the building or for its operation. The reduction should be reflected in the eligible basis reported on Line 7 of Form 8609 Part II, First-Year Certification, and on Line 1 of Form 8609-A, Annual Statement for Low-Income Housing Credit.

If the federal grant was received after the end of the first year of the credit period, the taxpayer will use Form 8609-A line 14 to make the adjustment for the federal grant. This adjustment may result in (1) a reduction of the allowable annual credit amount and (2) application of the IRC §42(j) recapture provisions. See Chapter 16.

Buildings Placed in Service After July 30, 2008

Determine whether any costs included in eligible basis as reported on Form 8609 line 7 were funded by federal grant funds. If so, eligible basis is reduced by the amount of these costs. Because eligible basis is determined at the close of the first year of the credit period, federal grants received after the first year of the credit period do not result in a reduction of a building's eligible basis.

Audit Issues

Taxpayers may attempt to change the character of a federally-sourced grant by documenting the grant as a loan and then using the proceeds to construct low-income housing. Consider the following example.

Example 1: Changing the Character of Federal Grant

A nonprofit entity applies for and receives a federal grant to construct affordable housing. The documentation identifies the name of the housing project, location, and characteristics of the

housing. The nonprofit entity then applies for and receives an allocation of IRC §42 credit from a state agency, and subsequently forms a partnership with an investment group with the intention of constructing IRC §42 housing meeting specifications of both the federal grant and the credit allocation. The nonprofit entity serves as the general partner and intends to operate the housing project.

The nonprofit entity then loans the proceeds of the federal grant to the partnership to construct the housing. The loan period is longer than the extended use period (a minimum of 30 years under IRC §42(h) (6) (D)). The interest rate is zero or significantly lower than the applicable federal rate, and no payment of principal or interest is payable until the loan matures.

Audit Techniques

- Review the balance sheet included with the tax return to identify loans and long-term debt.
- For buildings placed in service before July 31, 2008, determine whether the taxpayer has elected, under IRC §42(i)(2), to exclude the principal amount of a federally subsidized loan from the building's eligible basis. The election is made on Form 8609 line 9a. If an election has been made, ensure that the taxpayer did not include the proceeds of the loan in eligible basis.
- If a partner in the partnership is a nonprofit entity, further inquiry should be made to determine whether the nonprofit entity received any federal subsidies or grants and whether such funds were loaned to the partnership and then used to construct IRC §42 housing

Once a purported loan to the taxpayer has been identified, the following audit techniques should be used to establish the facts. See also Chapter 8.

- Ask the taxpayer for the loan agreement and any other related loan documents. Consider whether the terms are particularly favorable; i.e., a low interest rate or no interest rate, no repayment required until the loan is due, or a loan period longer than the 15-year compliance period. Consider whether the lender realistically expects to receive payments. Also determine whether the loan is secured by the property, which establishes that the lender can receive the property in lieu of payment.
- Interview the lender and determine the source of the funds used to make the loan. Also review documentation of the source of the funds. The documentation may identify the funds as a grant, loan, or other long-term payable. In addition, the documentation may identify the housing (by name, location, characteristics) for which the funds are to be used. This may indicate that the funds were originally intended by the federal source to be used for the low-income project and, if initially provided as a grant, could suggest that the funds should retain their original character as a federal grant.
- Review the financial feasibility analysis completed by the state agency. The federal tax issue is resolved if the state agency reduced the eligible basis by the amount of the purported loan when determining how much credit to allocate to the building. Under IRC §42(m) (2), the state agency cannot allocate more credit to a project than is necessary for the financial feasibility of the project and its viability as a qualified low-income housing

project throughout the credit period. When the project is finished, the state agency evaluates the sources and uses of funds, and the total financing planned for the project. The owner must disclose the full extent of all federal, state and local grants and subsidies.
- Determine whether the future value of the property securing the purported loan will equal or exceed the face value of the loan and accrued interest at the time the loan is due. Obtain an engineer's evaluation if the value of the property is in doubt.

Conclusion

If it can be established that (1) the funds loaned to the taxpayer are federally sourced, (2) the interest rate is below the applicable federal rate, and (3) the funds are included in eligible basis, then the tax treatment of the funds will be determined based on whether the future value of the property (reduced by any other debt on the property prior in right) equals or exceeds the face value of the loan plus interest at the time the loan comes due.

If the future value of the property (reduced by other debt on the property prior in right) does not equal, or is less than, the face value of the loan plus interest, then the purported loan will be deemed as not being able to be fully repaid and the funds, either fully or to the extent they cannot be repaid, will be treated as a federal grant and under IRC §42(d) (5) (A).

If the future value of the property (reduced by other debt on the property prior in right) is equal to, or greater than, the face value of the loan plus interest, then the funds will be treated as a federal loan and any cost paid from the loan proceeds may be includable in eligible basis. See Chapter 10 for additional discussion.

IRC §47, Rehabilitation Credit

Law

The IRC §47 Rehabilitation Credit provides a federal credit based on the cost of substantially rehabilitating qualifying buildings. The credit for any taxable year is computed as the sum of:

- 10% of the qualified rehabilitation expenditures for any qualified rehabilitated building other than a certified historic structure, and
- 20% of the qualified rehabilitation expenditures for an certified historic structure, as defined in IRC §47(c) (2) (B) (iv).

Under IRC §47(c) (2) (A) (i) (II), the IRC §47 qualified rehabilitation expenditures include amount properly chargeable to capital accounts for property for which depreciation is allowable under IRC §168 and which is residential rental property. The 10% credit is not allowable with respect to residential rental property under IRC §50(b) (2).

Reduction of Adjusted Basis

Under Treas. Reg. §1.48-12(e) (1) the basis of the rehabilitated property attributable to the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed.

Example

Example 1: Taxpayer Acquires Historic Structure

A taxpayers purchased an apartment building that has been designated a certified historic structure for $3,000,000, $500,000 of which is allocated to land. The taxpayer decided to rehabilitate the building for use as a 100% IRC §42 low-income building, and received an allocation of credit for both acquiring and rehabilitating the existing building. The taxpayer spent $4,000,000 on expenses qualifying for the IRC §47 rehabilitation credit.

The taxpayer first computes the allowable IRC §47 credit:

$4,000,000 x 20% = $800,000

The taxpayer then reduces the adjusted basis of the rehabilitation costs by the amount of the IRC §47 credit.

$4,000,000 - $800,000 = $3,200,000

The taxpayer computes the allowable annual IRC §42 credit for the cost of acquiring the building (less the $500,000 cost of the land), using a 4% applicable percentage, as:

$2,500,000 x 100% x 4% = $100,000

The taxpayer computes the allowable annual IRC §42 credit for the rehabilitation costs, which are treated as a new building, using a 9% applicable percentage and the reduced adjusted basis, as:

$3,200,000 x 100% x 9% = $288,000

The adjusted basis of the rehabilitation expenses is also reduced by the amount of the IRC §47 credit for depreciation purposes. See Treas. Reg. §1.48-12(e) (1).

IRC §48, Energy Credit

Law

IRC §48(a) (2) (A) (i) provides a 30% credit for energy property (10% for some types of energy property) placed in service during the taxable year. IRC §48(a) (3) (A) defines "energy property" to mean:

- equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool (30% credit),

- equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight but only with respect to periods ending before January 1, 2017, (30% credit),
- equipment used to produce, distribute, or use energy derived from a geothermal deposit (within the meaning of IRC §613(e)(2), but only, in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission state (10% credit),
- qualified fuel cell property (30% credit), or qualified microturbine property (10%) credit),
- combined heat and power system property (10% credit),
- qualified small wind energy property (30% credit), or
- equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, but only with respect to periods ending before January 1, 2017 (10% credit).

Under IRC §48(a) (3) (B), the construction, reconstruction, or erection of the "energy property" must be completed by the taxpayer, or if acquired by the taxpayer, original use of such property must commence with the taxpayer.

Under IRC §48(a) (3) (C), the "energy property" must be subject to depreciation (or amortization in lieu of depreciation).

IRC §48(a) (5) provides that a taxpayer may elect to treat certain property described in IRC §45(d) as "energy property" that is eligible for a 30% credit.

Under IRC §38(a) (3) (D), the "energy property" must meet the performance and quality standards (if any) which (1) have been prescribed by the Secretary by regulations (after consultation with the Secretary of Energy), and (2) are in effect at the time of the acquisition of the property.

The flush language following IRC §38(a) (3) further explains that "energy property" does not include any property which is part of a facility the production from which is allowed as a credit under IRC §45 for the taxable year or any prior taxable year.

Reduction of Depreciable Basis Includible in Eligible Basis

A taxpayer may include energy-producing systems as part of the IRC §42 project and include the cost in eligible basis. However, if the taxpayer claims the energy credit for the equipment under IRC §48, then the depreciable basis of the energy equipment must be reduced by 50% of the tax credits received. See IRC §50(c) (3).

For example, if a taxpayer constructs an IRC §42 project and includes qualifying solar panels with an adjusted basis of $10,000, the taxpayer may claim an IRC §48 energy credit of $3,000 and must reduce the eligible basis by $1,500. For purposes of determining the eligible basis for the IRC §42 credit, the taxpayer would include $8,500; i.e., $10,000 - $1,500.

Section 1603 Grant Funds

Under section 1603 of the American Recovery and Reinvestment Act, a taxpayer placing a qualifying renewable energy project in service may be eligible for a Section 1603 payment for 30% (or 10% for certain property). Under IRC §48(d) (3) (A), a Section 1603 payment is not includible in the taxpayer's gross income but is taken into account in determining the basis of the property to which the payment relates. The Section 1603 payment is subject to rules similar to IRC §50; specifically, under IRC §48(d) (3) (B), a taxpayer must reduce the basis of the property by 50% of the Section 1603 payment. This same basis reduction rule also applies for purposes of IRC §42.

For example, a taxpayer constructs an IRC §42 project, including solar panels with a depreciable (and eligible) basis of $100,000. The taxpayer receives $30,000 as a Section 1603 payment for the panels and reduces the $100,000 depreciable and eligible basis of the panels by $15,000, which represents 50% of the $30,000 Section 1603 payment, to arrive at an IRC §42 eligible basis of $85,000.

Supportive Services for the Homeless

IRC §42(c)(1)(E) provides that if the taxpayer is providing transitional housing for the homeless under IRC 42(i)(3)(B)(iii), then a building's qualified basis shall be increased by the lesser of:

- so much of the building's eligible basis as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
- 20% of the buildings qualified basis (determined without regard to the portion of the building used to provide support services).

See Chapter 8 for additional discussion.

Low-Income Buildings Financed with Tax-Exempt Bonds

IRC §103(a) provides that interest earned on state or local bonds is excluded from gross income if certain requirements are met. The maximum amount of bonds that can be issued under IRC §146 during any calendar year is referred to as the "volume cap" and is based on the population of the state or constitutional home rule city. The volume cap applies to tax-exempt multifamily housing bonds used to finance qualified residential rental projects under IRC §§ 142(a) (7) and 142(d), and can include low-income housing projects qualifying for the IRC §42 credit. That is, the low-income buildings can be financed with both tax-exempt bonds and equity investment.

One distinguishing feature of IRC §42 projects financed with tax-exempt bonds subject to the volume cap is that the credit assigned to the buildings is not "allocated" to the building from the state's housing credit ceiling as referenced in IRC §42(h)(1). Instead, under IRC §42(h) (4), the credit is associated with the IRC §146 volume cap. When the distinction is significant, projects financed with tax-exempt bonds are referred to as "buildings not subject to IRC §42(h) (1) by reason of IRC §42(h) (4)."

Credit allocations from the credit ceiling under IRC §42(h)(1) and credit associated with IRC §146 volume cap can be used together to finance a low-income housing project, in which case there will be two Forms 8609 to document the allowable credit from the different sources.

Documentation of Bond Financing

Buildings financed with tax-exempt bonds are identified on Form 8609.

- If there is no allocation of IRC §42 credit, line 1a on Form 8609, the date of allocation, is left blank.
- Line 4 will reflect the percentage of the aggregate basis of the buildings and the land on which the buildings are located that is financed with tax-exempt bonds.
- Line 6a or 6d should be selected to note that the new construction or IRC §42(e) rehabilitation expenditure are federally subsidized.

Coordinating IRC §42 and IRC §142(d) Requirements

IRC §42 projects financed with tax-exempt bonds are subject to all the IRC §42 requirements, as well as requirements for the tax-exempt bond financing under IRC §142(d).

Eligible Basis Limitation

For purposes of examining the IRC §42 credit, there is only one limitation to consider. Under IRC §42(h)(4)(B), if 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds, then the credit is based on the entire eligible basis of the qualified low-income buildings, regardless of the source of funds used to finance the qualifying costs. If less than 50% of the aggregate basis of the building and land are financed with tax exempt bonds, then only the eligible basis actually financed with the tax-exempt bonds is includable in eligible basis.

Example 1: Taxpayer Meets Requirement

A state assigns $500,000 of its volume cap under IRC §146 to an issue of exempt facility bonds designated for the development of a low-income residential project under IRC §142(d). The aggregate basis of the buildings and the land upon which the buildings are constructed is $700,000. Under the terms of the bond indenture, $490,000 of the proceeds will be used to finance costs includable in eligible basis of the buildings. The total eligible basis is $575,000.

$500,000 ÷ $700,000 = 71.43%

Since more than 50% of the aggregate basis of the buildings and land upon which the buildings are located is financed with tax-exempt bond proceeds, the taxpayer may:

- Claim IRC §42 credit without an allocation under IRC §42(h)(1), and

- The IRC §42 credit amount is based on the total $575,000 eligible basis of the low-income buildings, regardless of whether the costs were financed with the proceeds of the tax-exempt bond.

Example 2: Taxpayer Fails to Meet Requirement

A state assigns $500,000 of its volume cap under IRC §146 to an issue of exempt facility bonds designated for the development of a low-income residential project under IRC §142(d). The aggregate basis of the buildings and the land upon which the buildings are constructed is $1,100,000. The basis attributable to the buildings is $850,000 and the basis attributable to the land is $250,000. Under the terms of the bond indenture, $490,000 of the proceeds will be used to finance costs includable in eligible basis of the buildings.

$500,000 ÷ $1,100,000 = 45.45%.

Since less than 50% of the aggregate basis of the buildings and land on which the buildings are located is financed with tax-exempt bonds, only the qualifying costs financed with the proceeds of the tax-exempt bond can be included in eligible basis. In this case, eligible basis is limited to $490,000.

Allocating Bond Proceeds

Treas. Reg. §1.42-1T (f) (1) (ii) reads:

"(ii) Determining use of bond proceeds. For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in § 1.103-13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

Audit Techniques

To verify the original allocation of costs, review the bond indenture and related documents, and then compare to the computation of eligible basis and the aggregate basis of buildings and land.

Example 1: Costs Not Allowable in Eligible Basis Allocable to Land

A taxpayer received $5,000,000 of tax-exempt bond financing which is used, with $3,500,000 in capital contributions, to acquire and rehabilitate an existing residential rental building. The taxpayer made the following allocations:

Land: $500,000

Acquired Building: $3,000,000

Rehabilitation Cost: $5,000,000

Since more than 50% of the cost of the combined land and building costs are financed with the tax-exempt bonds, the taxpayer computed the eligible based on the entire $8,000,000; i.e.,

$5,000,000 ÷ $8,500,000 = 58.82%

The examiner determined that the taxpayer had undervalued the cost of the land when allocating the purchase price between the land and existing building. The examiner determined that the correct value of the land was $1,500,000 and the cost allocated to the acquired building was $2,000,000. Accordingly, the examiner adjusted the eligible basis used to compute the credit for the acquisition of the building. However, when the cost of the land and buildings is totaled, the combined costs are still $5,000,000 and 58.82% of costs are financed with the tax-exempt bond proceeds. No additional adjustment is needed.

Example 2: Allocating Tax-Exempt Bond Proceeds

A taxpayer received $5,000,000 of tax-exempt bond financing which is used, with $4,500,000 in capital contributions, to acquire and rehabilitate an existing residential rental building. The taxpayer made the following allocations:

Land: $500,000

Acquired Building: $3,000,000

Rehabilitation Cost: $5,000,000

The taxpayer also incurred $1,000,000 in costs that were not includable in eligible basis or the aggregate basis of the building and land.

The taxpayer has eligible basis of $8,000,000

The taxpayer reported that all $5,000,000 of the bond proceeds were used to finance the rehabilitation costs. Consequently, more than 50% of the cost of the combined land and building costs are financed with the tax-exempt bonds; i.e.

$5,000,000 ÷ $8,500,000 = 58.82%

Therefore, the taxpayer computed the eligible basis based on the entire $8,000,000 and claimed credit under IRC §42(h) (4).

The examiner reviewed the tax-exempt bond indenture, which specified that $1,000,000 of the proceeds must be used to finance certain costs of the project that are not includable in the aggregate basis of the building and the land or in the eligible basis. The indenture also requires that the remaining $4,000,000 be used to finance the rehabilitation of the building. Applying the allocation in the indenture, the examiner determined that less than 50% of the aggregate basis of the building and land on which the building is located was financed by tax-exempt bonds:

$4,000,000 ÷ $8,500,000 = 47.06%

Therefore, under IRC §42(h) (4) (A), only the portion of the IRC §42 credit attributable to the eligible basis financed by the tax-exempt bonds is exempt from the IRC §42(h) (1) credit allocation requirement. Because the state did not allocate any IRC §42 credit to the project from the state's credit ceiling under IRC §42(h) (1), the taxpayer will not be entitled to any amount of IRC §42 credit attributable to any portion of the eligible basis not financed by the tax-exempt bonds.

Community Service Facilities

IRC §42(d) (4) (C): Community Service Facility

Beginning with credit allocations after December 31, 2000, IRC §42(d) (4) (C) provides that the eligible basis of a qualified low-income building located in a qualified census tract can include a specified portion of a community service facility's adjusted basis. If financed with tax-exempt bonds, IRC §42(d)(4)(C) applies to buildings placed in service after December 31, 2000, but only with respect to bonds issued after December 31, 2000.

A "community service facility" is any facility:

- Located in a qualified census tract (discussed later).
- Designed to serve primarily individuals whose income is 60% or less of area median gross income (AMGI) within the meaning of IRC §42(g) (1) (B). Rev. Rul. 2003-77 provides that this requirement is satisfied if the following conditions are met. First, the facility must be used to provide services that will improve the quality of life for community residents. Second, the taxpayer must demonstrate that the services provided at the facility are appropriate and helpful to individuals in the area of the project whose income is 60% or less of AMGI. This may, for example, be demonstrated in the market study required under IRC §42(m) (1) (A) (iii), or another similar study. Third, the facility must be located on the same tract of land as one of the buildings that is part of the qualified low-income housing project. Finally, if fees are charged for services provided, they must be affordable for individuals whose income is 60% or less of AMGI.
- Used throughout the taxable year as a community service facility.

Adjusted Basis Limitation

- In addition to the requirements above, the increase in the eligible basis of any low-income building attributable to the adjusted basis of any community service facility is limited. For

purposes of limiting the costs included in eligible basis, all community service facilities associated with the same qualified low-income housing project are treated as one facility.

Buildings Placed in Service Before July 31, 2008

The adjusted basis of any community service facility included in eligible basis cannot exceed 10% of the eligible basis of the qualified low-income housing project of which it is a part.

Buildings Placed in Service After July 30, 2008

The adjusted basis of any community service facility included in eligible basis cannot exceed the sum of:

- 25% of so much of the eligible basis of the qualified low-income housing project of which it is a part as does not exceed $15,000,000, plus
- 10% of so much of the eligible basis of such project as is not taken into account under (1) above.

Example

An example of a qualifying community service facility is described in Rev. Rul.2004-82, Q&A #2.

A new qualified low-income building received a housing credit allocation on June 1, 2003, and was placed in service in 2004. The building is located in a qualified census tract (as defined by IRC §42(d) (5) (B) (ii), formerly IRC §42(d) (5) (C)). The neighborhood in which the building is located is an area with a high rate of crime. In 2004, the local police department leases a unit in the building to be used as a police substation. The substation is part of the police department's community outreach program and is intended to serve as a deterrent to crime in the community, assist the community with solving crime-related problems, reduce the response time to area calls for service, and provide the locally assigned police officers with a local office. The services provided by the police are free of charge. The substation's adjusted basis does not exceed 10% of the building's eligible basis.

As required by IRC §42(m)(1)(A)(iii), prior to the allocation of low-income housing credit to the building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by the building. The study found, among other items, that due to the high rate of crime in the com-munity in which the building is located, providing a police substation would be appropriate and helpful to individuals in the area of the building whose income is 60% or less of AMGI.

The substation qualifies as a community service facility under IRC §42(d) (4) (C) (iii). Under the facts presented, the substation is designed to serve primarily individuals whose income is 60% or less than AMGI for the following reasons:

- the services provided at the substation are services that will help improve the quality of life for community residents;
- the market study found that the services provided at the substation would be appropriate and helpful;
- the substation is located within the building; and
- the services provided at the substation are affordable to low-income individuals. Because the other requirements in IRC §42(d) (4) (C) are met, the building's adjusted basis will include the substation's adjusted basis; i.e., the substation's adjusted basis is includable in the building's eligible basis.

Low-Income Buildings in High Cost Areas

After considering all the limitations to eligible basis discussed above, the modification for high cost areas is made. Under IRC §42(d)(5)(B), if a low-income building is located in a high cost area, then the eligible basis of a new building or the eligible basis associated the rehabilitation of an existing building can be increased to as much as 130% of the actual cost. Buildings receiving this increase in eligible basis are identified on Form 8609, Part I, line 3b. This increased eligible basis is often referred to as a "stepped up" eligible basis.

Qualified Census Tracts

Certain census tracts qualify for the increase in eligible basis. The designation is made by Department of Housing and Urban Development (HUD) and is based on the character of the population; i.e., more individuals fitting the "low-income" definition within a limited area. Under IRC §42(d)(5)(B)(ii)(I), a "qualified" census tract is any HUD-designated census tract in which 50% or more of the households have income less than 60% of the area median gross income or a poverty rate of at least 25%.

Difficult to Develop Areas (DDA)

As defined in IRC §42(d)(5)(B)(iii)(I), "Difficult to Develop Areas" (DDAs) are areas designated by HUD where the costs of construction, land, and utilities are high compared to the area median gross income. In these locations, more credit is needed to subsidize costs that exceed the maximum costs otherwise allowable in eligible basis.

Gulf Opportunity Zone

Under IRC §1400N(c) (3), the Gulf Opportunity (GO) Zone, Rita GO Zone, and Wilma GO Zone are treated as IRC §42(d) (5) (B) (iii) (I) difficult development areas. State agencies may increase the eligible basis of low-income buildings located in these areas if:

- the building was placed in service after December 31, 2005 and before January 1, 2011, and
- a credit allocation to the building was made after December 31, 2005, and before January 1, 2009, or, to the extent the building was financed with tax-exempt bonds, the bonds were issued after December 31, 2005.

State Agency Designation

For buildings placed in service after July 30, 2008, state agencies can, under IRC §42(d)(5)(B)(v), designate buildings requiring an increase in credit in order for the building to be financially feasible and treat them as being located in a DDA. However, a state agency cannot designate buildings as requiring an increase in credit if any portion of the building's eligible basis is financed with tax-exempt bonds under IRC §142(d).

Coordination with 40-50 Rule under Former IRC §42(i) (2) (E)

If the building was placed in service before July 31, 2008, and is subject to the 40-50 Rule, then the building does not qualify for the increase in credit for buildings located in qualified census tracts or difficult development areas. Buildings subject to this rule are documented on Form 8609, line 6f. See former IRC §42(i) (2) (E) and Chapter 13.

Audit Techniques

- The taxpayer should provide documentation demonstrating that the low-income buildings are located in a qualifying area.
- Lists of qualified census tracts designated by HUD and DDAs are available at www.huduser.org/datasets/qct.html.

Example

Example 1: Low-Income Building Located in Qualified Census Tract

A taxpayer claimed IRC §42 credit for a new building based on an eligible basis of $10,000,000. The taxpayer also qualified for an increase in eligible basis to 130% of the actual costs. When reporting the building's eligible basis on Form 8609-A, line 1, the taxpayer entered $13,000,000.

The examiner made adjustments to the actual costs included in eligible basis equaling $700,000. The actual eligible basis is $10,000,000 - $700,000 = $9,300,000. When multiplied by 130%, the corrected eligible basis is $12,090,000. The adjustment to eligible basis is:

$13,000,000 – $12,090,000 = $910,000.

Summary

If the quality standards of a market-rate unit are above the average quality standards of the low-income units in the building, then the building's eligible basis is reduced by the eligible basis attributable to the market-rate unit. An exception applies if (1) the excess cost of the market-rate unit is not greater than 15% of the average cost per square foot of the low-income units, and (2) the taxpayer elects to exclude the excess cost from the building's eligible basis. The election is made on Form 8609, line 9b.

A building's eligible basis cannot include any costs financed with the proceeds of a federally funded grant. Federal grants are funds which originate from a federal source and which do not require repayment.

Taxpayers providing transitional housing for the homeless can include a specified portion of the building used to provide supportive services designed to assist tenants in locating and retaining permanent housing in eligible basis.

IRC §42 projects financed with tax-exempt bonds are subject to all the IRC §42 requirements, as well as requirements for the tax-exempt bond financing under IRC §142(d). If 50% or more of the aggregate basis of any buildings and the land on which the buildings are located is financed by tax-exempt bonds, then the credit is based on the entire eligible basis of the qualified low-income buildings, regardless of the source of funds used to finance the qualifying costs. If less than 50% of the aggregate basis of the building and land are financed with tax-exempt bonds, then only the eligible basis actually financed with the tax-exempt bonds is includable in eligible basis.

The IRC §47, Rehabilitation Credit, and IRC §48, Energy Credit, require reductions of the adjusted basis used to determine the eligible basis for IRC §42 purposes.

IRC §42 projects can include community service facilities designed to serve individuals with qualifying income in the qualified census tract in which the project is located. The adjusted basis of such facilities includable in eligible basis is limited to a specified percentage of eligible basis.

If a low-income building is located in a high cost area, the eligible basis of a new building or the eligible basis associated the rehabilitation of an existing building can be increased by as much as 130% of the actual cost.