

IRC §42, Low-Income Housing Credit - Part I Introduction and Pre-Contact Analysis

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Chapter 1 Introduction

The IRC §42 Low Income Housing Credit Program was enacted by Congress as part of the Tax Reform Act of 1986 to encourage new construction and rehabilitation of existing buildings as low-income rental housing for households with income at or below specified income levels.

Congress recognized that a private sector developer may not receive enough rental income from a low-income housing project to cover the costs of development and still provide a return to investors sufficient to attract the needed equity investment. The IRC §42 program provides tax incentives for investors to make equity investments. In exchange for equity, investors receive tax credits and other tax benefits associated with ownership of the project to offset federal income taxes for a ten year period. These tax benefits, plus the possibility of cash proceeds from the eventual sale of the project, represent the investors' return on investment.

Topics

- Overview of the IRC §42 Program
- State Housing Agency Responsibilities
- IRS Responsibilities: Chief Counsel
- IRS Responsibilities: LIHC Compliance Unit
- IRS Responsibilities: Audits
- Summary

Overview of the IRC §42 Program

The taxpayer agrees to provide low-income housing for at least thirty years.

- In exchange for the investment in low-income housing, the taxpayer will receive tax credits for each of ten years, which is known as the "credit period."
- To keep the credit, the taxpayer must provide low-income housing for fifteen years, which is known as the "compliance period." Failure to maintain the housing in compliance with IRC §42 requirements for the entire compliance period can result in the recapture of a portion of the credit allowable in prior years.
- After IRS jurisdiction ends, the state agency has sole jurisdiction and the taxpayer must continue to provide low-income housing for at least another fifteen years. The "extended use period" is at least 30 years, beginning with the first year of the credit period.

All three time periods begin on the same day; i.e., the first day of the tax year in which the building is placed in service, or if the taxpayer elects, the beginning of the following tax year.

Types of Housing

The credit supports a variety of housing opportunities. The taxpayer can build new housing or rehabilitate existing buildings. The housing can be apartments, single-family housing, single-occupancy rooms, or even transitional housing for the homeless. A building may be mixed low-income and market-rate rental units and a portion of the building may be for commercial use. Generally, the housing must be used on a nontransient basis; i.e., an initial 6-month lease term.

Also, the housing must qualify as residential rental property; e.g., no hotels, hospitals, or nursing homes, etc.

Combining with Other Tax Credits

Besides qualifying for the Low-Income Housing Credit under IRC §42, the taxpayer may also qualify for the Rehabilitation Credit under IRC §47 and the Energy Credit under IRC §48, but not the New Markets Credit under IRC §45D. A building may also qualify for tax-exempt bond financing under IRC §146, in which case the taxpayer is also subject to the rules under IRC §142(d). The taxpayer may also use other federally-sourced loans and grants to finance and operate the building.

Computation of Allowable Annual Credit

The amount of credit the taxpayer can claim each year is determined as:

- Eligible Basis x Applicable Fraction = Qualified Basis.
- Qualified Basis x Applicable Percentage = Annual Credit Amount

Eligible Basis

The Eligible Basis is the total allowable cost associated with the depreciable residential rental project. If the building is located in a high cost area, the eligible basis may be increased to 130% of the actual costs.

Applicable Fraction

The Applicable Fraction is the portion of rental units that are qualified low-income units; determined as the lesser of square footage or number of units. To qualify, the unit must be occupied (or last occupied) by an income-qualifying household and, if the household is comprised entirely of full-time students who otherwise qualify as low-income tenants, the unit is qualified only if an exception under IRC §42(i) (3) (D) is met. The housing must be suitable for occupancy and free from health and safety hazards. The rent must also be restricted; i.e., the rent cannot exceed 30% of the income limit applicable to the building location. The unit must be for use by the general public

Qualified Basis

Qualified Basis is the product of the Eligible Basis and the Applicable Fraction.

Applicable Percentage

The amount of credit, over the ten-year credit period, is equal to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing. The discount factor is known as the Applicable Percentage and is based on interest rates.

Compliance Requirements

The taxpayer is also subject to the following rules which may impact compliance on a unit-by-unit basis, at the building level, or the entire project.

Minimum Set-Aside – A housing project will not qualify for any credit unless it includes a specified minimum number of qualified low-income rental units.

Available Unit Rule – Generally, if the income of an existing tenant rises above a specific limit, the next available comparable unit in the building must be rented to an income-qualified tenant.

Vacant Unit Rule – If a low-income unit becomes vacant, the taxpayer must make reasonable attempts to rent the unit to income-qualified tenants before renting any market-rate units to tenants who are not income-qualified.

General Public Use – The rental units must be available for use by the general public. A unit is for use by the general public if the unit is rented in a manner consistent with housing policy governing non-discrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD)(24 CFR subtitle A and Chapters I through XX), and if the unit is not provided only for a member of a social organization, not provided by an employer for its employees, or not part of a hospital, nursing home, sanitarium, life care facility, trailer park, or intermediate care facility for individuals with mental or physical disabilities.

Material Participation of Qualified Nonprofit Organizations – If the taxpayer received an allocation under IRC §42(h)(5), a set-aside of credit designated for projects owned by qualified nonprofit organizations, then the qualified nonprofit organization must materially participate in both the development and operation of the project throughout the 15-year compliance period.

Extended Use Agreement – No credit is allowable for a taxable year unless this agreement between the taxpayer and the state agency allocating the credit is in effect as of the last day of such taxable year. The agreement must be recorded in the land records as a restrictive covenant and is enforceable under state law.

Certifications and Annual Reports – A taxpayer completes a certification with respect to the first year of the credit period, which is a one-time filing of Form 8609, Low-Income Housing Credit Allocation and Certification, with the IRS.

Part I is completed by the state agency and Part II is completed by the taxpayer.

The taxpayer also files Form 8609-A, Annual Statement for Low-Income Housing Credit, with its tax return for each year of the 15-year compliance period. The taxpayer is also required to certify at least annually to the state agency that the project met all the requirements.

Inspections by State Agency – Tenant records and the low-income project are subject to physical inspection by the state agency.

Credit Disallowance and Recapture

The credit may be disallowed (in part or in whole). Not only is the credit disallowed in the year of a noncompliance event, but if the qualified basis is less at the end of that taxable year than the qualified basis at the close of the preceding taxable year, the taxpayer is subject to the credit

recapture provisions under IRC §42(j). The recapture amount is computed as a percentage of the credit claimed in prior years plus interest. The recapture percentage is based on the year within the 15-year compliance period that the noncompliance occurred.

No credit is allowable for the year in which a taxpayer disposes of a building (or interest therein) and the recapture provisions are also applicable unless, under IRC §42(j) (6), it is reasonably expected that the new owner will continue to operate the building as a qualified low-income building for the remainder of the 15-year compliance period.

State Housing Agency Responsibilities

The program is jointly administered by the IRS and state-authorized tax credit allocating agencies. Each state receives tax credits on an annual basis. Under IRC §42(h) (3), the amount of credit available to the state for allocation to taxpayers for any calendar year is the "credit ceiling."

Qualified Allocation Plan (QAP)

The state agencies are responsible for determining which housing projects should receive credits and the dollar amount allocated. Under IRC §42(m) (1), the state agency must develop a Qualified Allocation Plan (QAP) that is approved by the governmental unit having jurisdiction over the state allocating agency. The QAP must have the following characteristics:

- Identifies the selection criteria to be used for determining housing priorities that are appropriate to local conditions. The selection criteria must include project location, housing needs characteristics, project and sponsor characteristics, tenant populations with special needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project.
- Gives preference to projects serving the lowest income tenants, for the longest periods, located in qualified census tracts, and which will contribute to a concerted community revitalization plan.

Allocating Credits

The allocating agencies are responsible for allocating tax credits to qualifying projects that meet the QAP's criteria. The allocation process varies among the states, but generally, real estate developers apply for the credit and submit proposals which are then ranked according to the criteria in the QAP. If accepted, the state agency and developer will enter into a contract, documented with a "reservation" of credit, followed by a "binding commitment" to allocate credit in the future, or "carryover allocation," which is documented on Schedule A (Form 8610), Carryover Allocation of Low-Income Housing Credit. Generally, owners must place the projects in service by the close of the second calendar year following the year the carryover allocation of credit is made or return the credit to the state for reallocation to other projects.

An allocating agency is to provide no more credit than deemed necessary to ensure the project's financial feasibility throughout the 15-year compliance period. In general, the agency is to compare the proposed project's total developmental costs with the anticipated private and governmental financing (other than equity raised from tax credits). The difference between the total development costs and financing (other than equity raised through the credit) is commonly referred to as the "equity" gap the IRC §42 credit is intended to fill. The Agency will allocate to the project only the amount of credit necessary to fill this equity gap.

The credit allocation is documented on Form 8609, Low-Income Housing Credit Allocation and Certification. The agency executes Part I and then mails the Form 8609 to the taxpayer. The taxpayer then completes the certification required under IRC §42(l) (1) for the first year of the credit period by completing Part II of the Form 8609 and submitting it to the IRS.

Compliance Monitoring

The QAP must also provide procedures that the state agency will follow to monitor the project for continuous compliance with IRC §42 requirements and notify the IRS if noncompliance occurs. The compliance monitoring requirement was made effective on January 1, 1992, and applies to all buildings for which a low-income housing credit under IRC §42 is, or has been, allowable at any time.

Treas. Reg. §1.42-5 provides the minimum standards for conducting compliance monitoring activities. At least once every three years, the state agency must conduct on-site inspections for all buildings in the project and, for at least 20% of the project's low-income units, inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units.

The compliance monitoring regulations also require the owner of a project, at a minimum, to certify annually to the state agency that for the preceding 12-month period the project was in compliance with the requirements of IRC §42. The certification covers a variety of requirements, including that the owner has received an annual income certification from each low-income tenant and documentation supporting that certification, and that each building in the project was suitable for occupancy, taking into account local health, safety, and building codes. Treas. Reg. §1.42-5(c) (1) lists the annual certification requirements.

Reporting Noncompliance to the IRS

When noncompliance is identified or there has been a building disposition, the state agencies are required to notify the IRS using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. If the state agency reports that the owner is "out of compliance," the IRS sends a notification letter to the owner identifying the type of noncompliance reported on Form 8823 with instructions to contact the state agency to resolve the issue. Once the issue is resolved, a "back in compliance" Form 8823 is filed with the IRS.

Annual Report to the IRS

IRC §42(l)(3) requires state agencies to submit annual reports to the IRS identifying the annual credit amount allocated to each building for such year, sufficient information to identify each such building and the taxpayer with respect thereto, and other information needed for the administration of the program.

The annual report is made by submitting Form 8610, Annual Low-Income Housing Credit Agencies Report, with copies of the Forms 8609 issued that year and Schedule A (Form 8610), documenting credit carryover allocations, to the IRS by February 28th of the following year. Part I is a reconciliation of the forms submitted with Form 8610, Part II is a reconciliation of the state's credit ceiling and credit allocations, and Part III is a report of the state agency's compliance monitoring activities and compliance with the requirements of Treas. Reg. §1.42-5.

State agencies are subject to penalties under IRC §§ 42(l) (3) and 6652(j) for any failure to submit the report timely.

IRS Responsibilities: Chief Counsel

The Chief Counsel is the chief law officer of the IRS and is the legal advisor to the Commissioner and the Commissioner's employees. The Office of Chief Counsel furnishes legal opinions for the preparation and review of rulings and memoranda of technical advice; prepares, reviews, and assists in the preparation of proposed legislation, treaties, regulations, and Executive orders relating to laws affecting the IRS; represents the Commissioner in the Tax Court; and determines which civil actions should be litigated under the laws relating to the IRS and prepares recommendations for the Department of Justice regarding commencement of legal actions. In the Office of Chief Counsel, Branch 5 in the Passthroughs and Special Industries division is responsible for IRC §42, as well as §§ 45D, 47, and certain other tax incentives.

IRS Responsibilities: LIHC Compliance Unit

The Low-Income Housing Credit (LIHC) Compliance Unit is responsible for processing information submitted to the IRS by state agencies and taxpayers, providing assistance, and evaluating noncompliance for audit potential.

Form 8610, with Form 8609 and Schedule A (Form 8610)

Form 8610, Annual Low-Income Housing Credit Agencies Report, with Forms 8609, Low-Income Housing Credit Allocation and Certification, and Schedule A (Form 8610), Carryover Allocation of Low-Income Housing Credit, submitted by the state agencies are reconciled and processed. Forms 8609 submitted by taxpayers are matched to the state agencies' submissions and processed.

Form 8823

Forms 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, are processed and a notification letter is sent to the taxpayer identifying the potential noncompliance issues. The Forms 8823 are also evaluated for audit potential.

Form 8821

On May 19, 1999, a Memorandum of Understanding (MOU) was finalized as part of a FedState initiative to improve the administration of the LIHC program. The state agencies can require project developers to complete Form 8821, Tax Information Authorization, as part of their application for an allocation of IRC §42 credit. The taxpayer designates the state agency as the appointee to receive tax information regarding the applicant's prior compliance with IRC §42 requirements; i.e., audit results and Form 8823 filings from other state agencies. The information is used to help the state agency make better informed decisions about credit allocations. The LIHC Compliance Unit provides the information to the state agencies upon request.

IRS Responsibilities: Audits

Based on the state agencies' noncompliance reports, taxpayers are identified for further consideration of audit potential. The taxpayer's tax returns, Forms 8823 filed for the buildings, and other information are evaluated. If it is determined that an audit is warranted, the complete file is sent to the appropriate field office. The taxpayer is then notified that an audit has been scheduled. This is not the only method for selecting tax returns on which the low-income housing credit has been claimed, and, at the examiner's discretion, the audit may be expanded to include additional issues or tax returns.

Summary

IRC §42 provides federal tax incentives for equity investments in low-income housing.

The taxpayer can build new housing, or acquire and rehabilitate existing housing. The housing can be apartments, single-family housing, single-occupancy rooms, or even transitional housing for the homeless. The project may include both low-income and market-rate rental units, and a portion of the property may be for commercial use. The housing must qualify as residential rental property; e.g., no hotels, hospitals, or nursing homes, etc.

The taxpayer agrees to provide low-income housing for at least thirty years. The taxpayer receives credit for ten years (credit period), must provide low-income housing under IRS jurisdiction for fifteen years (compliance period), and under the state agency's sole jurisdiction for at least an additional fifteen years (extended use period). All three time periods begin on the same day; i.e., the first day of the tax year in which the building is placed in service, or if the taxpayer elects, the beginning of the following year.

The amount of credit the taxpayer can claim each year is determined as:

Eligible Basis x Applicable Fraction = Qualified Basis

Qualified Basis x Applicable Percentage = Annual Credit Amount

The eligible basis is the total allowable costs associated with the depreciable residential rental project. The applicable fraction is the portion of rental units that are qualified low-income units.

The applicable percentage is the discount factor needed to limit the annual credit to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing.

The allowable credit may be reduced (in part or in whole) if the taxpayer is not compliant with IRC §42 requirements. The taxpayer may also be subject to the recapture of credit claimed in prior years under IRC §42(j).

If a taxpayer disposes of a low-income building (or interest therein), no credit is allowable in the year of the disposition and the taxpayer is subject to recapture unless the taxpayer reasonably expects that the building will continue to be operated as a low-income building for the remaining compliance period.

The program is jointly administered by the IRS and state-authorized tax credit allocating agencies. Each state receives tax credits annually. The agencies are responsible for identifying the state's housing needs, allocating credit to qualifying projects that meet the state's QAP criteria, and monitoring the operating project for on-going compliance with IRC §42. Noncompliance is reported to the IRS.

The IRS' compliance responsibilities include the processing of forms submitted by state agencies and taxpayers, and ensuring compliance through activities such as auditing taxpayers' federal income tax returns.

Chapter 2 Pre-contact Analysis

Introduction

This chapter provides guidelines for analyzing tax returns before contacting the taxpayer to determine which items related to the IRC §42 credit should be examined.

Topics

- Form 8609, Low-Income Housing Credit Allocation and Certification
- Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
- Form 8609-A, Annual Statement for Low-Income Housing Credit
- Balance Sheet
- Schedule K and Schedule K-1
- Ownership By Individuals
- Prior and Subsequent Year Returns
- Related Returns
- Risk Analysis
- Initial Information Document Request
- Summary

Form 8609, Low-Income Housing Credit Allocation and Certification

Form 8609 documents the state agency's allocation of credit (Part I) and the taxpayer's certification for the first year of the credit period (Part II). It provides basic information about the low-income building, the terms of the credit allocation, and the taxpayer's elections.

Without a Form 8609 completed and signed by the state agency, the taxpayer cannot complete the first-year certification required under IRC §42(l) (1) and, therefore may not be entitled to claim IRC §42 credits. If Forms 8609 are not included in the case file, determine whether the forms were received from the taxpayer after the tax return was selected for audit by contacting the LIHC Compliance Unit. If completion of the first-year certification cannot be confirmed, refer to Chapter 4.

Amount of Credit Allocated

Compare the amount of credit claimed on the tax return to the amount allocated on Form 8609. The taxpayer is not entitled to claim more IRC §42 credit than the dollar amount reflected on Form 8609, line 1b. Form 8586, Low-Income Housing Credit, is filed with the tax return; line 1 indicates the total number of Forms 8609-A attached and line 3 indicates the total amount of credit from all the attached Forms 8609-A.

Eligible Basis and Qualified Basis

Compare the Maximum Qualified Basis identified on line 3a by the state agency and the eligible basis identified on line 7 by the taxpayer.

- If the numbers are the same, then (1) the building was intended to be a 100% low-income building and (2) the state agency determined that it was necessary to allocate the maximum amount of credit possible to assure that the project would remain feasible throughout the 15-year compliance period.
- If the eligible basis is more than the qualified basis, then either the building is a mixed-use building (both low-income and market-rate units) or the state agency determined that it was not necessary to allocate the maximum amount of credit possible to assure that the project would remain feasible throughout the 15-year compliance period.
- If the eligible basis is less than the maximum qualified basis, the issue should be addressed during the audit.

If the percentage on line 3b is larger than 100%, then the eligible basis identified on line 7 has been artificially increased above the actual costs because the building is in a location that is considered difficult to develop; e.g., the costs of construction, land, and utilities are high compared to the location's Area Median Gross Income or there is a particularly high concentration of low-income individuals. The increased eligible basis increases the amount of credit available to subsidize costs that cannot be supported by debt or future cash flow from rents.

There should be a one-to-one match of Forms 8609 to Forms 8609-A filed with the tax return. Compare the eligible basis on Form 8609, line 7, to the eligible basis identified on Form 8609-A, line 1. The numbers should be the same. If the eligible basis on Form 8609-A, line 1, is less than reported on Form 8609, then a recapture event may have occurred and the issue needs to be addressed during the audit. The eligible basis on Form 8609-A, line 1, should never be larger than the eligible basis reported on Form 8609, line 7.

Applicable Percentage

Compare the applicable percentage reported by the taxpayer on Form 8609-A, line 5, to the applicable percentage identified on the matching Form 8609, line 2. Since this applicable percentage is fixed and identified by the state agency, the applicable percentage is seldom an audit issue.

Type of Allocation

The type of credit allocated to a building is dependent on two factors:

- Whether the housing is newly constructed, an existing building, or an existing building that has been rehabilitated, and
- Whether federal subsidies were used to construct or rehabilitate the building.

The possible combinations of the two characteristics are presented on Form 8609, lines 6a-e. The options are mutually exclusive so only one of the boxes should be marked on any one form. A building can receive more than one type of allocation, which requires the preparation of multiple Forms 8609.

Tax-Exempt Bonds

Projects financed with tax-exempt bonds under the IRC §146 Volume Cap and as defined in IRC §142(d) can also qualify for IRC §42 credits, but are limited to the 30% credit. The percentage of the aggregate basis financed by the tax-exempt bonds is identified on Form 8609, line 4, and the type of building is identified on line 6a or 6d. Note: the aggregate basis used for the percentage computation is different than eligible basis or qualified basis.

Nonprofit Set-Aside

A portion of a state's credit ceiling is set-aside for allocation to projects involving qualified nonprofit organizations. These allocations are identified on Form 8609, line 6g, starting with the November 2003 revision of the form. If an earlier revision was used, then the state agency should be asked to confirm whether the allocation was from the nonprofit set-aside. The nonprofit entity must (1) own an interest in the property and (2) materially participate in both the development and on-going operation of the low-income project throughout the 15-year compliance period. See Chapter 6.

Credit Period: BINs, Dates, and Elections

Form 8609, line 1a, date of allocation, identifies the date (1) the taxpayer and state agency entered into a carryover allocation, or (2) the state agency signed the completed Form 8609, Part I, if the taxpayer was able to receive the allocation and place the building in service all within one calendar year. However, because of the complexity of real estate development, most IRC §42 projects are developed using a carryover allocation under IRC §42(h) (1) (E) or (F). If the IRC §42 project is a qualified residential rental project under IRC §142(a) (7), line 1a is left blank.

Form 8609, line E, identifies the unique Building Identification Number (BIN) assigned to the low-income building and should consist of the two letter state abbreviation, a two-digit year for the year the allocation was made, and a five-digit number assigned by the state agency. The BIN is helpful in determining the lifecycle of buildings financed with tax-exempt bonds. However, once the BIN is assigned, it will also be the BIN for all subsequent allocations of credit.

Form 8609, line 5, date the building was placed in service, is the date the first unit in the building is ready and available for occupancy under state or local law. For taxpayers receiving carryover allocations of credit, the placed in service date should be no later than the close of the second calendar year following the calendar year in which the allocation was made. For example, if the allocation date is June 14, 2009, the placed in service date should be no later than December 31, 2011.

Form 8609, line 10a, documents the taxpayer's election to begin the credit period the first year after the building is placed in service. Based on the information on lines 5 and 10a, the first year of the credit period can be determined, which is important because:

- Generally, the applicable fraction is determined as of the last day of the taxable year. For the first year of the credit period, however, the applicable fraction is computed using an averaging methodology described in IRC §42(f) (2).
- If an adjustment to the credit is made and the recapture provisions under IRC §42(j) are triggered, a portion of the credit claimed for each prior year of the 15- year compliance period is recaptured. The recapture percentage is also dependent on the year of the compliance period for which the recapture provisions are triggered.

Multi-Building Projects

Form 8609, line 8b, documents the taxpayer's election to treat the building as part of a multi-building project. If the election is made (the "Yes" box is checked), the taxpayer must identify all the buildings to be included in the project on an attachment to the Form 8609. The buildings should be identified by name, address, BIN, and the amount of credit allocated to each building. Under IRC §42(g) (7) and Treas. Reg. §1.103-8(b) (4) (ii), two or more qualified low-income buildings can be included in a project only if the buildings:

- are located on the same tract of land (including contiguous parcels), unless all of the dwelling units in all the buildings are rent restricted,
- are owned by the same person for federal tax purposes,
- are financed under a common plan of financing, and

- have similarly constructed housing units.

Identifying which buildings are included in the project is important for determining whether the project met the minimum set-aside requirement under IRC §42(g) (1).

Minimum Set-Aside

Form 8609, line 10c, documents the taxpayer's election of a minimum set-aside, which establishes three criteria against which the taxpayer's compliance will be evaluated:

- The minimum number of low-income units the taxpayer must provide to be a qualified low-income project,
- The income limit used to identify income-qualified households, and
- The maximum rent the taxpayer may charge for a low-income rental unit.

The minimum set-aside must be the same for all low-income buildings included in a project.

If the project is financed with tax-exempt bonds, the taxpayer may elect, on Form 8609, line 10d, to be a deep rent skewed project under IRC §142(d)(4)(B). At least 15% of the low-income units in the project must be occupied by households whose income is 40% or less than the applicable income limit. This election is in addition to the minimum set-aside election.

Property Address

Using the building address (Form 8609, line A), research the local property records. Recorded documents provide information regarding:

- the value of the land and buildings,
- changes in ownership during the life of the project that may have triggered the credit recapture requirements,
- debt financing used to finance the low-income project,
- contracts imposing additional restrictions on the use of the property, and
- the extended use agreement. If an extended use agreement is not recorded, then the project may not be a low-income project qualifying for the credit. Local courthouse records can be reviewed.

Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

The Forms 8823 submitted by the state agency provide information about the building to supplement what is known from the Forms 8609 and can help identify issues that should be addressed during an audit.

Form 8823 is considered an information return. The state agency's conclusions are accepted as correct unless otherwise proven to be incorrect (see IRM 4.10.7.6.1.2). The IRS can use the

information to make adjustments to the IRC §42 credit. However, the IRS cannot project the state agency sample's results to the entire population of low-income units.

Reconciliation to Forms 8609

The Forms 8609 and the Forms 8823 should be matched up by BIN and reconciled:

- Reconcile the amount of credit allocated on the Form 8609, line 1b, to the amount of credit on Form 8823, line 5; there may be more than one Form 8609 for a building. If Form 8823, line 5, is blank or zero, then the taxpayer had not received the Forms 8609 at the time the state agency filed the Form 8823 with the IRS. Compare the dates the Forms 8609 and Forms 8823 were signed by the state agency.
- Compare the owner's name and EIN; different owners indicate a prior sale of the building.

Rental Units

Forms 8823, lines 7a-d, provide information about the rental units:

- Line 7a identifies the total number of rental units in the building and line 7b identifies the total number of low-income units in the building. If line 7b is less than line 7a, then the building has a mix of low-income and market-rate rental units. For "mixed-use" buildings, audit issues should include consideration of the taxpayer's compliance with the Available Unit Rule, the Vacant Unit Rule, and the requirement to perform annual income recertifications for all low-income households. Noncompliance with any of these rules may result in failure to meet the minimum set-aside requirement.
- Line 7c identifies the total number of rental units in a building for which noncompliance issues were identified by the state agency. The extent of known noncompliance can be estimated by comparing this number to line 7a.
- Line 7d identifies the total number of low-income units reviewed by the state agency. By regulation, the state agency is required to review at least 20% of the low-income units on a "project" basis. If line 7d is more than 20% of line 7a, then the state agency may have expanded the sample size because extensive noncompliance was identified; e.g., poor internal controls (significant risk of error), multiple problems, a significant number of noncompliant units, or the state agency had credible information from a reliable source.

Period of Noncompliance

The time period during which the taxpayer was noncompliant can be determined by comparing the dates on Form 8823, lines 8 and 9. The length of time will indicate whether the noncompliance possibly impacts more than one tax year. Line 9 will be left blank if the noncompliance had not been corrected by the time the Form 8823 was filed.

Categories of Noncompliance

Form 8823 identifies 16 specific categories of noncompliance, as well as a catch-all category for other noncompliance issues. The IRS has provided the state agencies with a guide for completing Form 8823. The guide includes a separate chapter for each category of noncompliance which explains the underlying law and its application to specific fact patterns. The Guide is available on www.irs.gov; the catalogue number is Training 23092-001.

The relevant chapters should be reviewed to understand the issues of noncompliance reported by the state agency. Note, however, that the scope of the guide is limited to identifying, correcting, and reporting noncompliance issues to the IRS. It does not address how noncompliance affects the amount of credit a taxpayer may claim.

Dispositions

State agencies report dispositions of low-income buildings, or interests therein, on Form 8823, line 13a-d. Information includes how the property was disposed of and who purchased the property (or interest therein). The disposition (gain or loss) should be reflected on the tax return.

Form 8609-A, Annual Statement for Low-Income Housing Credit

Form 8609-A is filed by the taxpayer owning the low-income building to complete the annual certification of on-going compliance under IRC §42(l) (2) and to compute the allowable credit for that tax year. The form is filed with the taxpayer's tax return for each year in the 15-year compliance period that begins after December 31, 2004. A separate Form 8609-A is filed for each allocation, so there should be a one-to-one match of Forms 8609 and Forms 8609-A.

Part I, Compliance Information

Based on the responses to questions A and B, the Form 8609-A can be associated with the correct Form 8609.

As noted earlier, the taxpayer cannot complete the certification for the first year of the credit period under IRC §42(l) (1) without receiving the executed Form 8609 from the state agency. Question C puts the taxpayer on notice that any building owner claiming credits without receiving a completed Form 8609 that is signed and dated by a state agency is subject to disallowance of the credit.

Questions D and E allow for self-reporting of events that may require a recapture of credit under IRC §42(j).

Part II, Computation of Credit

The second part of Form 8609-A is the computation of the allowable credit for the taxable year. The computation involves a number of steps needed to account for various types of low-income housing and circumstances. At this point, it is not necessary to analyze the whole equation, but note the following:

- The eligible basis entered on Form 8609-A, line 1, should be the same as disclosed on Form 8609. Differences should be addressed during the audit. The amount entered on Form 8609-A, line 1, is the "per return" amount and the starting point for any adjustment made to the eligible basis.
- The applicable percentage on Form 8609-A, line 5, should be the same as disclosed on Form 8609, line 2. If the applicable percentages are not the same, the taxpayer should be asked to provide an explanation.
- Form 8609-A, line 15, is the allowable credit, but cannot be higher than the amount of credit identified on Form 8609, line 1b.
- If credit is claimed on Form 8609-A, line 17, then the tax return is for the eleventh year of the credit period. Any credit not allowed in the first year of the credit period because of the special rule for computing the applicable fraction is allowable in the 11th year of the 15-year compliance period under IRC §42(f)(2)(B).

Balance Sheet

The balance sheet included with the tax return provides financial information about the property. All large, unusual, or questionable items should be addressed during the audit.

Land Values

Determine whether the land value reported on the balance sheet is reasonable and comparable to the valuation in the land records. Extremely low values should be audited. Land costs are not included in the eligible basis and the issue will be whether the taxpayer has allocated costs to the low-income buildings that should be allocated to the land.

Buildings and Other Depreciable Assets

Most IRC §42 projects are owned by single-asset entities; i.e., the only business activity is the IRC §42 project. The eligible basis used to compute the credit should also appear on the balance sheet as depreciable property.

The depreciable asset figure should approximate the eligible basis reported collectively on the Forms 8609, line 7, and on Forms 8609-A, line 1, filed with the tax return. For low-income buildings in an area that is difficult to develop, multiply the depreciable assets by the percentage on Form 8609 line 3b, and then compare to the eligible basis.

Compare the balances of depreciable assets at the end of the year to the beginning of the year. Any significant decrease may be an indication of a sale or disposition of part (or all) of the IRC §42 project. For any such decrease in assets, there may be an IRC §42(j) credit recapture issue.

Accounts Receivable and Payable

Receivables and payables need to be reviewed. Large, unusual, or questionable amounts may be indicative of related party transactions or transactions that should be reviewed during the audit.

Schedule K and Schedule K-1

For a partnership, Schedule K and Schedules K-1 should be inspected to identify the type of financing involved, including nonrecourse financing. This information is good to know up front as the state agency records and taxpayer records will fully clarify the types and extent of financing used to develop and operate the IRC §42 project.

A comparison of the Schedules K-1 from year to year will identify changes in ownership percentages.

Ownership By Individuals

Individuals also own IRC §42 projects directly, and the requirements are exactly the same. The Form 8609 should identify the individual as the owner in box C of Part I. As with business entities, ensure that the Form 8609 was completed and signed by the state agency and that the taxpayer completed the IRC §42(1) (1) certification.

The taxpayer should be maintaining financial statements and summaries (including balance sheets, depreciation schedules, and income statements) regarding the operation of the IRC §42 project.

Prior and Subsequent Year Returns

The taxpayer's prior and subsequent year returns should be reviewed to verify filing, address issues related to the year under audit, and identify any large, unusual, or questionable items. Also review the Schedules K-1 filed each year to identify changes in the partnership ownership. Partners selling their interest in the partnership are subject to the recapture provisions under IRC §42(j).

Related Returns

Related returns are tax returns that have a relationship to the tax return under audit. Returns are considered related if an adjustment to one return requires adjustment to the other return so that the issue is treated consistently on both returns. Returns are also considered related for audit purposes if the returns are for entities that a taxpayer controls and can manipulate to divert income or camouflage transactions.

Partners: Consistent Treatment

If the entity under audit is claiming the credit as a result of an interest in a flow-through entity, identify the name and EIN for the related partnership owning the IRC §42 project. Tax returns often include a schedule listing partnership interests and accumulating the flow-through income, loss, or credits. See Chapter 19 for a complete discussion.

General Partner: Additional IRC §42 Projects

If the entity under audit owns the IRC §42 project, it is likely that it is a flow-through entity and the general partner is the project's developer. Determine whether the general partner is also the general partner for additional IRC §42 projects. If significant noncompliance is identified, the examination may need to be expanded to include the related entities.

Risk Analysis

A reasonable projection of the potential additional tax should be estimated based on all current year adjustments, recapture of credit from prior years, and future year revenue protection. Any examination adjustments that propose to decrease the applicable fraction or eligible basis will result in changes not only to the taxable year under audit, but also in the recapture of a portion of the credit allowable in prior years and will possibly limit the amount of allowable credit in the remaining years of the credit period. A single potential adjustment can significantly impact the allowable credit when projected over the entire 10-year credit period.

Example 1: Estimating Potential Tax

A taxpayer was allocated a credit of \$30,000 for one low-income building. During 2007, the fifth year of the credit period, the state agency determined that the project was no longer in compliance or participating in the IRC §42 program, and reported its finding to the IRS on Form 8823. The taxpayer, however, disregarded the state agency's determination and claimed the credit. The taxpayer's tax return for the fifth year was audited. For purposes of quickly estimating the potential adjustment, the examiner identified the following:

- The \$30,000 credit claimed for 2007 was not allowable.
- The taxpayer claimed \$30,000 for the 2003, 2004, 2005, and 2006 tax years.
- The credits are subject to recapture under IRC 42(j).
 - The credit portion of the recapture amount is $\$30,000 \times .333 \times 4 \text{ years} = \$39,960$.
- See Credit Disallowance and Recapture for explanation of the recapture percentage (.333).

Note: The recapture amount also includes an interest portion calculated separately for each year. The computation is complex and should not be attempted for purposes of the risk analysis.

- The taxpayer will not be able to claim credit in any of the remaining years of the 10-year credit period. $5 \times \$30,000 = \$150,000$.

Initial Information Document Request

Under Treas. Reg. §1.42-5(b), taxpayers are subject to recordkeeping and record retention provisions specific to IRC §42. The records must be retained for at least six years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least six years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

The following records and documents are necessary for the examination of specific issues related to the IRC §42 credit and should be requested at the beginning of the audit. However, as every case is different, the list should be tailored for the taxpayer under audit.

General Information about the Taxpayer

The following documents should be analyzed early in the audit to assist in setting the scope and depth of the audit.

- Partnership Agreement,
- Prospectus/Offering Memorandum related to the organization or syndication of the partnership,
- Documentation pertaining to the partners' capital contributions including all notes,
- Credit Allocation Application,
- Market Study,
- Credit Allocation Award/Contract or Carryover Allocation,
- Extended Use Agreement,
- All Forms 8609 issued to the taxpayer, and
- Internal audit reports.
- All Forms 8823

Tax Returns

The following documents will be needed to ensure consistent treatment from year to year:

- Copies of tax returns for the tax year prior to the earliest year under audit and all tax returns for years subsequent to the tax years under audit.
- Trial balance and any workpapers used to prepare the tax return under audit.
- Depreciation schedules.

Eligible Basis

The audit of eligible basis will start with an analysis of the following documents to identify specific costs for in-depth consideration as large, unusual, or questionable items:

- Final cost certification submitted to the state agency with supporting documentation; e.g., purchase agreements and construction contracts, or settlement documents if existing buildings were acquired.
- Documentation of all financing sources; e.g., grants, loans, tax-exempt bonds, below market federal loans, and loans payable to the developer or any partner. The taxpayer should provide all debt instruments; e.g., mortgages and promissory notes. Identify outstanding balances and records for all loan repayments.
- Financial reports; e.g., compilations, reviews, or audited financial statements.
- Development contracts or agreements for the acquisition, construction, or rehabilitation of the IRC §42 project and related payments and/or notes.

- Documentation of cost allocations between land, land improvements, and depreciable residential rental property included in eligible basis.

Qualifying Low- Income Households

While a review of the tenant files will be completed during the audit, the starting point will be an analysis of the tenant rolls. For the first document request, the taxpayer should provide:

- For the years under audit, rent rolls identifying the households and family size for each low-income unit.
- Documentation of internal controls in place to ensure that income-qualified households occupy the low-income units (e.g., copies of written procedures) and the taxpayer's policies (e.g., employment requirements and training).

1st and 11th Year of the Credit Period

If the first year of the compliance period is audited, the special rule for computing the applicable fraction under IRC §42(f) (2) is used. The taxpayer should provide:

- Certificates of Occupancy, which will establish when the units were first available for occupancy. The taxpayer may provide alternative documentation. See Notice 1988-116.
- A schedule indicating when each low-income unit was first occupied by an income-qualified household.
- Computation of the applicable fraction, including the computation of the applicable fraction for each month.

If the eleventh year of the compliance period is audited and the taxpayer has claimed credit, the taxpayer should provide the information identified above as well as a copy of the tax return for the first year of the credit period.

Additions to Qualified Basis

Units first occupied by qualifying households after the end of the first year of the credit period will result in an increase in qualified basis. The units qualify for the credit, but the applicable percentage applied to the additional qualified basis is 2/3 of the applicable percentage shown on Form 8609, line 2. See IRC §42(f) (3). The taxpayer should:

- Provide a list of units first occupied by qualifying tenants after the end of the first year of the credit period and identify when a qualifying household first occupied the unit, or
- Confirm that all units were occupied by qualifying households by the end of the first year of the credit period.

Examination of Income: Rents & Other Sources of Income

Gross income is to be considered and the minimum income probes completed. See Chapter 20. Generally, taxpayers owning IRC §42 projects are single-purpose entities and the rents from

leasing residential rental units will be the primary source of income. In addition to the records needed to complete the examination of income, the taxpayer should also provide:

- Description of residential rental units, including total number of units, total number of low-income units, size (number of bedrooms) and rents charged for low-income and market-rate units. Also identify units for on-site managers or security personnel.
- Documentation that rents are correctly restricted, including computations of the maximum allowable gross rent based on unit size.
- Sources of rent subsidies; e.g., HUD section 8 payments.
- Utility allowances and documentation of the computation.
- Fees for services provided to tenants in addition to housing; e.g., providing meals or cleaning services in assisted living housing.
- Other income from related activities; e.g., vending machines, laundry facilities, or charges for cable/satellite television.
- Other income sources such as from the commercial use of a portion of the property; e.g., the taxpayer may receive income for a cell phone tower installed on the roof of a building.
- Documentation of funds received from other sources; e.g., federal grants or subsidies received during the year, additional capital contributions, or loan proceeds.

Noncompliance

If Forms 8823 were filed by the state agency, the taxpayer should provide documentation for corrective actions taken to restore the project to compliance.

Dispositions

If the project was sold, documentation regarding the sale should be provided.

Particularly, the sales contract and settlement documents, computation of the capital gain/loss, how the gain/loss was distributed among the partners, and whether the sale required the new owner to operate the project as a qualified low-income project for the remainder of the 15-year compliance period.

IDR & Crosswalk to Issues

Exhibit 2-1, following this chapter, provide a discussion of documents that should be requested during the audit with reference to the relevant chapters in this guide

Summary

Before beginning the examination, the file should be reviewed and information analyzed to determine the scope and depth of the examination. For audits of the IRC §42 credit, the analysis should also include consideration of information presented on IRS forms, as well as on the tax return itself, including:

- Form 8609, Low-Income Housing Credit Allocation and Certification
- Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition
- Form 8609-A, Annual Statement for Low-Income Housing Credit
- Balance Sheet
- Schedule K and Schedules K-1

Based on the analysis of available information, a reasonable projection of the potential additional tax can be made. The estimate should include the current year adjustment, credit recapture under IRC §42(j) from prior years, and revenue protection if the potential adjustment affects future years of the 15-year compliance period.

An Information Document Request (IDR) should be prepared and sent to the taxpayer with the initial contact letter as specific information will be needed to audit IRC §42 issues. See Exhibit 2-1, IDR & Crosswalk to Issues

Exhibit 2-1 IDR & Crosswalk to Issues

The following records and documents are necessary for the examination of specific issues related to the IRC §42 credit and should be requested at the beginning of the audit. However, as every case is different, the IDR should be tailored for the taxpayer under audit.

General Information about the Credit Allocation

The following documents should be analyzed early in the audit to provide an overview of the credit allocation.

- All Forms 8609 issued to the taxpayer (see Chapter 2 for analysis and Chapter 4 for possible issues).
- Extended Use Agreement (see Chapter 5).
- If the credit allocation is from the nonprofit set-aside (see Chapter 6), the taxpayer should provide a copy of the IRS determination letter to confirm the nonprofit was granted nonprofit status.
- Copies of tax returns for the tax year prior to the earliest year under audit, and all tax returns for years subsequent to the tax years under audit, will be needed to ensure consistent treatment from year to year.

Eligible Basis

The audit of eligible basis (see Chapter 8) will start with an analysis of the following documents to identify specific costs for in-depth consideration as a large, unusual, or questionable item.

- Final cost certification submitted to the state agency with supporting documentation; e.g., purchase agreements and construction contracts, or settlement documents if existing buildings were acquired.

- Documentation of cost allocations between land, nonqualifying land improvements and depreciable residential rental property included in eligible basis.
- Development contracts, agreements or other documents related to a developer's involvement in the acquisition, construction, or rehabilitation of the IRC §42 project. Also request documentation of payments for the services provided and/or deferment of payment.
- Documentation of all financing sources; e.g., grants, loans, tax-exempt bonds, below market federal loans, and loans payable to the developer or any partner. Provide all debt instruments; e.g., mortgages and promissory notes. Identify the outstanding balances and records for all loan repayments. (See Chapter 10.)

Qualifying Low- Income Households

While a review of the tenant files will be completed during the audit, the starting point will be an analysis of the tenant rolls. See Chapter 12. The taxpayer should provide:

- For the years under audit, rent rolls identifying the households and family size for each low-income unit.
- Documentation of internal controls in place to ensure that income-qualified households occupy the low-income units (e.g., copies of written procedures) and the taxpayer's policies (e.g., employment requirements and providing training).

1st and 11th Year of the Credit Period

If the first year of the compliance period is audited, the special rule for computing the Applicable Fraction under IRC §42(f)(2) is used (see Chapter 12). The taxpayer should provide:

- Certificates of Occupancy, which will establish when the units were first available for occupancy.
- A schedule indicating when each low-income unit was first occupied by an income-qualified household.
- Computation of First Year Applicable Fraction, including the computation of the Applicable Fraction on a monthly basis.

If the eleventh year of the compliance period is audited and the taxpayer has claimed credit, the taxpayer should provide the information identified above as well as a copy of the tax return for the first year of the credit period.

Additions to Qualified Basis

Units first occupied by qualifying households after the end of the first year of the credit period will result in an increase in qualified basis. The units qualify for the credit, but the applicable percentage applied to the additional qualified basis is 2/3 of the applicable percentage shown on Form 8609, line 2. The computation of the credit allowable for increases to qualified basis is included on line 7 of the Form 8609-A filed with the tax return.

If the taxpayer is claiming credit for additions to qualified basis, then the taxpayer should provide a list of units first occupied by qualifying tenants after the end of the first year of the credit period and identify when qualifying households first occupied the units. See Chapter 13.

Rents & Other Sources of Income (Minimum Income Probes)

Gross income is to be considered and the minimum income probes completed (see Chapter 20). Generally, taxpayers owning IRC §42 projects are single purpose entities and the rents from leasing residential rental units will be the primary source of income. In addition to the routine records needed to complete the examination of gross income, the taxpayer should also provide:

- Description of residential rental units, including total number of units, total number of low-income units, size (bedrooms) and rents charged for low-income and market units. Also identify units for on-site managers or security personnel.
- Documentation that rents are correctly restricted, include HUD schedules of Area Median Gross Income (AMGI) and computations of the maximum allowable gross rent for the year under audit.
- Sources of rent subsidies; e.g., HUD section 8 payments.
- Utility Allowances and documentation of the computation.
- Fees for services provided to tenants in addition to housing; e.g., providing meals or cleaning services in assisted living housing.
- Other income from related activities; i.e., vending machines, laundry facilities, charges for cable/satellite television, etc.
- Other income sources such as from the commercial use of a portion of the property; e.g., the taxpayer may receive income for a cell phone tower installed on the roof of one building.
- Documentation of funds received from other sources; e.g., federal grants or subsidies received during the year, additional capital contributions, or loan proceeds.

See Chapter 12 for discussion of these topics.

Noncompliance

If the audit resulted from the filing of Forms 8823 by the state agency, the taxpayer should provide documentation for corrective actions taken to restore the project to compliance. Refer to the Guide for Completing Form 8823 for explanations of the individual noncompliance issues identified on the form.

Dispositions

If the property was disposed of; (e.g., a sale), documentation regarding the disposition should be requested. Particularly, the sales contract and settlement documents, computation of the capital gain/loss, how the gain/loss was distributed among the partners, and whether the sale required the new owner to operate property as a qualified low-income project for the remainder of the 15-year compliance period.

See Chapter 13.

Chapter 3 Audit Techniques

Introduction

Auditing includes the accumulation of evidence for evaluating the accuracy of a taxpayer's tax return. Evidence takes many forms, including a taxpayer's testimony, a taxpayer's books and records, an examiner's own observations, and documents from third parties.

Audit techniques should be selected based on the information and evidence needed and the burdens placed upon both the examiner and taxpayer. If evidence is not directly available, alternative sources should be considered.

Topics

- Interviewing Taxpayers
- Touring IRC §42 Projects
- Evaluating Internal Controls
- Third Party Contacts
- Summary

See Chapter 20 for additional audit techniques for conducting the examination of income.

Interviewing Taxpayers

The purpose of an interview with the taxpayer is to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records in order to evaluate the accuracy of such information.

- The interview should be held with the person(s) most knowledgeable about the development and on-going operation of the IRC §42 project. It may be necessary to interview more than one person.
- The interview should be held early in the examination because the interview is an opportunity to gather information that can help establish, and possibly limit, the scope and depth of the examination.
- Generally, interviews should be conducted after reviewing the documents requested in the first Information Document Request (IDR).

IRC §7521(c) authorizes a representative to represent a taxpayer at any interview. However, the taxpayer's voluntary presence should be requested if the representative cannot provide:

- firsthand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices, and daily operations,
- factual and reliable responses to questions,

- timely follow-up information for any questions that could not be answered at the time of the initial interview, or
- A properly authorized Form 2848, Power of Attorney and Declaration of Representative (POA), or Form 8821, Tax Information Authorization from the taxpayer.

Background and Financial History

The taxpayer should provide background and financial information regarding the formation of the ownership entity and development of the project. The taxpayer should specifically discuss the development of the IRC §42 project, including:

- The people and entities responsible for the planning and construction phases of the project, including the disclosure of related parties.
- The services provided by the developer, the terms of the development contract, and to what extent the fee has been paid.
- How the project was acquired; i.e., undeveloped land or land with improvements and existing buildings. The taxpayer should also explain how costs were allocated between land, nonqualifying land improvements, and depreciable residential rental property included in eligible basis.
- The financial resources such as construction loans, permanent financing, grants, and funding from local, state, or federal programs.
- The terms of IRC §42 credit allocation and any additional requirements imposed on the taxpayer by the state agency as part of the extended use agreement.
- How the final cost certification was prepared.

The interview is also an opportunity for the taxpayer to answer any questions arising from a review of documents such as the partnership agreement, the prospectus or offering memorandum, the credit allocation application, market study, credit allocation award, final cost certification, or depreciation schedules. For example, if the depreciable basis on the depreciation schedules is substantially different than what is reflected on the final cost certification, the taxpayer needs to explain the differences in costs.

Business Practices

The taxpayer should explain how the IRC §42 project is managed and identify the people and organizations responsible for the project's day-to-day operations during the tax years under audit, including personnel responsible for determining whether households were income-qualified, preparing and maintaining the tenant files, receiving rents, making bank deposits, paying expenses, and accumulating financial information used to prepare the tax return.

The taxpayer should explain to what extent it is involved with the on-going operation of the project, how often the project is physically inspected, and whether the financial records are reviewed. If a management company is involved, how often does the taxpayer receive updates, reports, or financial summaries for the IRC §42 project? How and when does the management company notify the taxpayer of any irregularities? Does the taxpayer approve expenditures or to what extent does the taxpayer delegate responsibilities and to whom?

Does the taxpayer maintain written policies and procedures for the operation of the IRC §42 project describing how the project is intended to operate? Who opens the mail? Who receives rents from the tenants? Who deposits the rents in the bank? Who has authority to write checks? Who approves expenditures? Who reconciles bank statements? Are there periodic reviews by independent third parties?

Internal Controls

Ask the taxpayer to describe the books and records created as part of the day-to-day operation of the IRC §42 project. What are the common transactions? What books and records are maintained? Does the taxpayer review the books to ensure transactions are timely recorded and how often?

Does the taxpayer separate the duties of on-site personnel? The taxpayer should explain what checks and balances are in place to establish that all income is properly accounted for from the time the rents are received by the site manager. For expenses, the taxpayer should illustrate the review and approval process for approving expenditures, especially any large or unusual expenditure.

Does the taxpayer conduct internal audits? If so, why and what were the results? Does the general partner report to a representative for the limited partners? Do the limited partners conduct their own independent audits?

Compliance with IRC §42

The taxpayer should explain what policies and procedures are in place to ensure that the project is operated in compliance with IRC §42.

Physical Maintenance

The taxpayer will need to expend resources to make repairs and maintain the project in a manner suitable for occupancy. Does the taxpayer maintain reserves for this purpose? Who decides when maintenance is needed? How often does the taxpayer conduct physical inspections of the project?

Tenant Qualifications

How does the taxpayer ensure that new tenants are income-qualified at move-in? Does the taxpayer train employees? Does the taxpayer review tenant files? Is the taxpayer using an independent management company? Is the taxpayer frequently changing management companies? Does the taxpayer conduct internal audits or review of the tenant files?

Tenant Files

Who prepares the files? How are they maintained? Where are they stored?

Rents

How does the taxpayer determine the maximum allowable rent? Are utility costs included in the rent, or does the tenant pay utility costs based on actual use? If the tenant pays utilities, how does the taxpayer compute the utility allowance? In addition to housing, does the taxpayer provide services for which the taxpayer charges fees in addition to rent? Does the taxpayer charge pet fees? Does the taxpayer charge for the use of a laundry facility? Are there vending machines on site? Does the taxpayer provide cable or satellite for a fee in addition to rent? Does the taxpayer receive rent subsidies from programs such as HUD's section 8 voucher program?

Cash Flows

Generally, it is expected that the rents generated from the operation of the low-income project will be sufficient to pay on-going operating expenses and retire debt. Did that expectation hold true? If not, it is important to understand why cash flows were insufficient and how the taxpayer responded. Did the taxpayer forgo maintenance or otherwise limit costs? Did the taxpayer find additional sources of revenue? Did the taxpayer stop servicing the debt, incur additional debt, or find alternative financing such as a grant? Did the partners make supplementary capital contributions?

Community Service Facilities

The taxpayer should be asked whether the project included a community service facility. If so, what services were provided, and were they provided throughout the taxable year? How did the taxpayer determine that the facility was used primarily to provide services for individuals whose income is 60% or less than the area's median gross income as required by IRC §42(d)(4)(C)?

Forms 8823

If the state agency filed any Forms 8823 for the low-income building with the IRS, the circumstances of the noncompliance and subsequent correction should be explained. The taxpayer should also explain how the noncompliance was accounted for when computing the allowable credit for the affected tax year.

Prior and Subsequent Year Tax Returns

If the analysis of the prior and subsequent year returns indicates that the amount of credit claimed varies from the credit claimed for the years under audit, the taxpayer should be asked to explain why.

Large, Unusual, or Questionable Items

If any item on the return is a large, unusual, or questionable item (LUQ), inquiries should be made about such items during the initial interview.

Related Parties or Returns

Related returns are tax returns that have a relationship to the tax return under audit because (1) any adjustment to one return will require a corresponding adjustment to the other return to ensure consistent treatment, or (2) the returns are for entities over which the taxpayer has control and which can be manipulated to divert funds or camouflage financial transactions.

Does the taxpayer own more than one IRC §42 project? While this taxpayer may be a single asset partnership, did the general partner and limited partner form additional partnerships owning IRC §42 projects? If so, how are the books and records for the different entities kept separate? Does the same management company operate all the IRC §42 projects?

Is the project developer or management company also a general partner or related to a general partner? The interrelationships of the parties involved in the development and operation of an IRC §42 project can facilitate the efficient production and management of low-income housing. However, these relationships may have tax implications if proper controls are not in place.

Touring IRC §42 Projects

The IRC §42 project should be toured to ensure the housing exists and is suitable for occupancy and for use by the general public. The tour is also an opportunity to observe the taxpayer's compliance with IRC §42 requirements and test internal controls. Treas. Reg. §301.7605-1(d)(3)(iii) states that "regardless of where an examination takes place, the Service may visit the taxpayer's place of business or residence to establish facts that can only be established by direct visit... The Service generally will visit for these purposes on a normal workday of the Service during the Service's normal tour of duty."

Preparing for Tour of an IRC §42 Project

Examiners should review the credit allocation documents and extended use agreement before touring an IRC §42 project. These documents will identify the terms and conditions of the credit allocation that may be observable during the tour; e.g., providing services, income restrictions lower than the minimum set-aside election, rent skewing, housing types, etc.

Physical Characteristics to Observe When Touring IRC §42 Projects

Touring an IRC §42 project can provide insight and understanding needed to identify and address IRC §42 issues. Characteristics to consider include:

Signage and Advertising: Signs posted around the project provide insight as to how the owner is representing this project. Are there any indications that the project is low-income housing?

Site: Particularly if housing is new construction, try to envision the amount of land grading, clearing, grubbing, cutting, filling and rough grading costs the developer might have incurred to prepare the land for construction.

Buildings and Assets: Identify garages, picnic areas, gazebos, laundry rooms, community rooms, and other buildings on the project site that could be classified as: (1) a facility for the

tenants' exclusive use as part of the leasing of a low-income unit, or (2) a facility necessary for the operation of the project.

Additional Income-Producing Activities: Look for potential uses of the assets that might generate additional income for the taxpayer, such as renting the roof for commercial advertising or as a radio tower.

On-Site Management or Security: The taxpayer may require the site manager or maintenance personnel to live on the premises. Similarly, to deter crime in and around the project, the taxpayer may lease a rental unit to a security officer. How many rental units are occupied by employees and security officers?

Physical Maintenance: Look at the buildings, windows, grounds, sidewalks, parking lot, dumpsters, common areas, and landscaping to observe the owner's diligence in providing low-income housing. This is particularly important if the state agency reported that the project was not suitable for occupancy. See Chapter 12.

Landscaping: How much landscaping is there? Is it maintained? Is it trimmed? Is it overgrown or weedy? Is there a pond or lake on the property? Would the landscaping be destroyed if the low-income housing was destroyed?

Educational Institutions: Is the project located near a school? Compliance with the rules for households composed entirely of full-time students will be an issue if the IRC §42 project is in close proximity to post-high school educational institutions.

Duplication or Diversion of Costs: If the owner or general partner owns more than one project, is the construction similar? Are the construction material and designs similar for all the projects? If the taxpayer or general partner buys building materials and supplies in bulk, ensure that the appropriate materials (and appropriate amounts) were delivered and used at the intended site. In addition, consider whether internal controls were in place to ensure all costs are properly attributed to the appropriate project.

Building Interiors: What does the project look like on the inside? Tour the interiors of structures. Look for any common areas or non-rental areas that may not have been visible during the tour of the grounds. Look for additional sources of income, such as laundry facilities, access to cable television (the taxpayer may wire the entire building and provide access at a discount), or services provided for the residents in addition to housing. Due to privacy issues and the intrusiveness of such inspections, currently occupied units should not be inspected unless a specific reason is identified.

Rents

The internal controls should be tested for consistency with the taxpayer's description of how rents are collected, recorded, and deposited. Examiners should trace or "walk through" common business transactions and original entries throughout the accounting system. Is there a difference between what should happen and what actually happens? Look for weaknesses in the taxpayer's

internal controls. Test the books against charges to individual tenant records. Are there points in the process where the internal controls could be compromised?

Income Qualifying New Tenants

Observe how the taxpayer determines whether new tenants are income-qualified.

- Does the potential tenant fill out applications? Did the taxpayer charge an application fee? Are all applicants charged a fee?
- How does the taxpayer determine the income limits used to evaluate a potential tenant's income?
- How does the taxpayer verify the information provided by the potential tenant? Acceptable methods include third party verifications, reviews of documents submitted by the tenant (such as check stubs), and tenant certifications made under penalties of perjury.

Randomly select and review a few tenant files on site. Do they reflect the income- verification process observed? Are the files organized?

Mixed-Use Projects

If the project is a mixed-use project with both low-income and market-rate rental units, then:

- Inspect and analyze any structural differences between market-rate units and low- income units. Are there noticeable differences between the size, cost, or upgrades in the market-rate and low-income units? If there are disproportionate standards, the issue will need to be addressed during the audit. See Chapter 11.
- Ask the on-site manager to demonstrate how over-income units are tracked to ensure the Available Unit Rule is not violated. See Chapter 12.

If the project also includes commercial space, then inspect the commercial space. Are there any shared assets, such as a parking lot used by customers and low-income residents?

Community Service Facilities

If the project includes a community service facility, then the facility should be inspected.

Analyzing Results

Collectively, observations made during the tour of the project should be consistent with what the taxpayer explained during the interview and what was recorded in the books and records. What was observed and what wasn't? What was different than expected? Does it make sense?

- Confirm that assets represented on the tax return were physically observed. If not, what happened to the asset? Was the asset something that could have been included in eligible basis? Were assets observed during the tours that are not represented on the tax return?
- Were additional sources of income identified during the tour?

- Were internal controls functioning? Can the books and records be relied upon?
- Is the project operating in compliance with IRC §42 requirements?

Case File Documentation

The case file should include documentation that the project was inspected and describe the results, including observations and resolution of any questions.

Evaluating Internal Controls

Examiners need to understand how a taxpayer has delegated or separated duties related to the operation of the low-income housing to ensure that the project is in compliance with IRC §42 requirements. In other words, does the taxpayer have sufficient internal controls in place that allow an examiner to rely on the records and information presented by the taxpayer?

Information about the taxpayer's internal controls can be obtained by interviewing the taxpayer, observing the internal controls in place during the tour of the project, and by testing the taxpayer's books and records.

Control Environment

The control environment is composed of the factors that affect the taxpayer's policies and procedures; e.g., management philosophy and style, personnel policies, and organization structures.

Prepare a diagram of the ownership structure and identify entities and individuals who are responsible for or participated in the development and/or on-going operation of the IRC §42 project. Once all the entities are identified, determine each entity's responsibilities and whether there are sufficient controls between the entities to allow for the compiling and maintaining of reliable information with respect to the project.

Generally, IRC §42 projects are owned by partnerships. It is not uncommon for a general partner to own a financial interest in the entity that develops the project, the entity that manages the project, or some other entity within the partnership structure. The presence of related entities can defeat the validity of many internal controls that appear to be in place, as the related entities are in a position to exert influence on the business decisions of the related entities. If related parties are identified, analyze all transactions between the parties.

Accounting System

Examiners need to know how the IRC §42 project operates on a day-to-day basis with respect to tenants occupying the housing, on-site personnel, and management oversight. What are the common transactions? What books and records are maintained? Examiners should be familiar with the normal flow of each type of transaction, including (1) what records are created, (2) how the transaction is recorded, and (3) how the funds flow into and out of the business.

Create a diagram of the business operation depicting transactions and identifying who completes the transaction, when and where it is transacted, and who records it.

Control Procedures

Control procedures are the policies and procedures established by the taxpayer to ensure that the project operates as intended and that the assets are protected. Separation of duties is the primary control procedure used to limit the opportunity for any one person or entity to both perpetrate and conceal irregularities in the operation of the IRC §42 project. Other specific procedures include:

- Documentation of procedures and transactions,
- Supervision by management,
- Periodic review by independent third parties, and
- Timely recording of transactions.

Testing Internal Controls

The taxpayer's internal controls should be tested by "walking through" representative transactions, including physical observation when transactions are recorded:

- Select different types of transactions,
- Look for consistency in recording similar or repetitive transactions, and
- Identify points where existing internal controls could be compromised.

Establishing Scope and Depth of the Audit

The taxpayer's internal controls should be evaluated to determine the accuracy and reliability of the taxpayer's books and records. Based on that determination:

- Establish the scope of the audit; i.e., identify issues requiring further examination and eliminate issues with little risk of material misstatement.
- Establish the depth of the audit; i.e., select appropriate method for the examination of IRC §42 issues and determine the extent to which they should be used.

Third Party Contacts

Third party contacts may be necessary to validate or corroborate information and documentation submitted by a taxpayer during an audit. Third party contacts can also provide information unavailable to the taxpayer.

Contacting State Agencies

The state agencies maintain complete project histories and are the best source for information (other than the taxpayer) about the project. State agency contact information can be identified on

Form 8823 (lines 14 and 15) or at the website for the National Council of State Housing Agencies, www.ncsha.org.

IRC §7602(c) requires the IRS to provide advance notice to the taxpayer when contacts may be made with third parties. See IRM 4.10.1.6.12. State agencies should not be contacted about specific taxpayers until the decision to proceed with the examination has been made and only after providing notice to the taxpayer.

The state agency will be able to provide:

- The credit allocation application,
- The credit carry-over agreement,
- The final cost certification submitted by the taxpayer,
- The state agency's gap analysis,
- Results of physical inspections,
- Notices of noncompliance, and
- Correspondence between the state agency and the taxpayer.

The state agency may be contacted to provide additional information and clarifications. Documentation of a state agency's reviews of the project may be available and can provide insight regarding specific instances of noncompliance and the taxpayer's overall ability to maintain the project in compliance.

Other Third Party Contacts

When making third party contacts, consider the source and quality of the information received. When making third party contacts, it is important to make multiple contacts to help establish a pattern or frequency of noncompliance (if such exists).

- Former site managers and employees may have information about the taxpayer's books and records, as well as insight into the taxpayer's business practices and policies.
- Former tenants can provide information regarding the operation of an IRC §42 project. For example, did the taxpayer allow households to rent units significantly larger than needed based on the household's size? Did the taxpayer try to keep the project in good condition?
- When there are questions about a tenant income certification, it is important to verify the accuracy of the information. This is especially true where there is a pattern of incomplete or questionable information in the tenant files.

Summary

A determination of a taxpayer's tax liability must be made based on all available information, including facts that support the taxpayer's position. In this chapter, the following audit techniques used to gather information and how these techniques can be used when auditing IRC §42 issues have been discussed.

Interviews with the taxpayer provide an opportunity to obtain an understanding of the taxpayer's background, financial history, business operations and internal controls, and books and records.

IRC §42 projects are toured to ensure the housing exists, includes the assets described in the records, and is suitable for occupancy. The tour is also an opportunity to observe the taxpayer's compliance with IRC §42 requirements and test internal controls.

The taxpayer's internal controls are evaluated to determine the reliability of the taxpayer's books and records. Consideration is given to the control environment, accounting system, and control procedures. The scope and depth of the audit will be established based on this evaluation. Information about the taxpayer's internal controls can be obtained by interviewing the taxpayer, observing the internal controls in place during the tour of the project, and by testing the taxpayer's books and records.

Third party contacts should be made if information cannot be provided by the taxpayer, or it becomes necessary to validate or corroborate information or documentation.