Klein Hornig LLP

The Low Income Housing Tax Credit Outline

2024 Edition

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With deep appreciation to Steven L. Paul

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Klein Hornig LLP provides tax and syndication expertise to developers and syndicators of, and investors in, affordable housing projects utilizing the low-income housing tax credit as well as other federal and state credits and incentives. Services offered by the Firm include tax and structuring advice, preparation of offering materials, partnership agreements and other syndication documents, rendering of tax opinions and, when appropriate, obtaining IRS private letter rulings. The Firm regularly works on projects nationwide sponsored by nonprofit organizations and for-profit developers. Our experience includes projects for families, mixed-income projects, including large-scale 80-20 projects, projects for the elderly, including congregate care and assisted-living facilities, single-room occupancy projects for homeless individuals or individuals with substance abuse problems, projects for tenants with special needs, twinned 9/4 projects, low-income housing projects that include renewable energy credits and/or energy efficient home credits, mixed-use projects and projects eligible for both the low-income housing and rehabilitation tax credits, including projects utilizing the master-lease pass-through structure.

Katie Day, a partner at Klein Hornig and co-chair of the tax department, assists developers, investors, and syndicators in navigating the myriad of complex tax issues that arise in affordable housing and community development projects. The transactions she works on often involve multiple credit incentives and other subsidies, including low-income housing tax credits (LIHTC), historic tax credits (HTC), new market tax credits (NMTC), energy incentives and state credits. Katie regularly advises clients on compliance issues, investor exits, Year 15 issues, and unwinds. Combining creativity with practicality, she works with clients to identify and mitigate potential risks and produce solutions that fit real-world business needs and objectives. Prior to joining Klein Hornig, Katie worked for Locke Lord LLP (formerly Edwards Wildman Palmer LLP) as a member of the firm's Tax, Benefits & Compensation Department. Katie received her B.A. from The College of William & Mary in 2003, her J.D. from Boston College Law School in 2006 and her L.L.M. in Taxation at Boston University in 2014.

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Alana Paris, an associate at Klein Hornig, counsels developers, investors, and syndicators alike on leveraging federal and state tax incentives to develop communities in underserved markets. The transactions she works on often involve multiple credit incentives and other subsidies, including low-income housing tax credits (LIHTC), new market tax credits (NMTC), historic tax credits (HTC), energy incentives, and state credits. Her passion for research, driven by a background in literature, uniquely lends itself to reviewing the often-intricate laws governing affordable housing and allows her to work through complex issues to help clients understand them in a way that directly benefits their projects. Clients appreciate Alana's ability to utilize tax structuring to address the practical concerns that often arise throughout a transaction. Before joining Klein Hornig, Alana worked for Applegate & Thorne-Thomsen, P.C. as a member of the firm's tax group. Alana received her B.A. from the University of North Carolina at Asheville in 2014 and her J.D. from Northwestern Pritzker School of Law in 2021.

Acknowledgements:

Katie, Becca and Alana would like to acknowledge the many people who have contributed to this Outline over the years. First and foremost, Katie and Becca would like to thank Steven L. Paul, who retired from Klein Hornig in 2020, after many decades of practice. Steve often liked to joke that he was there when the '86 Act was passed and that he had to retire when clients started reaching out for the third re-syndication of the same project. Steve was a creative and thoughtful tax practitioner, a supportive mentor and teacher and is an all around good guy. His fingerprints are all over this Outline and this Outline would not exist (and we would not be here today) without his many years of hard work and dedication.

We would also like to acknowledge the assistance of Steven Ching, Matthew Woodbury, Emily Blumberg and Sara Ferrara in the updating of this Outline.

Katie, Becca and Alana would like to dedicate the Outline to William (Bill) Driggers who plans to retire from Klein Hornig at the end of this year. Bill is an incredible lawyer – creative, patient, smart and humble – and a wonderful mentor and friend. We will dearly miss Bill but wish him all the best in this next phase of life (you'll probably find him at a music festival, camping in his car or perusing records).

Katie would like to dedicate the Outline to her Dad, Lyell G. Galbraith, formerly of Nixon Peabody LLP, who passed away earlier this year.

Becca would like to dedicate the Outline to her husband, Eli, her girls, Casey and Riley, and her parents, Liz Ritvo and Bob Kunzendorf.

Alana would like to dedicate the Outline to her mentor and friend, Eric Mittereder, formerly of Applegate & Thorne-Thomsen, P.C., who passed away earlier this year.

As always, an honor, a privilege, and a pleasure – YOTS

November 2024

HIGHLIGHTS OF 2024 EDITION

Over the past five years, Congress has amended portions of Section 42 of the Internal Revenue Code and the Internal Revenue Service ("IRS") has promulgated regulations thereunder to include, among other things, the so-called "4% floor" for bond-financed projects and existing buildings and a third minimum set-aside test, the Average Income Minimum Set-Aside Test. This edition discusses these significant statutory and regulatory updates, as well as other industry updates, including, but not limited to, impacts of the Inflation Reduction Act on affordable housing projects and rights of first refusal.

Notably, this edition does not address the various extensions and updates related to the COVID-19 pandemic because such guidance is generally set to expire by the end of this calendar year 2024, if not before. However, we point readers to Notice 2022-52, 2022-43 I.R.B. 337 for the most recent COVID-related extensions with respect to placed-in service deadlines, agency-established reasonable restoration periods, agency-established correction periods and compliance-monitoring physical inspections. Additionally, we want to note that in 2024 the United States Supreme Court overruled a decades-long precedent requiring courts to defer to an agency's reasonable regulatory interpretation of ambiguous statutory language (known colloquially as "Chevron deference") and it is still unclear what impact this decision will ultimately have on the interpretation of agency decisions moving forward.

References to "Section" generally refer to sections of the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder, unless otherwise noted.

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I. TIMING AND AMOUNT OF CREDIT

A. Ten Year Period.

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

1. The first-year credit is reduced to reflect the number of months of qualified occupancy (determined as of the last day of each month) during the first year. Note that although first-year occupancy is determined at the end of each month, a unit must be in service for the full month to qualify for credits. Code § 42(f)(2)(A)(i); Rev. Rul. 2004-82, 2004-2 C.B. 350.

2. Although Section 42(f)(1) refers to ten "taxable years," IRS views the Credit Period as covering 120 months so that credit is prorated for short taxable years. Rev. Rul. 91-38, 1991-2 C.B. 3, Questions 2 and 3.

3. Any unused portion of first-year credit is allowed in the 11th year. Code § 42(f)(2)(B).

4. <u>Note</u>: Under Section 42, in cases where a building has been subdivided into condominiums under state law, each condominium unit is treated as a separate "building." Notice 88-91, 1988-2 C.B. 414. Accordingly, each condominium unit receives its own Building Identification Number ("BIN"), is issued its own Form(s) 8609, and has its own placed-in-service date. Because buildings in a project have separate Credit Periods, developers of affordable housing may try to improve equity pricing by dividing a single physical building into multiple condominium units to accelerate credit delivery while avoiding so-called "2/3rds credits". However, a particular state credit agency's internal policy may limit a taxpayer's ability to utilize this strategy. Some state credit agencies will not issue Forms 8609 for a project's separate condominium units until all the condominium units in the single physical building or development have been placed in service (or until the cost certification for the entire development has been completed). Some investors are hesitant to take credits until issuance of the Form(s) 8609.

   <u>Example:</u> A single physical building contains 25 residential rental units, 20 of which will be placed in service and occupied by income-qualified tenants by the end of 2024 (the "2024 Apartments") and the remaining units will be placed in service and occupied by income-qualified tenants in the first quarter of 2025 (the "2025 Apartments"). Because the value of a credit available in 2024 is greater than the value of a credit available in 2025 based on time value of money principles, the developer would like to divide the building into two condominium units, with one of condominium unit containing only the 2024 Apartments and the other containing only the 2025 Apartments. Absent a state credit agency willing to issue Forms 8609 for the condominium unit commencing its Credit Period in 2024, this strategy may not work. Additionally, the accelerated credit

delivery may not result in additional equity if the investor is unwilling to claim credits based on estimates – *i.e.*, before issuance of the Forms 8609.

If an agency is willing to issue Forms 8609 in tranches, the developer will need to obtain a separate cost certification for each condominium unit. This will increase project costs and decrease the net value of additional equity. In addition, the need for multiple cost certifications creates complexity for the building contractor, since costs will need to be segregated and tracked on a per-condominium unit basis, which means more record-keeping for the contractor. If costs are not adequately tracked, the project accountant may be able to allocate costs among condominium units pro rata according to a reasonable metric (e.g., square footage or unit count), but this method can lead to fewer costs being allocated to the buildings placed in service earlier. Some investors, however, will claim credits based on estimates, typically for 9% deals, since 9% credit estimates generally are more accurate since the annual credit amount is capped.

5. The Credit Period for costs of acquiring an existing building generally does not begin until the building has been substantially rehabilitated. Code § 42(f)(5). For projects consisting of the acquisition of an occupied building and a substantial rehabilitation of the building, the taxpayer may claim first-year credits for both rehabilitation and acquisition costs based on the number of full months of occupancy of the acquired building during the year the rehabilitation expenditures are placed in service, provided the tenants are certified as qualified tenants within a reasonable period following the acquisition of the building (this is referred to as the "Tack-Back Rule"). Code § 42(e)(4)(B); PLR 200044020.

- **a.** <u>Comment</u>: Absent an election to defer the start of the Credit Period (see I.A.5.b below), the Tack-Back Rule may result in a loss of credits for investors admitted after acquisition but prior to completion of the rehabilitation when all events occur in the same year.

- **b.** <u>Example</u>: A fully occupied building is purchased by a limited partnership on January 20, tenants are certified by March 1, an investor limited partner is admitted on May 1 and rehabilitation of the building is completed in December, all in the same year. Eleven months of credits on both acquisition and rehabilitation costs are available that year, from February through December, with one month of credits deferred until the eleventh year. Credits for three months, February through April, will not be available to the investor unless the Partnership elects to commence the Credit Period the following year. <u>Query</u>: Assuming the project was not previously syndicated using LIHTC for which an existing extended use agreement remains in effect, if certification of tenants is not completed until May 1, might the Credit Period start then so that the February through April Credits are deferred to year eleven, rather than being lost to the investor entirely?

6. <u>Comment</u>: Election to defer the Credit Period may be useful:

- **a.** to avoid "wasting" of credits prior to syndication (see I.A.4 above);

b. to maximize Eligible Basis (defined in II.A.1 below), which includes costs incurred through the end of the first year of the Credit Period (see II.A below);

c. to avoid reduction of credits to 2/3 of applicable percentage for units first occupied by eligible tenants after the year of placement in service (see I.B.9 below).

d. Note: The IRS may grant a reasonable extension of time to the taxpayer to make (or correct) the election if the taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government. *See, e.g.,* PLR 202431002; PLR 202346007; PLR 201832002.

e. Split-Year Allocations. In some states (e.g., Massachusetts), split-year allocations (e.g., credits awarded to a project from two separate annual credit ceilings (e.g., 2024 and 2025)) are increasingly common and can be problematic, particularly for single building projects. First, under the first-year convention, a project owner may only claim a portion of the annual allocation for the first year in the Credit Period based on the number of months of qualified occupancy during such year. Code § 42(h)(7)(C). For example, assume a project comprised of a single building receives a binding forward commitment in 2023, the year the project is placed in service, for $500,000 of 2024 Credits and $500,000 of 2025 Credits. As a threshold matter, the project needs to elect to defer the start of the Credit Period until 2024. This is true even though the project is not eligible to claim credits in 2023. *See* PLR 201518011. If the project is instead placed in service on July 1, 2024, and fully leased up on or before July 31, 2024, the project owner would be entitled to claim $250,000 (not $500,000) of Credits in 2024 under the first-year convention. Note that if the entire $1 million allocation had come from the State's 2024 annual credit ceiling, the project owner would be entitled to claim $500,000 of Credits in 2024 based on 6 months of qualified occupancy. In addition, because a building has a single Credit Period of 120 months, a building with a split-year allocation that either (i) does not defer the start of the Credit Period to the year of the latest allocation, or (ii) as in the example above, is not able to defer the start of the Credit Period until 2025 (the latest year of allocation) since the building is placed in service in 2023, would lose a portion of the last year of Credits from the 2025 allocation (credits for July through December of 2034 in the example above). When a project includes multiple buildings, this can be avoided by allocating one year of Credits (i.e., 2024 Credits) to certain buildings (Buildings 1 and 2) and the other year (i.e, 2025 Credits) to the balance of the buildings (Buildings 3 and 4) so that no single building has a split-year allocation. Alternatively, in the example above, the project owner could avoid the potential wasting of Credits by either (i) delaying placement in service of the building until 2024 and electing to defer the Credit Period until 2025 or (ii) if feasible, if the project consists of a single physical building, dividing the physical building into multiple condominium units (see prior discussion at I.A.4 above).

7. Placement in Service

a. New or existing buildings are placed in service when they are ready and available for their specifically assigned functions, i.e., the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. Advance Notice 88-116. A temporary or conditional certificate of occupancy may provide adequate documentation of a building's placed in service date, provided that the local jurisdiction issuing the temporary certificate of occupancy requires that the building be habitable at the time the temporary certificate of occupancy is issued. PLR 9243032; CCA 200137044, Question 1.

b. Rehabilitation expenditures are generally treated as placed in service at the close of any 24-month period over which such expenditures are aggregated for purposes of determining whether they are "substantial" (including a period that ends less than 24 months after commencement of the rehabilitation), apparently without regard to the readiness or availability of the building. Code § 42(e)(4)(A); Advance Notice 88-116; Rev. Rul. 91-38, Question 6. If, however, the rehabilitation is completed and the minimum expenditures requirement of Section 42(e)(3)(A) is met in less than a 24-month period, the taxpayer may elect to place the rehabilitation expenditures in service at the close of that shorter period of time. PLR 200044020.

c. Actual occupancy by low-income tenants is not required for placement in service. Advance Notice 88-116; *but see* II.A.2 below (concerning "Qualified Basis" computation).

d. If the rehabilitation is also a certified historic rehabilitation under Section 47, the placed-in-service date for purposes of the Section 47 rehabilitation tax credit is based on either (i) when a new certificate of occupancy (which may be temporary in nature) is issued for a vacant building, or (ii) when qualified rehabilitation expenditures within the meaning of Section 47(c)(2) exceed the adjusted basis of the building. Accordingly, the placed-in-service date for purposes of the historic rehabilitation tax credit under Section 47 may differ from the placed-in-service date for purposes of the low-income housing tax credit under Section 42. PLR 200605004; PLR 8934048. The 2006 ruling concluded that placement-in-service under Section 47 for purposes of the historic rehabilitation tax credit could occur in the year after placement-in-service for LIHTC purposes. In such ruling, the taxpayer received a Year 1 Carryover Allocation as well as an additional allocation of Year 3 LIHTC. The taxpayer placed the project in service for LIHTC purposes in Year 2 and elected to defer the start of the LIHTC Credit Period until Year 3. In addition, the taxpayer placed the qualified rehabilitation expenditures for purposes of Section 47 in service in Year 3. This enabled the taxpayer to receive a split-year allocation of LIHTC and claim LIHTC on expenditures incurred in Year 3.

(i) Note: In cases where the rehabilitation is also a certified historic rehabilitation under Section 47 and is structured as a single-tier transaction, i.e., the investor limited partner is allocated both the LIHTC and federal historic tax credit, the amount of LIHTC which the project can claim is reduced by reason of the reduction to adjusted basis in the amount of the historic rehabilitation credit. See Code § 50(c)(1) (which requires a reduction in the basis of property for purposes of Subtitle A of the Code (i.e., for all income tax purposes) by the amount of any historic rehabilitation credit determined with respect to such property).

(ii) Note: After amendment by the Inflation Reduction Act of 2022, eligible basis is no longer reduced by the amount of the federal energy credit under Sections 48 or 48E, as applicable, but depreciable basis is required to be reduced by 50% of the amount of such energy credit. Code § 50(c)(3)(C).

(iii) Comment: In light of increased construction costs and the current interest rate environment, developers are confronting financing gaps and we have seen an uptick in master-lease pass-through transactions, which avoids the reduction to eligible basis and accordingly increases the amount of LIHTC equity as compared to a single-tier transaction. Master-lease pass-through transactions raise a host of complex tax structuring issues, which are beyond the scope of this Outline.

8. First-Year Credits in Re-Syndication of an Existing Low-Income Housing Project.

a. A low-income unit occupied by an over-income tenant at the time of acquisition in connection with a re-syndication continues to qualify as a low-income unit for purposes of the new Credit Period. The Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition Audit Technique Guide: Guide for Completing Form 8823 (last revised January 24, 2024) published by the IRS (the "Audit Technique Guide") provides that "Households determined to be income-qualified for purposes of the [Section 42 credit] during the 15-year compliance period are concurrently income-qualified households for purposes of the +30 year extended use agreement. As a result, any household determined to be income qualified at the time of move-in for purpose of the extended use agreement is a qualified low-income household for any subsequent allocation of [Section 42] credit." If the unit was determined to be an over-income unit under Section 42(g)(2)(D) of the Code at the time of the household's last recertification, then the owner of the project is subject to the so-called "next available unit rule" (unless the project is a 100% low-income housing tax credit project, in which case the next available unit rule does not apply). Accordingly, a low-income unit occupied by an over-income tenant at the time of acquisition continues to qualify as a low-income unit provided the next available unit rule, if applicable, was satisfied.

b. In the case of a mixed-income project, an over-income unit does not cease to qualify as a low-income unit if the over-income tenants are temporarily relocated during the rehabilitation provided the over-income tenants return to their original unit or occupy a unit in the same building following the rehabilitation. The Audit

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

B. Amount of Credit.

1. For new buildings not receiving other federal subsidy, the credit is equal to an annual amount over the Credit Period intended to have a present value equal to 70% of Qualified Basis (defined in II.A.2 below) (the "70% Present Value Credit" or "9% Credit"). On an annual basis, the 70% Present Value Credit has represented approximately 7-9% of

Qualified Basis. This rate is now not less than 9% of Qualified Basis. *See* Code § 42(b)(2)(B).

a. Rehabilitation expenditures are treated as "new buildings" provided that they are allocable to or substantially benefit one or more low-income units and the amount of such expenditures incurred within any 24-month period equals the greater of (i) 20% of the adjusted basis of the building or (ii) an amount sufficient to cause the "Qualified Basis" resulting from such expenditures to equal or exceed $6,000 per low-income unit (as adjusted, $8,500 per low-income unit for expenditures treated as placed in service during calendar year 2025 per Rev. Proc. 2024-40, 2024-45 I.R.B. 1100; previously $8,300 per low-income unit for calendar year 2024 per Rev. Proc. 2023-34, 2023-48 I.R.B. 1287). *See* Code § 42(e)(3)(A)(ii)(II). Expenditures for common areas may provide the requisite substantial benefit. PLR 9338013.

(i) <u>Note</u>: The IRS publishes inflation adjustments annually and determining the amount for years after 2025 will require looking at the most recent IRS inflation adjustments applicable to tax rates and brackets.

b. Rehabilitation expenditures on buildings acquired from governmental entities, at the election of the taxpayer, need only be $6,000 (adjusted for inflation, so $8,500 in 2025) per low-income unit to qualify as a "new building." Code § 42(e)(3)(B). Note that rehabilitation expenditures treated as a "new building" under Section 42(e)(3)(B) are only eligible for the 4% credit.

c. The IRS has ruled that when a developer of a condominium project in which the units had been developed and held for sale sells condominium units to an unrelated partnership which intends to hold the units as low-income housing, the units are "new buildings" in the hands of the partnership, provided that no depreciation had been claimed by the developer with respect to the units. *See* PLRs 9101006 and 9120021.

2. For (i) new buildings receiving other federal subsidy, or (ii) existing buildings, the credit is equal to an annual amount over the Credit Period intended to have a present value equal to 30% of Qualified Basis (the "30% Present Value Credit" or "4% Credit"). On an annual basis, the 30% Present Value Credit has represented approximately 3-4% of Qualified Basis. This rate is now not less than 4% of Qualified Basis. *See* Code § 42(b)(3).

3. Definition of "other federal subsidy." Code § 42(i)(2).

a. For this purpose, "federal subsidy" means <u>only</u> tax-exempt financing, the proceeds of which can or will be used (directly or indirectly) with respect to the building or the operation thereof. Below-market federal loans will not cause a building placed in service after July 30, 2008 to be treated as federally subsidized**.** Federal grants have never been treated as "federal subsidy".

b. If a building owner elects to reduce Eligible Basis (defined in II below) by an amount equal to the amount of "federal subsidy," the building will not be treated as receiving federal subsidy. Code § 42(i)(2)(B). The election must be made on Form 8609 for the taxable year in which the building is placed in service. Treas. Reg. § 301.9100-7T(b). The IRS may grant a reasonable extension of time to the taxpayer to make the election if the taxpayer acted reasonably and in good faith. *See* PLR 201606026; PLR 200726020; PLR 200725021.

(i) The amount of Eligible Basis reduction is reflected on the Form 8609 for each building.

(ii) While allocation of federal subsidy among multiple buildings may permissibly be based on costs, to date there is no definitive guidance discussing whether other methods of allocation would be permitted, whether allocations should be made separately to acquisition and rehabilitation costs which are treated as separate buildings, or the impact of basis reductions for Section 47 credits in a single-tier transaction.

c. Tax-exempt construction financing is not considered federal subsidy if such financing is repaid prior to placement in service. Code § 42(i)(2)(C). Conversely, retirement of tax-exempt financing immediately after placement in service should not prevent a project from qualifying for the 30% Present Value Credit without an allocation of credits, provided that at least 50% of the basis of the land and buildings in the project was financed with such financing. *See* IV.H.1 below.

d. Federal grants are not a federal subsidy for this purpose, but Eligible Basis cannot include any costs financed with the proceeds of any federally funded grant. Code § 42(d)(5)(A). The basis reduction rule applies to federally funded grants received before or during the Compliance Period (defined in I.C below). However, no basis *reduction* is required for federally funded grants received during the Compliance Period to enable the property to be rented to low-income tenants if those grants do not otherwise *increase* the Eligible Basis in the building.

e. Comment: After the Housing and Economic Recovery Act of 2008 ("HERA"), the so-called "IRP Decoupling" program pursuant to which HUD continues Section 236 interest subsidy payments following repayment of a Section 236 loan and such payments are applied to reduce the effective interest rate on a new loan should not be included in the definition of "federal subsidy" and would seem to be compatible with both the 70% and 30% Present Value Credit. In addition, to the extent that these payments fund deductible interest expense (and not capitalized construction-period interest), they should not be treated as the type of federal grants that reduce Eligible Basis.

f. If a city or a project sponsor receives a federal grant and then lends the grant funds for use in a project, the loan proceeds do not constitute either a grant or a below-market federal loan. *See* PLR 8813024 and former Code § 42(i)(2)(D) (because after HERA, below-market federal loans are no longer considered federal subsidies under Section 42(i)(2)(A), PLR 8813024 in part relates to prior law) (*See* Housing and Economic Recovery Act of 2008, Pub. L. 110-289, §3002(b)(1) (striking "or any below market Federal loan")). Note: Loans from project sponsors which are treated as related persons with respect to the project ownership entity may raise additional issues. *See* IX.A.3 below.

g. Credits are allowed for buildings receiving Section 8 moderate rehabilitation assistance under Section 8(e)(2) of the United States Housing Act of 1937, including assistance received under the McKinney Homeless Assistance Act as in effect on October 26, 1990, provided the buildings are placed in service after July 30, 2008. Code § 42(c)(2). Buildings placed in service before that date which receive rental assistance payments pursuant to the renewal of Section 8 Housing Assistance Payment contracts under Section 524 of the Multifamily Assisted Housing Reform and Affordability Act of 1997 are ineligible to receive credits if the original contract was authorized under the Section 8 moderate rehabilitation assistance program. PLR 200044013.

h. The fact that rehabilitation expenditures are made with respect to an existing building previously financed with tax-exempt bonds will not cause the rehabilitation expenditures to be treated as "federally subsidized," provided that no "material modification" is made to the tax-exempt financing. *See* Treas. Reg. 1.1001-3 for rules regarding material modifications. Thus, those rehabilitation expenditures may qualify for the 70% Present Value Credit. *See* H. Rep. No. 99-841, 99th Cong. 2d Sess. II-89 (1986). Based on this legislative history, the IRS has ruled that the purchase of existing buildings subject to tax-exempt bonds, where the taxpayer merely assumes an existing tax-exempt bond loan that has not been materially modified since the loan closed, did not taint either rehabilitation expenditures on those buildings or newly constructed buildings on land that secured the bonds. PLR 9601005.

i. The IRS has refused to extend the foregoing legislative history to permit the proceeds of tax-exempt bonds used to acquire and rehabilitate a multiple building project to be allocated exclusively to certain buildings in the project, and, thus, to avoid the federal subsidy taint for the other buildings, especially when all the buildings collateralize the bonds. TAM 9528002. Similarly, the IRS has taken the position that when the rehabilitation and acquisition of a building are financed by the issuance of tax-exempt bonds and taxable bonds, both of which close on the same date and use the same bank trustee, allocating the proceeds of the tax-exempt bonds solely to the acquisition costs of the building will not enable the rehabilitation costs of the building to avoid the federal subsidy taint. If, however, the acquisition and rehabilitation financings are independent transactions, the taint of the tax-exempt financing will not extend to the rehabilitation expenditures. PLR 200035016.

(i) *See also* PLR 9001046 (revoked by PLR 9011017 in which the IRS appeared to approve and then reject a tracing of federal subsidy proceeds).

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

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

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

(i) In an acquisition/rehabilitation transaction, a building can be divided into two condominium units from the start. The 4% unit can be purchased and rehabilitated with bond proceeds while the 9% unit does not receive any direct or indirect bond financing. The two units would be separately owned by distinct entities, although the sponsor and equity investor may be the same for both projects, and there may be two separate construction contracts, with a cost-sharing agreement entered into to fund work performed on the condominium common areas. Bond proceeds would be spent solely on the acquisition and rehabilitation of the 4% unit and its proportionate share of common area rehabilitation expenses equal to the unit owner's percentage interest in the condominium.

(ii) In the case of new construction, in some jurisdictions the condominium units may not be able to be established until construction is at least partially completed. In Massachusetts, for example, a condominium cannot be declared without identifying walls. In such an instance, the land could be purchased by the entity that will ultimately own the 9% unit, initial construction of the entire development could be financed without the use of tax-exempt financing, and once walls are in place, two separate condominium units could be created. The 4% unit could then be conveyed to a separate owner that would fund its purchase of the unit using tax-exempt financing, causing it to be considered bond-financed and eligible for 4% Credits, while the 9% unit avoids the "taint" of bond financing and remains eligible for 9% Credits. A building can be partially or entirely built without bond proceeds and still meet the 50% test (see I.B.3.k(ii) below) and qualify for 4% Credits so long as a sufficient amount of bond proceeds are spent to finish the building or to repay construction financing. *See* PLR 201049018; PLR 199912023; PLR 9816018. All of the bonds would be required to remain outstanding through the end of the first year of the 4% unit's Credit Period. *See, e.g.*, PLR 9853036.

(iii) An alternative structure in the case of new construction is for tax-exempt bond proceeds to be drawn to fund the initial construction, and then a portion of the bonds corresponding to the 9% unit redeemed with the proceeds of the sale of the 9% unit. This approach relies on an exception to the "federally subsidized" definition which states that tax-exempt bonds used to provide construction financing for a new building will not cause that building to be federally subsidized if: (i) the bonds identified the building for which they would be used and (ii) the bonds are redeemed before the building is placed in service. Code §42(i)(2)(C). At the closing of the transaction, the 4% owner would own the site and borrow tax-exempt bond proceeds to help finance initial construction of the entire structure. One tranche, or series, of the bonds would be identified specifically to be used for the 9% unit and used to fund a corresponding element of the loan to the 4% owner (the "9% unit tranche"). When the 9% unit was conveyed to the 9% owner, the 4% owner would use the sale proceeds to repay and redeem the 9% unit tranche. This would occur before the 9% unit is placed in service, so the 9% unit would qualify for 9% Credits under the special rule for subsidized construction financing cited above. The remaining elements of the 4% owner's bond loan would continue to finance the 4% unit at least until the 4% unit is placed in service, so that loan could be used to satisfy the 50% test for the 4% unit. Once the units were separated, the 9% unit would no longer serve as collateral for the bonds and the two units would continue under separate plans of finance. Although this approach would allow tax-exempt financing to be utilized during construction, it is unclear that bond issuers would allow the use of volume cap for these purposes, when no credits would be generated as a result of the bonds.

C. Determination of Applicable Percentage.

4. The annual credits are expressed as a percentage of Qualified Basis, referred to as the "applicable percentage," that over a 10-year period has a present value equal to 70% or 30% of Qualified Basis, as the case may be.

    a. Applicable percentages are announced monthly in the same revenue rulings that announce "applicable federal rates" but are currently locked at not less than either 9% (for 70% present value credits) or 4% (for 30% present value credits). *See* Code §§ 42(b)(2)(B); 42(b)(3).

5. For any new building that is not federally subsidized, the applicable percentage for 70% Present Value Credits will be the greater of the published monthly rate or 9%. Code § 42(b)(2).

6. For any (A)(i) existing building and/or (ii) new building that is federally subsidized and (B) which is placed in service after December 31, 2020, the applicable percentage for 30% Present Value Credits will be the greater of the published monthly rate or 4%. Code § 42(b)(3).

    a. <u>Note:</u> The Taxpayer Certainty and Disaster Tax Relief Act of 2020, signed into law on December 27, 2020, created a permanent 4% minimum applicable percentage for (i) existing buildings and (ii) new buildings that are federally subsidized. *See* Pub. L. No. 116-260, Div. EE, Title II, §201(a). Under this Act, the minimum 4% rate applies to (i) any building which receives an allocation of housing credit dollar amount after December 31, 2020, and (ii) in the case of a building financed with tax-exempt obligations issued under the state volume cap, any such building if such obligation financing the building is issued after December 31, 2020.

    b. <u>Comment</u>: In deals with acquisition credits, the costs of acquiring an existing building includible in Eligible Basis will only be eligible for the minimum 4% rate if the acquisition is made after December 31, 2020.

    c. <u>Note</u>: On December 31, 2021 the IRS published Revenue Ruling 2021-20, 2021-51 IRB 875 and Revenue Procedure 2021-43, 2021-51 IRB 882, which address the ability of a qualified low-income building that is placed in service after December 31, 2020 to qualify for the "4% floor" set forth in Section 42(b)(3) when financed in part with tax-exempt bond obligations issued prior to January 1, 2021 and in part with tax-exempt bond proceeds issued after December 31, 2020 (herein referred to as a "Straddle Period Project"). Revenue Ruling 2021-20 provides, in relevant part, that a Straddle Period Project does not qualify for the 4% floor if the tax-exempt bonds that finance such Straddle Period Project and which are issued after December 31, 2020 are de minimis. Revenue Ruling 2021-20 goes on to state that "…it is consistent with the apparent intent of section 201(b) for the 4 percent floor to apply to buildings whose financing includes both pre-2021 exempt facility bonds and a *non-de-minimis amount* of exempt facility bonds that are part of an issue that is issued after December 31, 2020" (emphasis added). Revenue Procedure 2021-43 provides a safe harbor for determining whether an exempt facility bond issue that is issued after December 31, 2020 is more than de minimis for purposes of Revenue Ruling 2021-20. An exempt facility bond issued after December 31, 2020 that finances a qualified low-income building is not de minimis if, as of the latest issue date of any such issue, the aggregate amount of the post-2020 obligations is at least 10 percent of the total amount of all Section 42(h)(4)(A) obligations that finance such building (the "Safe Harbor"). For purposes of the Safe Harbor, an issue is taken into account only to the extent that it finances the particular building in question. In other words, the Safe Harbor is applied on a building-by-building basis rather than a project-wide basis in the case of a multiple building LIHTC project.

7. For a particular project, the "applicable percentage" is that in effect for either:

a. the month in which the project is placed in service; or

b. at the election of the taxpayer, the month in which the taxpayer and the housing credit agency enter into a binding agreement as to the dollar amount of annual credits to be allocated. Sections 42(b)(1)(A)(ii)(I), 1.42-8(a) and Notice 89-1, 1989-1 C.B. 620, provide that this binding agreement must:

(i) be in writing;

(ii) specify the dollar amount of credits (although the Regulations are not entirely clear on this point, the taxpayer should be held to the same standard used in obtaining a carryover allocation, meaning the dollar amount of credits may be specified either on a project basis or on a building by building basis);

(iii) specify whether the credit relates to newly constructed, substantially rehabilitated or existing building(s);

(iv) be binding under state law on the taxpayer, the agency and all successors in interest; and

(v) be dated and signed by the parties during the month in which requirements (i) through (iv) are met.

c. In the case of a bond-financed project for which no allocation is made, at the election of the taxpayer, the month in which the bonds are issued may be used. Code § 42(b)(1)(A)(ii)(II) and Treas. Reg. §1.42-8(b).

d. Elections under paragraphs (b) or (c) above must be made by the 5th day following the close of the month to which they relate and may be made either in the binding agreement or a separate document (referencing the binding agreement, if applicable) but, in either event, must:

(i) be in writing;

(ii) reference Sections 42(b)(1)(A)(ii)(I) or (II), as the case may be;

(iii) if it is in a separate document, reference the binding agreement that meets the requirements of Section 1.42-8(a)(1);

(iv) in the case of bond-financed projects, state the percentage of basis in land and building that is being financed with bond proceeds, the month in which the bonds were issued, and that such month is the month for which the election is being made;

(v) be signed by the taxpayer; and

(vi) be notarized on the last page of the election (and not on a separate page) within 5 days after the close of the month to which the election relates.

e. Note: a taxpayer should not elect to lock the applicable credit percentage since the 4% and 9% floors are just that, floors, and theoretically the applicable credit percentages announced monthly could exceed 4% and 9%, respectively.

8. The applicable percentages determined under elections described in 4(b) above continue to apply to all subsequent allocations issued with respect to the same building even if the original binding agreement is rescinded (because, for example, a new carryover allocation is issued, see IV.B.4 below) or if there is any increase in credit allocations for the building, whether the increase occurs in the same or a subsequent taxable year. Treas. Reg. § 1.42-8(a)(4) and (7), Ex. 1(ii). Although the Regulations do not address the effect of multiple allocations issued with respect to the same building when the taxpayer does not elect to fix the applicable percentage at the time of the initial allocation but does elect to fix the applicable percentage on a subsequent allocation, the IRS has taken the position that the application of an election to fix the applicable percentage to allocations made prior to the election is consistent with the objectives of Treas. Reg. § 1.42-8(4)(a), provided no previous election to fix the applicable percentage has been made for the building. PLR 9714015.

9. Increases in Qualified Basis after the first year of the Credit Period may qualify for credits (within the limits of the original credit allocation) based upon 2/3 of the applicable percentage. Code § 42(f)(3). The 2/3 credit is available annually for the remainder of the Compliance Period (defined in I.C below). An increase in Qualified Basis to which the 2/3 credit applies is typically attributable to an increase in the percentage of occupancy by low-income tenants.

a. If the original credit allocation is insufficient to utilize the 2/3 credit, the credit agency is permitted to make an additional allocation in the year in which the 2/3 credit becomes available.

b. For bond-financed projects which do not receive credit allocations but anticipate a 2/3 credit, it is suggested that the Section 42(m)(2) letter issued on or before completion provide sufficient cushion to support the additional 2/3 credit.

c. Note that claiming the 2/3 credit will also require new or amended Form(s) 8609 and amendments to the extended use agreement. *See* III.F.5.c(i)(b) below (relating to the requirement of an "extended use" commitment beyond 15 years).

D. Compliance Period.

1. The low-income portion of a project must be maintained as such for fifteen years, beginning with the commencement of the Credit Period (the "Compliance Period"), or credits will be subject to recapture. *See* V below (Recapture of Credit); *see also* III.F.5.c(i)(b) below (relating to the requirement of an "extended use" commitment beyond 15 years).

II. ELIGIBLE BASIS/QUALIFIED BASIS

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

A. New Buildings and Substantial Rehabilitations.

1. Eligible Basis is the adjusted basis of the residential rental portion of a building determined as of the close of the first year of the Credit Period, subject to certain modifications (see II.C below). Code § 42(d).

2. Portion of Eligible Basis constituting Qualified Basis (the "Applicable Fraction") is determined annually (except with regard to the first year as discussed below) and is the lesser of:

a. Low-income units as percentage of total residential units ("Unit Fraction"); or

b. Floor space of low-income units as percentage of total floor space of all residential units ("Floor Space Fraction"). Code § 42(c).

Note: A unit is not a low-income unit until it is actually occupied by low-income tenants. Qualified occupancy is not required for placement in service of a unit but is required for inclusion of the unit in Qualified Basis. During the first year of the Credit Period, the applicable fraction is determined on a monthly basis. A unit will be treated as a low-income unit (and therefore includable in the monthly applicable fraction) provided that the unit has been in service for the full month and is occupied by a qualified tenant by the end of the month. Rev. Rul. 2004-82, 2004-2 C.B. 350.

If the Credit Period begins in the year a unit is placed in service, but occupancy of the unit by low-income tenants does not occur until the following (or any subsequent) year, there is an "increase" in Qualified Basis and only 2/3 of the applicable percentage is used to determine credits for this increase. *See* I.B.7 above. Under these circumstances an election to defer commencement of the Credit Period until the year after placement in service may be advisable. *See* I.A.5.b above.

3. Qualified Basis may be reduced to the extent that the quality of low-income units is less than other units. Code § 42(d)(3).

4. Comment. In the case of a substantial rehabilitation, costs includable in Eligible Basis may be incurred over a period of several years. For example, if a 24-month period designated as the placed-in-service date ends on January 1, 2005, it will include expenditures incurred beginning on January 1, 2003. The commencement of the Credit Period can be deferred until January 1, 2006 (see I.A above), so that includable costs are those incurred through December 31, 2006, the end of the first year of the Credit Period.

5. A unit occupied by a resident manager or a full-time, resident security officer is not a residential rental unit for purposes of Section 42 and thus is excluded from both the numerator and denominator of the fractions used to calculate qualified basis. However, costs attributable to the construction or rehabilitation of such unit(s) are includable in Eligible Basis and thus generate additional credits and tax credit equity. Program Manager Technical Advice 2014-22, CCA POSTN-111812-14; Rev. Rul. 92-61, 1992-2 C.B. 7; Rev. Rul. 2004-82, 2004-2 C.B. 350; PLR 9538015; *see also* PLR 9330013 (similar treatment of units occupied by maintenance personnel but different treatment of model units which were held to be "residential rental units" included not only in Eligible Basis but also in the denominator of the fraction used to calculate Qualified Basis). The CCA clarified that charging rent, utilities or both to a resident manager or maintenance personnel does not cause the unit to be treated as a residential rental unit (it remains a facility reasonably required for the project) and that the general-public-use requirement does not apply to units for resident managers or maintenance personnel because such units are facilities reasonably required for the project, not residential rental units. Program Manager Technical Advice 2014-22, CCA POSTN-111812-14.

6. Because Eligible Basis is fixed at the end of the first year of the Credit Period, subsequent expenditures do not increase Qualified Basis and do not qualify for the 2/3 credit.

B. Existing Buildings.

1. The Eligible Basis of an existing building is also generally its adjusted basis as of the end of the first year of the Credit Period, but does not include so much of adjusted basis as is determined by reference to the basis of other property held by the person acquiring the building. Code § 42(d)(2)(C). However, the Eligible Basis of an existing building is zero unless the following four requirements are satisfied.

a. The building must be acquired by "purchase" (as defined in Code § 179(d)(2)) from an unrelated seller. Code §§ 42(d)(2)(B)(i) and (D)(ii).

b. 10 years must have elapsed since the date the building was last placed in service (the "10-Year Rule"). Code § 42(d)(2)(B)(ii).

c. The building must not have been previously placed in service by the purchaser or a related party with respect to the purchaser. A person will be treated as a "related party" with respect to the purchaser if the relationship between such person and the purchaser is one specified in Sections 267(b) or 707(b)(1) of the Code or the person and the purchaser are engaged in trades or businesses under common control (within the meaning of Code §§ 52(a) and (b)). Code § 42(d)(2)(D)(ii).

(i) Comment: In determining whether a person and/or a partnership is related to a partnership, Section 707(b)(1) looks to whether there was ownership of either a capital interest or a profits interest. There is no guidance on the meaning of the term "profits interest" in this context. Thus, if a general partner is given a greater than 50% interest in the proceeds from a sale of property (following the repayment of all the capital contributions of the limited partner), or is paid an unreasonably large incentive management fee (i.e. 60% of gross cash receipts with no dollar cap), the general partner might be treated as having a more than 50% profits interest with respect to such partnership.

d. Substantial rehabilitation costs are incurred. Code § 42(d)(2)(B)(iv).

2. Waivers and exceptions to the 10-Year Rule.

a. Pursuant to Section 42(d)(6), the 10-Year Rule is automatically waived for federally-assisted or state-assisted projects.

(i) For this purpose, a building is federally-assisted if it is substantially assisted, financed or operated under any housing program administered by HUD or the Rural Housing IRS of the Department of Agriculture, including Section 8 of the United States Housing Act of 1937, Sections 221(d)(3), 221(d)(4) or 236 of the National Housing Act, and Section 515 of the Housing Act of 1949.

(a) Note: We note that practitioners are increasingly comfortable relying on loans made pursuant to the risk sharing program with the United States Department of Housing and Urban Development authorized under Section 542(b) of the Housing and Community Development Act of 1992 for purposes of qualifying for the substantially federally financially assisted exception to the 10-year rule.

(ii) A state-assisted building is a building which is substantially assisted, financed or operated under any state law similar in purposes to the laws referred to in (i) above.

Comment: Although the exception to the 10-Year Rule for federally or state assisted projects has been law for several years, there is no guidance on the scope of this exception (and, according to IRS personnel present at the ABA Forum in Washington, D.C. in May 2024, none is forthcoming), for example, the extent to which HOME or CDBG funding can be considered federal assistance and when such assistance is considered "substantial." There is also no guidance on whether the assistance must pre-date the acquisition and, if so, for how long. We note that a number of practitioners are comfortable with buy-side only assistance provided that such assistance is in place at the time of acquisition.

(iii) Note: A waiver of the 10-Year Rule no longer requires a private letter ruling from the IRS which, in turn, required the requesting party to obtain a certification from HUD, FmHA, the RTC, FDIC or other appropriate agency that a condition for waiver has been satisfied.

b. In determining if 10 years have elapsed since a building was last placed in service, the following placements in service are disregarded:

(i) Placements in service by government entities and qualifying nonprofit organizations, if the 10-Year Rule had been satisfied at the time of such placements in service. Code § 42(d)(2)(D)(i)(III); *see* PLR 200652015; PLR 8851046; PLR 8834054.

(ii) Placements in service by mortgagees, provided the mortgagees transfer the property within 12 months, if the 10-Year Rule had been satisfied at the time of such placements in service. Code § 42(d)(2)(D)(i)(IV). Comment: If a state housing finance agency, other governmental entity or qualifying nonprofit organization forecloses on property, it ought not to be subject to the requirement that it resell the property within 12 months, but there is no authority directly on point.

(iii) In the case of a single-family home, placement in service by individual owners who used the building only for a principal residence. Code § 42(d)(2)(D)(i)(V).

(iv) Placement-in-service by persons who acquired the property either with a carryover basis from their transferors or with a stepped-up basis by reason of inheritance. Code § 42(d)(2)(D)(i)(I) and (II). Terminations of partnerships occurring on or after May 9, 1997 provide the "new" partnership with a carryover basis in property of the terminated partnership. Treas. Reg. § 1.708-1(b)(4)(iv), Example (ii). Thus, such a termination is disregarded for purposes of the 10-Year Rule under Section 42(d)(2)(D)(i)(I). PLR 200614019; PLR 200508009 ; PLR 200502019. Note that the TCJA has repealed technical terminations of partnerships for tax years after 2017.

(a) Note: Certain tax-free transfers in which the transferee takes a substituted basis rather than a carryover basis (e.g. liquidating distributions from partnerships or like-kind exchanges) are not disregarded.

(b) In Private Letter Ruling 200204006, the IRS held that a Section 743(b) adjustment to basis was not a placed-in-service event for purposes of Section 42(d)(2)(B)(ii)(I). *See also* PLR 200614019.

c. A foreclosure of purchase-money debt secured by partnership interests (which resulted in a termination of the old partnership and formation of a new partnership under Section 708), if the subsequent sale by the new partnership to the taxpayer within 12 months of foreclosure satisfied the 10-Year Rule pursuant to the exception provided for mortgagees in possession for less than 12 months. Code § 42(d)(2)(D)(i)(IV); PLR 200235018. Although not addressed in this ruling, an alternative basis for concluding that the 10-Year Rule is satisfied is that the termination of the old partnership, even if unrelated to a foreclosure, does not constitute a placement in service for purposes of that rule. *See* PLR 200508009; PLR 200502019.

d. As a general matter, a transfer of property results in a new placement in service if, as of the date of transfer, the property is ready and available for its intended purpose. Rev. Rul. 91-38. 1991-2 C.B. 3, 5. However, acquisition of a property that is not fit for habitation or other use is not considered a placement in service. PLR 200009032; PLR 9402010.

e. The IRS has ruled that a transfer of property followed by a rescission of the transfer within the same taxable year did not constitute a transfer for federal tax purposes and, thus, did not result in a new "placement in service." *See* PLR 200309009 (ruling based on transfer/rescission rule of Rev. Rul. 80-58, 1980-1 C.B. 181).

f. A prior placement in service in a nonresidential use, e.g., as a warehouse, will be taken into account. Rev. Rul. 91-38, Question 9.

g. A transfer of property pursuant to a court-ordered restructuring of a housing program did not constitute a transfer and, therefore, did not result in a new "placement in service" for purposes of the 10-Year Rule. PLR 9735007.

h. An assignment by a mortgagee of its successful foreclosure bid on a low-income property to an affiliate of the mortgagee who, as a matter of course, holds title to any real estate collateral acquired by mortgagee, was treated as though the affiliate had acquired the project by foreclosure of a security interest held by the affiliate and therefore the acquisition by the affiliate was treated as an acquisition by the "mortgagee" and disregarded for purposes of the 10-Year Rule pursuant to the exception provided for mortgagees in possession for not more than 12 months. PLR 200003037.

i. The 10-Year Rule, including the prohibition against prior placement in service by a related party as discussed in (1)(c) above, does not apply to a purchase during the Compliance Period; instead the purchaser "steps into the shoes" of the seller and may continue to claim credits based on the seller's Eligible Basis. Code § 42(d)(7); PLR 200652015. See V.A below concerning potential credit recapture.

3. As with new buildings, determine Qualified Basis for existing buildings based on lesser of Unit Fraction or Floor Space Fraction. *See* II.A.2 above.

4. An increasing number of projects are being syndicated for a second or even a third time. Assuring acquisition credits for an existing building can raise a number of structuring concerns in avoiding a purchase from a related person and/or a prior placement in service by a related person, including overlap between prior investors and current investors which have been exacerbated by the numerous bank mergers over the years. Consider the following examples (keeping in mind that HERA changed the ownership percentage for related person status from 10% to 50%):

   a. Project X was constructed and placed in service in 1980 by Sponsor through Partnership A (in which a Sponsor affiliate was the general partner and individual investors were limited partners). Operating profits and losses were allocated 99% to the limited partners and 1% to the general partner with gain on sale 60% to the limited partners and 40% to general partner. In 1997 half the limited partners transferred their interests to the Sponsor. Project X was then re-syndicated by a sale from Partnership A to Partnership B in which operating profits were allocated .01% to a new Sponsor affiliate and 99.9% to a bank investor (Bank I) with gain on sale allocated 9.9% and 90.1%, respectively. Sponsor now proposes to cause Partnership B to sell the Project to Partnership C in which another Sponsor affiliate will have .01% of operating profits and 90% of gain on sale and another bank investor (Bank II) unrelated to Bank I will have 99.99% and 10%, respectively. Partnership C is unrelated to Partnership B so the acquisition by Partnership C should be by "purchase". Partnership C arguably is also not related to Partnership A as of the time Partnership A placed the Project in service in 1980 even though they may have become related by the time Partnership A sold the Project to Partnership B in 1997. While the transfer of limited partner interests in Partnership A to Sponsor should not constitute a placement in service by Partnership A, the fact that a Sponsor affiliate held more than 50% of capital or profits in a prior owner of the Project may disqualify the purchase by Partnership C from qualifying for acquisition credits. Out of an abundance of caution, the Sponsor affiliate's interest in Partnership C should be limited to no more than 50% of capital and profits, i.e., the Sponsor affiliate should be entitled to no more than 50% od gain on sale in the above example.

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

c. Assume the facts are the same as above except that in 2011 Bank II acquired Bank I. The 1997 placement in service by Partnership B may preclude acquisition credits for Partnership C even though Bank I and Bank II were not related at that time, although this remains the subject of debate with some practitioners looking as to whether Bank I and Bank II were related at the time the Project was previously placed in service and concluding that since they were not related at such time, Partnership C would qualify for acquisition credits.

C. Special Rules for Calculating Eligible Basis.

1. Exclude from Eligible Basis costs <u>not</u> attributable to "residential rental property," e.g., land and commercial space.

a. The IRS has ruled that a garage connected to a residential unit but rented through a separate, nonmandatory lease agreement is not residential rental property for purposes of Section 42. PLR 201149011. Therefore, the adjusted basis of the garage is not includible in calculating Eligible Basis. However, optional payments for the use of the garage are not taken into account as rent for purposes of Section 42(g)(2). *See* III.D.4 below.

2. Include costs allocable to common areas, recreational facilities and functionally related and subordinate facilities.

a. Initially, Eligible Basis could only include costs allocable to common areas and recreational facilities if the use of such facility was functionally related and subordinate to the qualifying low-income building and made available to all tenants on a comparable basis and free of charge. *See* H.R. Rep. No. 841, 99th Cong. 2d Sess. II-89 to II-90 (1986). Then, in 2008, Congress revised Section 42(d)(4)(C)(iii) to allow Eligible Basis to include costs attributable to certain common areas and recreational facilities that may serve non-tenants, known as community service facilities, as discussed in II.C.12.i below.

b. Prior to revising Section 42(d)(4)(C)(iii), the IRS had ruled that the cost of a kitchen that is used to prepare meals for which a separate fee is charged is not includable in Eligible Basis. PLR 9338013. The IRS had also ruled that the cost of a community building with meeting rooms, laundry facilities, a kitchen, management offices, and classrooms equipped for childcare that is used to provide social services for which a separate fee will not be charged is includable in Eligible Basis. PLR 9822026; *see also* PLR 199948025.

c. The cost of coin-operated laundry machines is not includable in Eligible Basis, although the cost of the building or portion thereof containing laundry facilities is includable, provided all tenants have access to such building at no additional cost. *See* Audit Technique Guide (rev. Jan. 24, 2024).

3. Per TAMs 200043015-17, the IRS found that land preparation costs are only includable in Eligible Basis if they are so inextricably associated with the low-income building, common areas, recreational facilities or functionally related and subordinate facilities that the land preparation will be retired, abandoned or replaced contemporaneously with such items. For example, the costs of clearing, grubbing and general grading to prepare a site suitable for any type of structure are inextricably associated with the land and are added to the cost of the land, and as a result are not includable in Eligible Basis, while the costs incurred for fill dirt that is used to set the foundation of a low-income building are treated as inextricably associated with the low-income building and are therefore includable in Eligible Basis. Additionally, costs associated with obtaining a construction loan may be capitalized and amortized over the life of the loan, and any amortized deductions incurred during the construction period should be capitalized under Section 263A and added to the basis of the produced property. The IRS has taken the position that the property being produced includes the land, land improvements and the building, and that the taxpayer must reasonably allocate the amortization deductions among all of the produced property. As a result, the taxpayer may include in Eligible Basis only those amortized deductions that are properly allocable to produced property that qualifies as residential rental property. TAMs 200043016-17. The IRS has also allowed taxpayers to use the "substitute cost method" to determine Eligible Basis. PLR 200305015.

a. <u>Comment</u>: Additionally, in TAM 200043015, the IRS stated that costs associated with the issuance of tax-exempt bonds (including FHFA fees, state board fees, rating agency fees, trustee fees, underwriter fees, investment fees, legal fees, inspection fees, and costs for photos, prints and renderings) are excluded from Eligible Basis, regardless of whether the costs are allocable to construction activities because such costs are amortized as Section 167 intangibles and not subject to depreciation under Section 168 (as required by Section 42(d)(4)). However, in a recent case published in February 2024, the U.S. Tax Court held that all financing costs, including bond fees, incurred by reason of the taxpayer's construction of residential rental property before the end of the first year of the Credit Period are includable in Eligible Basis. *23rd Chelsea Assocs. v. Commissioner*, No. 22382-19., 162 T.C. No. 3 (Feb. 20, 2024). We note that the IRS failed to timely appeal the Tax Court's decision. Query whether the Tax Court's analysis applies to relocation costs discussed below.

4. In Revenue Ruling 2002-9, 2002-1 C.B. 614, the IRS ruled that local impact fees (i.e., one-time costs with respect to a piece of property that are assessed when new construction takes place and may relate to such items as roads, water capital, educational facilities, law enforcement and fire/rescue facilities) incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under Sections 263(a) and 263A and therefore includible in Eligible Basis (overturning a position it had taken in TAM 200043016 that impact fees are a separate intangible and therefore not includable). Then, relying on Revenue Ruling 2002-9, the IRS further ruled that infrastructure improvements such as streets and underground utility connections that are constructed by a developer in connection with a low-income building but conveyed to a municipality and, thus, dedicated improvements within the meaning of Section 1.263(a)-4(d)(8)(iv), are indirect costs that may be capitalized under Section 263A into the basis of the Project's residential rental buildings and includible in Eligible Basis. PLR 200916007. The IRS has also ruled that costs to relocate an easement as required by a city for issuance of permits are indirect costs that may be capitalized under Section 263A into the basis of the Project's residential rental building and thus, includible in Eligible Basis. PLR 201515007.

5. The IRS on examination may recharacterize certain fees paid to developers as attributable, in whole or in part, to services other than the acquisition, construction, or rehabilitation of a building and exclude them from Eligible Basis. In settling the case of *Williamsburg Gardens, a Limited Partnership, Thomas E. Connelly, Jr., Tax Matters Partner v. Comm'r*, the Commissioner and the taxpayer agreed to re-characterize 20% of a "developer fee," which taxpayer had included in Eligible Basis as syndication costs, land costs, and organization costs not includible in Eligible Basis. Tax Court Docket No. 10953-98. The Commissioner permitted a developer fee of 15% of the amount of Eligible Basis to be included in Eligible Basis. *See also* TAM 200043017; II.C.9 below.

6. No reduction in Eligible Basis for depreciation. Code § 42(d)(4)(D).

7. Tax credit application and allocation fees paid to the housing credit agency are not includible in Eligible Basis. Rev. Rul. 2004-82, 2004-2 C.B. 350.

8. The IRS has held that nonrecourse notes taken to finance the construction of a building are genuine debt includable in the Eligible Basis of the building despite the fact that such notes may have lengthy terms (30 years) with significant accruals of interest and do not require payments of principal or interest prior to the maturity date. FSA 199948006. Note: The FSA does not address the deductibility (or adequacy) of accrued interest.

9. The IRS has held that the deferred portion of a developer fee represented by a developer fee note is includable in the Eligible Basis of a project, provided there is clear evidence that the note will be repaid at maturity. In reaching its conclusion that the developer fee note was a non-contingent obligation, the IRS considered the following facts: (i) although payments prior to maturity were contingent on cash flow and proceeds of capital transactions, the note was payable at maturity for a fixed amount; (ii) the general partners of the partnership were obligated to contribute to the partnership the amount necessary to repay the developer fee note upon maturity (which was the thirteenth anniversary of the completion date); and (iii) the general partners had the right to refinance the property within one year prior to maturity of the developer fee note in order to repay the note in full. TAM 200044004.

a. Comment: Additionally, the Audit Technique Guide indicates that the terms and conditions of a deferred developer fee note and/or other documents may suggest that the taxpayer does not intend to pay the deferred fee and that this issue is of particular concern if the parties to the transaction are related. The Audit Technique Guide indicates that the lack of an interest rate, contingent or substantially delayed payments, subordination to payment of other debts that make it unlikely that payment on the deferred fee would ever be made, the existence of a statutory right of first refusal held by the developer for a price that may be below fair market value, or an obligation on the part of a general partner who is or is related to the developer to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date may indicate that the deferred fee is not bona fide debt and thus should not be included in Eligible Basis. In a letter to the IRS dated March 27, 2014, the Tax Credit-Equity Financing Committee of the American Bar Association on Affordable Housing and Community Development Law ("ABA Forum") provided comments on the draft Audit Technique Guide published by the IRS in December 2013. In its letter, the ABA Forum noted that the lack of a stated interest rate, which is common in the industry, should not be viewed as indicative that the taxpayer has no intention of paying the deferred fee as it is not unusual in the context of a low-income housing transaction for debt instruments to bear no interest or below- market rates of interest and below-market interest rates were expressly sanctioned by Congress under Section 3002(b) of HERA, which modified Section 42(i)(2)(A) by eliminating the concept of "below market federal loans" with the effect of permitting low or no interest rate loans to be included in Eligible Basis. *See* Code § 467(g) (indicating that Regulations, which have not yet been issued, would be required to impute interest on deferred payments for services). IRS and judicial guidance does not support a conclusion that nominal or no interest is, by itself, determinative of true debt status and the Code acknowledges the existence of no or below-market interest rate loans. The ABA Forum also argued that if the IRS believes that a portion of a deferred fee represents interest, the IRS should recharacterize a portion of the deferred fee as interest under the imputed interest rules rather than excluding the entire fee from Eligible Basis under the theory that the deferred fee does not represent true debt. The ABA Forum also noted that if the developer is a qualified nonprofit organization, government agency or a tenant organization, under Section 42(i)(7) no federal income tax benefit, including the benefit of tax credits and depreciation attributable to the inclusion of a deferred development fee in basis, may be denied to a taxpayer merely because the developer has a right of first refusal to purchase the property at a purchase price equal to outstanding debt plus exit taxes. Finally, the ABA Forum noted that an obligation on the part of the general partner to contribute funds to enable the partnership to pay the deferred fee by a specified date does not suggest that the taxpayer does not intend to pay the deferred fee but the contrary. An obligation on the part of the general partner to contribute capital sufficient to pay the deferred fee on or before its maturity date suggests that the taxpayer intends to pay the deferred fee and suggesting that such an obligation evidences an intent not to pay the deferred fee is in direct conflict with TAM 200044004. In the Technical

Advice Memorandum, the general partner was obligated to make additional capital contributions at the maturity of the development fee obligation in an amount sufficient to enable the taxpayer to repay the deferred fee. The IRS viewed this fact as a positive indicator that the deferred developer fee was not contingent – "While payments are contingent prior to maturity – it is payable at maturity for a fixed amount that is not contingent."

10. Relocation Costs. In Appendix IX of the MSSP Training Guide, the IRS takes the position that costs attributable to moving a qualified low-income household and providing temporary housing for the household during rehabilitation are expensed as ordinary and necessary business expenses under Code Section 162 and thus are not includable in Eligible Basis. *See* MSSP Training Guide, IRC § 42 Low-Income Housing Tax Credit, Part IX Appendix, Acquiring Occupied Building: Tenant Relocation Costs. At the American Bar Association Forum on Affordable Housing and Community Development 2015 Annual Meeting, IRS representatives indicated that the IRS believes relocation costs should be expensed rather than capitalized because such costs are not associated with construction but rather are related to the landlord's obligation to provide housing to tenants. Many practitioners believe that costs to relocate tenants from a building incurred solely to rehabilitate the building should be capitalized as an indirect cost to the building under Section 263A (or may be capitalized pursuant to an election under Section 266) and accordingly should be included in Eligible Basis. Moreover, in light of the recent U.S. Tax Court's decision in *23rd Chelsea Associates* discussed above, temporary relocation costs should be includable in Eligible Basis under a similar analysis.

a. Query: Whether state housing agencies will accept relocation costs as part of a taxpayer's cost certification in light of the IRS' stated position that such costs are to be expensed, which position appears to be inconsistent with the analysis regarding the inclusion of Bond issuance costs in the *23rd Chelsea Associates* case discussed above.

11. Reduce Eligible Basis to the extent costs are funded with federal grants. *See* I.B.3.d above.

12. QCTs and DDAs. Eligible Basis of new buildings, including substantial rehabilitations, may be increased to 130% of what it would otherwise be if HUD determines that the building is located in either a qualified census tract or a difficult development area. Code § 42(d)(5)(B). Any building (other than bond-financed projects for which no allocation is made) placed in service after July 30, 2008 that is designated by a state housing credit agency as requiring the enhanced low-income housing credit for that building to be financially feasible as part of a qualified low-income housing project will be treated, for purposes of the rules governing the enhanced low-income housing credit, as located in a designated difficult development area. Code § 42(d)(5)(B)(v). A qualified census tract is defined as a census tract in which at least 50% of the households have an income of less than 60% of the area median gross income for such year or which has a poverty rate of at least 25%. Code § 42(d)(5)(B)(ii).

a. Announcement 91-112, 1991-31 Internal Revenue Bulletin 46, confirms that this 130% rule is available for bond-financed new construction or rehabilitation.

b. HUD publishes new difficult to develop area and qualified census tract designations annually. The HUD designations of qualified census tracts and difficult to develop areas for allocations made and bond-financed buildings placed in service on or after January 1, 2025 are listed in 89 Federal Regulations 73113 (Sep. 9, 2024). The HUD designations of qualified census tracts and difficult to develop areas for allocations made and bond-financed buildings placed in service on or after January 1, 2024 are listed in 88 Federal Regulations 65188 (Sep. 21, 2023); the HUD designations of qualified census tracts and difficult to develop areas for allocations made and bond-financed buildings placed in service on or after January 1, 2023 are listed in 87 Federal Regulations 64515 (Oct. 25, 2022). HUD makes the designations of DDAs in its annual notice based on modified Fiscal Year (FY) Small Area Fair Market Rents (Small Area FMRs, SAFMRs), FY 2024 nonmetropolitan county FMRs, FY income limits, and Census population counts, and QCT designations based on new income and poverty data released in the American Community Survey.

c. As with past designations, if an area is not on a subsequent list, the 2025 QCT and DDA designations will remain effective for an area if (i) for a 9% project, (A) the allocation of credit to an applicant is made no later than the end of the 730-day period after the applicant submits a complete application to the LIHTC allocating agency *and* (B) the submission is made before the effective date of the subsequent list; or (ii) for a bond-financed project, if (A)(x) the bonds are issued *or* (y) the building is placed in service no later than the end of the 730-day period after the applicant submits a complete application to the bond issuing agency *and* (B) the submission is made before the effective date of the subsequent list, provided that *both* the issuance of the bonds and placement in service of the building occur *after* the application is submitted.

(i) An application is deemed to be submitted on the date it is filed if the application is determined to be "complete" by the credit allocating or bond issuing agency. A complete application means that no more than de minimis clarification of the application is required for the agency to make a decision about the allocation of tax credits or issuance of bonds requested in the application. There is no additional guidance on what constitutes a complete application for this purpose. For example, does a subsequent submission to the bond issuing agency to address a change in the number of units, affordability matrix, or request an increase in the amount of volume cap bonds for a project suggest that the applicant's original submission was not complete? Practitioners often rely on a written statement from the applicable tax credit or bond issuing agency confirming that the original application submitted was deemed complete and that any subsequent modifications do not undermine such conclusion.

d. Note: When a project located in a difficult development area received an allocation in Year 1, and seeks an additional allocation in Year 2 when the area in which it is located is not a difficult development area, the maximum amount allocable in Year 2 is equal to the excess of the amount of credits that would be allocable to the project in Year 2 based on 100% of its Eligible Basis over the amount of credits allocated to the project in Year 1. PLR 9712003.

e. As with past designations, HUD has addressed in the notice accompanying the 2025 QCT and DDA designations how "multiphase" LIHTC projects are to be treated when DDA or QCT designations change between phases. 89 Fed. Reg. 73113 (Sep. 9, 2024). While the notice references multiphase bond-financed projects, one of the requirements for a multiphase project is that the aggregate amount of LIHTC applied for on behalf of, or that would eventually be allocated to, the buildings on the site exceeds the one year limitation on credits per applicant as defined in the QAP or the annual per capita authority of the credit agency is the reason the applicant must request multiple allocations over two or more years. Based on informal discussions with HUD, HUD has indicated that the multiphase provision is intended to apply solely to 9% projects since the purpose of such provision is to assist taxpayers forced to divide a project into multiple phases due to the limit on allocated credits that a single project can receive under a state's QAP. Accordingly, HUD takes the position that the multiphase provision does not apply to bond-financed projects despite the fact that in many jurisdictions volume cap is a scarce resource, i.e., demand far outstrips supply and bond issuers are increasingly capping the amount of volume cap bonds a single project can receive.

f. Comment: Application of the 130% basis boost to bond-financed projects increases the amount of credits available because there is no corresponding charge against the state volume cap. *See* IV.C.3 below.

g. Comment: Legislation has been introduced that would permanently treat certain buildings located in specified rural and Native American areas as DDAs eligible for a 30% discretionary basis boost and allow state agencies to give bond-financed properties a discretionary basis boost of 30% through December 31, 2028, upon a finding that the increase is necessary for the financial viability of the project. To date, such legislation has not passed. *See* IX.N below.

h. Comment: Legislation providing an appeal process for difficult to develop area and qualified census tract designations was introduced in the House in 2014; however, the bill was never passed. H.R. 5198, 113th Congress (2014). Accordingly, at present, there is no procedure by which a taxpayer can appeal DDA or QCT designations or loss thereof.

i. Community Service Facilities. The definition of Eligible Basis for a project located in a qualified census tract includes a portion of the building (of a character subject to the allowance for depreciation, and not otherwise included in Eligible Basis) used as a community service facility (such as a childcare center or employment training center), provided the increase in Eligible Basis of any building placed in service after July 30, 2008 does not exceed (a) 25% of the first $15 million of Eligible Basis, plus (b) 10% of the Eligible Basis not included above under (a). Code § 42(d)(4)(C)(ii). A community service facility means any facility designed to serve primarily individuals with incomes 60% or less of area median income. Code § 42(d)(4)(C)(iii). This requirement is satisfied if the following conditions are met (Rev. Rul. 2003-77, 2003-2 C.B. 75): (i) the facility is used to provide services that will improve the quality of life for community residents; (ii) such services are demonstrated to be appropriate and helpful to individuals in the area of the facility whose incomes are 60% or less of area median income. This requirement may be satisfied through the use of a market study such as that required to be conducted by the qualified allocation plan, or a similar study; (iii) the facility is located on the same tract of land as one of the buildings comprising the project; and (iv) any fees charged for the services provided, are affordable to individuals whose incomes are 60% or less of area median income.

(i) The IRS has ruled that a portion of a qualified low-income building leased to a local police department for use in its outreach program may qualify as a community service facility. Rev. Rul. 2004-82, 2004-2 C.B. 350.

(a) Comment: The Revenue Ruling does not indicate whether the building owner charged the police department rent and if so, whether such rent was equal to fair market rent. However, there is general consensus in the affordable housing industry that the relevant inquiry is with respect to whether fees charged to the ultimate recipient of services, if any, are affordable to individuals whose income is 60% or less of AMI and not whether the taxpayer charges rent or other fees to an organization that is providing those services.

(ii) Query: How is the requirement that services provided be affordable to individuals whose incomes are 60% or less of AMI applied to LIHTC projects that elect average-income as the minimum set-aside test and have tenants with incomes above 60% of AMI but at or below 80% of AMI?

(iii) Note: The basis of the community service facility is allocated among the buildings based on some reasonable method (e.g., units or square footage). This is similar to how costs attributable to common areas are allocated among buildings. If buildings will be placed in service over multiple years, buildings placed in service in the earlier year can only include costs from the community service facility in eligible basis if such costs were incurred prior to the end of the year in which such buildings were placed in service (unless the owner elects to defer the start of the Credit Period). As a result, to the extent costs associated with the community service facility, or other common elements, are incurred in a later year, the buildings placed in service in the first year may not be able to include their share of those costs in basis and that portion of the costs would not generate credits for any of the buildings.

(iv) Use of bond proceeds to finance community service facility. Bond counsel generally take the position that bond proceeds cannot be used to finance a community service facility that is used by non-residents on the basis that the facility is not "exclusively" for the use of project residents and, therefore, is not functionally related and subordinate to the residential rental project. In other words, the costs of such a facility are not qualifying costs for purposes of the bond 95-5 test, even though such costs may be includible in eligible basis for purposes of Section 42.

13. Comment: Since 2015, the Ways and Means Committee in the House of Representatives has on multiple occasions introduced legislation that would provide up to a 50% Eligible Basis boost for properties that reserve at least 20% of their units to extremely low-income households for allocation; however, such bills have not passed to date. *See, e.g.*, H.R. 1662, 114th Congress (2015); H.R. 3238, 118th Congress (2023).

D. Property Purchased During Construction.

When a project which has received a carryover allocation of credits (See IV.B.4 below) is purchased during construction, the purchaser's Eligible Basis equals the seller's Eligible Basis (whether the purchase price is greater or less than the seller's Eligible Basis) plus any costs incurred by the purchaser after the purchase, to the extent includable in Eligible Basis. Rev. Rul. 91-38, 1991-2 C.B. 3 (Question 4).

III. DEFINITION OF "QUALIFIED LOW-INCOME BUILDING"

A. Meaning of "building."

1. A qualified low-income "building" may be an apartment building, a single-family dwelling, a townhouse, a rowhouse, a duplex or a condominium. Notice 88-91, 1988-2 C.B. 414; PLR 200107022; PLR 9120021; PLR 9101006; PLR 8910015; PLR 8920073.

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

C. Must be part of a "Qualified Low-Income Housing Project".

1. A "qualified low-income housing project" is a project for "residential rental property" that satisfies both rent-restriction and a tenant-income requirement under one of three minimum set aside tests:

a. 20-50 test: 20% or more of the residential units are both rent-restricted and occupied by individuals whose income at initial occupancy is not more than 50% of area median gross income ("AMGI"). Code § 42(g)(1)(A).

b. 40-60 test: 40% or more of the residential units are both rent-restricted and occupied by individuals whose income at initial occupancy is not more than 60% of AMGI. Code § 42(g)(1)(B).

c. Average Income ("AI") Test: 40% (25% in NYC) or more of the residential units are both rent-restricted and occupied by individuals whose income at initial occupancy does not exceed the imputed income limitation designated by the taxpayer; and the average of the imputed income limitations designated shall not exceed 60% of AMGI. Code § 42(g)(1)(C).

D. Minimum Set Aside Test

1. Generally, a project must satisfy the 20-50, 40-60, or AI test by the end of the first year of the Credit Period and for the duration of the Compliance Period.

2. The taxpayer must elect the set-aside test to apply to a low-income project in the taxable year in which the project is placed in service, and that choice is irrevocable. Code § 42(g)(1). The election is made on Form 8609 (Part II, Item 10(c)). The IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that it acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government. Treas. Reg. § 301.9100-3(a). *See also* PLR 201501005; PLR 201342003; PLR 201328002; PLR 201302014; PLR 201134022; PLR 201010017; PLR 200807010; PLR 200737011; PLR 200731001. In addition, the IRS may grant an extension of time to make such an election under the same standard to allow a taxpayer to correct an inadvertent mistake as to which test is being selected. PLR 201206002.

3. The Average Income Test.

a. Under the Average Income Test, the designated imputed income limitation of each unit must be one of the following percentages of AMGI: 20%, 30%, 40%, 50%, 60%, 70%, or 80%.

(i) Comment: Some state credit agencies prohibit the use of certain otherwise permissible income designations. For example, the Massachusetts Executive Office of Housing and Livable Communities ("EOHLC") only allows 30%, 50%, 60%, or 80% AMGI designations; and therefore does not permit 20%, 40%, or 70% AMGI designations.

b. Satisfying the AI Minimum Set-Aside Test. In October 2022, the IRS published final Regulations on the Average Income Test in Treasury Regulations Section 1.42-19. Such Regulations clarify that for purposes of satisfying the average income minimum set-aside test, the taxpayer must identify a subset of units (i.e., less than all low-income units) constituting at least 40% of total units (25% in NYC), which units have designations that average to 60% or less of AMGI and are occupied by income-qualified tenants (the "AI Qualified Group"). The units in the AI Qualified Group must, first, individually satisfy the criteria that would qualify each unit as a low-income unit under the 20-50 or 40-60 set-asides.

Specifically: (1) each unit must be rent-restricted; (2) occupants of the unit must satisfy the imputed income limitation for such unit; (3) no other provision in Section 42 or the regulations thereunder denies low-income status to the unit (including Section 42(i)(3)(B)-(E)); and (4) the average of the designated imputed income limitations of the units in the AI Qualified Group must not exceed 60% of AMGI.

(i) Comment: To obtain an overall average of 60% AMGI or less for unit designations, a unit with a designation of greater than 60% (i.e., 70% and 80% AMGI units) must be offset by one or more units with designations of less than 60% AMGI (i.e., 20%, 30%, 40%, or 50% AMGI units) such that the combined average percentage divided by the number of units is equal to or less than 60% (for example: five units with one designated 20% and four designated 70%; or two designated 30% and three designated 80%; both of which would equal a 60% average exactly).

(ii) Determining the Applicable Fraction. In addition to identifying the units included in the AI Qualified Group, the taxpayer must identify a separate group of units (which would include all low-income units in the Project, including those included in the AI Qualified Group) (the "Applicable Fraction Qualified Group"). The AI Qualified Group and the Applicable Fraction Qualified Group may be identical if the Project is only 40% low-income. The units in the Applicable Fraction Qualified Group must meet the requirements set forth above in III.D.3.b above.

(iii) Identifying Units. As discussed, a taxpayer separately identifies (i) units in the AI Qualified Group and (ii) units in the Applicable Fraction Qualified Group. A taxpayer identifies the units in the AI Qualified Group and Applicable Fraction Qualified Group, respectively, by recording the units in the taxpayer's books and records, and the taxpayer must communicate that annual identification to the applicable credit agency as required in Sections 1.42-19(b)(3)(iii) and 1.42-19T(c)(1) of the temporary Regulations. The identification must be retained for a period not shorter than the record retention requirement under Section 1.42-5(b)(2). The temporary Regulations also provide credit agencies with the discretion, on a case-by-case basis, to waive in writing any failure to comply with the temporary regulations' recordkeeping and reporting requirements. The waiver may be done up to 180 days after discovery of the failure, whether by the taxpayer or the credit agency. At the discretion of the applicable credit agency, this waiver may treat the relevant requirements as having been satisfied. The initial designation of a unit must be made no later than when a unit is first occupied as a low-income unit (contrast this with the requirement under the Proposed Regulations, which required that designations be made by the end of the first year of the Credit Period). As a result, designations can take place in different taxable years for different units depending on lease-up and the final and temporary regulations allow for conversion of a market rate unit to a LIHTC unit provided such designation occurs before such unit is occupied.

(iv) Changing a Unit's Imputed Income Designation. Under the final Regulations, a taxpayer may change the imputed income limitation designation of a previously designated low-income unit under the following circumstances (contrast this with the requirement under the Proposed Regulations, which prohibited imputed income limitations from being changed once designated):

(a) In accordance with any procedures established by the IRS in forms, instructions, or guidance published in the Internal Revenue Bulletin pursuant to Section 601.601(d)(2)(ii)(b).

(b) In accordance with a credit agency's publicly available written procedures, if those procedures are available to all of the credit agency's projects that have elected the average income test.

(c) To enhance protections set forth in the Americans With Disabilities Act of 1990 (ADA), the Fair Housing Amendments Act of 1988, the Violence Against Women Act of 1994, the Rehabilitation Act of 1973, or any other State, Federal, or local law or program that protects tenants and that is identified by the IRS or an agency in a manner described in (a) or (b) above.

Comment: The tenant protections that apply to an average-income project and that redesignation may enhance do not necessarily have any specific connection to Section 42. For example, the protections may be ones that apply to all multifamily rental housing, or they may apply to the project at issue because some congressionally authorized spending supported the project with Federal financial assistance.

(d) To enable a current income-qualified tenant to move to a different unit within a project keeping the same income limitation (and thus the same maximum gross rent), with the newly occupied unit and the vacated unit swapping income limitations.

Comment: This conforms the AI minimum set-aside to the general LIHTC rule that units switch statuses when tenants move between units in a building.

(e) To restore the required average income limitation for purposes of identifying either (i) the AI Qualified Group or (ii) the Applicable Fraction Qualified Group.

Comment: If one or more units lose low-income status or if there is a change in the imputed income limitation of some unit(s) and if either event would cause a previously qualifying group of units to cease to be a qualified group, then the taxpayer may designate an imputed income limitation for a market rate unit or may reduce the existing imputed income limitations of one or more other units in the project in order to restore compliance with the average income requirement. This rule is limited to newly designated, or redesignated, units that are vacant or are occupied by a tenant that would satisfy the new, lower imputed income limitation.

A taxpayer effects a change in a unit's imputed income limitation by recording the limitation in its books and records, where it must be retained for a period not shorter than the record retention requirement under §1.42-5(b)(2). *See* § 1.42-19T(d)(2). The new designation must also be communicated to the applicable agency in the time and manner required by the applicable agency and must become part of the annual report to the agency of income designations. An agency may, if it wishes, require identification of the justification for the redesignation. The prior designation must be retained in the books and records for the period specified in Section 1.42-19T(c)(3)(iv).

c. Recapture. If a unit is removed from the Applicable Fraction Qualified Group, there is recapture with respect to such unit. However, an owner can redesignate an occupied unit at a lower imputed income limitation if an income qualified tenant at the lower income bracket occupies the unit. This may require an amendment to the extended use agreement to restrict rent at a lower income limit.

d. Note: If a project includes multiple buildings, the average at 60% requirement is applied on a project-wide (rather than building-by-building) basis provided a multiple building election is timely made on Form 8609.

e. Note: Following promulgation of the final Regulations, the so-called "cliff" under which a single noncompliant unit could cause the entire project to fail the AI minimum set-aside test has been eliminated.

f. AI Next Available Unit Rule. In a 100% LIHTC project where one or more units goes over-income, any unit that subsequently becomes available must be rented according to its income designation. For example, if a LIHTC project includes 10 units, 5 of which are designated at 40% AMGI and 5 of which are designated at 80% AMGI and one of the 40% AMGI units goes over-income, if an 80% AMGI unit becomes available it must be rented to a tenant with income at or below 80% of AMGI. In a mixed income project, i.e., a project that is not 100% LIHTC, if a LIHTC unit goes over-income, the next available market rate unit of equal or smaller size must be designated at the highest imputed income limitation such that the average of all imputed income designations does not exceed 60% of AMGI, not taking into account the over-income LIHTC unit. For example, a LIHTC project that includes 10 units, 4 of which are designated at 40% AMGI, 4 of which are designated at 80% AMGI and 2 of which are market rate units, if one of the 40% AMGI units goes over-income and a market rate unit becomes available, such market rate unit must be designated at 40% or less AMGI and leased to a tenant with income at or below 40% AMGI. In a building with multiple over-income units, the order the units are occupied does not matter but the order of designations may matter. For example, assume the same facts as above but one 40% AMGI unit and one 80% AMGI unit go over-income. When one of the two market rate units becomes available, the taxpayer must designate such unit as a 40% AMGI unit. However, when the second market rate unit becomes available (and the taxpayer designates the second market rate unit as an 80% AMGI unit), the fact that the second market rate unit (now designated as an 80% AMGI unit) is leased prior to leasing the first market rate unit (now designated as a 40% AMGI unit) will not cause the Project to run afoul of the next available unit rule. A taxpayer is permitted to make the highest designation possible so long as the average of the designations (not taking into account over-income units) average to 60% or less of AMGI. See further discussion of the next available unit rule in III.D.7.i below.

g. Comment: AI was not incorporated in the tax-exempt bond rules and accordingly, a project that elects AI as the Section 42 minimum set-aside test must still satisfy either the 20-50 or 40-60 bond minimum set-aside test. The next available unit rule under Section 142 requires that if a unit that is necessary to meet the bond minimum set-aside goes over income you must rent the next unit of comparable or smaller size to a resident whose income does not exceed the applicable income limit. It is theoretically possible that you could be in compliance for LIHTC purposes and fail the bond minimum set-aside test. For example, assume you have a 100-unit project, 20 units at 40% AMGI, 20 units at 80% and 60 market rate units and the project owner elects AI as the LIHTC minimum set-aside test and the 20-50 set-aside for bond purposes. Assume that one of the 40% AMGI units goes over-income and the next available unit that becomes vacant is an 80% AMGI unit. For LIHTC purposes, no issue. All the taxpayer is required to do is rent the 80% AMGI unit to a tenant with income at or below 80% of AMGI. However, if the taxpayer rents the 80% AMGI unit to a tenant with income above 50% AMGI the taxpayer will fail the bond minimum set-aside test because the bond rules do not recognize the 80% AMGI unit as a rent-restricted unit. This should not be an issue in most bond deals that elect AI because projects typically have a cushion for purposes of satisfying the bond minimum set-aside test.

h. Comment: Despite the promulgation of the final AI Regulations, a number of credit agencies continue to have different policies/requirements with respect to projects electing AI. For example, EOHLC guidance (published prior to the final AI Regulations) contemplates approval of projects using income averaging on a limited basis and "primarily in 4 percent preservation projects."

4. For purposes of the three set-aside tests, qualifying units must be "rent restricted." A residential unit is "rent-restricted" if the gross rent with respect to such unit does not exceed 30% of the "imputed" income limitation applicable to such unit. Code § 42(g)(2)(A). The imputed income limitation for a unit is the income limitation that applies under the elected set-aside limitation to the individuals occupying the unit, assuming that a studio apartment houses one person and that apartments with separate bedrooms house 1.5 persons per bedroom. *See* Code § 42(g)(2)(C).

a. For purposes of the "rent-restriction" requirement, imputed income may increase above but cannot decrease below a floor which will be based on AMGI at the date of the credit allocation or, if the taxpayer elects, at the time the building is placed in service. Rev. Proc. 94-57, 1994-2 C.B. 744. No such floor exists for purposes of the tenant income requirements. *See* III.D.7.l below. As a result of the codification of the income limit hold harmless policy (introduced by HERA), which requires that the rent limit of a development shall never decrease after the development is placed in service, an owner should generally not elect the gross rent floor, i.e., should not make any election. However, if the Credit agency requires that the form be completed (some Credit Agencies do require the taxpayer to make an election), the owner should elect the rent floor at the time the 42(m) letter is issued (in a Bond deal) or the time the carryover allocation is issued (for a 9% deal) because (1) if the rents at the time of the 42(m) letter/carryover allocation are higher than the rent limits at placement in service, the owner gets the benefit of the higher rents at the time of 42(m) letter/carryover and (2) if rents at the time of placement in service are higher than rents at the time of the 42(m) letter/carryover, the owner gets the benefit of the higher rents at placement in service despite having elected the rent floor at the time the 42(m) letter/carryover allocation was issued as a result of the hold harmless provision introduced by HERA.

b. Section 1.42-10, last updated in March 2019, includes definitions of utility allowances for purposes of determining amounts included in determining gross rent for "rent-restricted" units. Treas. Reg. § 1.42-10(a). Utility costs based on actual consumption in a submetered rent-restricted unit are treated as paid directly by the tenant, and not by or through the owner of the building. Treas. Reg. § 1.42-10(a); Notice 2009-44, 2009-21 I.R.B. 1037. However, to the extent a building owner actually bills for utilities using an actual consumption method, the utility rate charged to the tenants must not exceed the rate incurred by the building owner for that utility, and, to the extent the utility is purchased from a local utility company or produced from a renewable source, the building owner may not charge tenants rates in excess of those the local utility company would have charged if they had acquired energy from that company instead. *See* Treas. Reg. § 1.42-10(e). The Regulations also provide rules for determining the applicable utility allowance based upon whether the building or tenants receive rental assistance from the Rural Housing Service (RHS), rents and utilities of the building are reviewed by HUD, or the applicable public housing authority sets the utility allowances. *See* Treas. Reg. § 1.42-10. Furthermore, if tenants are charged a fee for administering an actual consumption submetering arrangement, the fee is considered gross rent for purposes of 42(g)(2) unless the fee is computed in the same manner for every unit receiving the same submetered utility service, or the monthly fee does not exceed the greater of (i) five dollars, (ii) an amount designated by publication in the IRB, or (iii) the lesser of a dollar amount specifically set under a State or local law or a maximum amount designated in the IRB. Treas. Reg. § 1.42-10(e)(2); *see also* T.D. 9755.

c. Rents do not include Section 8 assistance or any comparable rental assistance program (including, most recently, the HUD-VASH (U.S. Department of Housing and Urban Development-Veterans Affairs Supportive Housing). Rev. Proc. 2024-38, 2024-43 I.R.B. 1010.

d. <u>Comment</u>: If, because of an increase in a tenant's income above 50% or 60% of AMGI or, in the case of a project that elects AI, the designated imputed income limitation, as the case may be, rental assistance is decreased and rents payable by a tenant are increased, a unit may still qualify as "rent restricted" if the total subsidy and rent for the unit does not exceed what the total would have been had the tenant's income not increased above those levels and this limitation of the total subsidy and rent is mandated by Federal statute.

e. Rents do not include payments made to the unit owner to the extent that such owner pays an equivalent amount to the Farmers Home Administration under Section 515 of the Housing Act of 1949.

f. The IRS has ruled that a one-time application fee charged to tenants to reimburse the owner's out-of-pocket costs for obtaining credit checks and references for tenants is not included in rents. PLR 9330013.

g. Rents do not include charges for meals and other services such as laundry, housekeeping and assistance to elderly tenants, even if the services are substantial, provided that the services are optional. Treas. Reg. § 1.42-11(a); Rev. Rul. 91-38, Question 12; PLR 8945036; PLR 8944042; and PLR 8920003. Services may not be considered optional unless there is a practical alternative for tenants to obtain them from sources other than the project or the project owner. Treas. Reg. §1.42-11(b)(1). Apparently, meal service may be treated as optional even when the units contain no kitchen facilities, provided there is a practical alternative for tenants to obtain meals other than from a common dining facility. PLR 8945036.

h. Rent does not include the optional fee for access to and use of a garage by tenants. PLR 201149011.

i. Payments for services which are not optional are generally included in rents (PLR 8921035), even if building owners are required by law to provide the services. Continual or frequently provided nursing, medical or psychiatric services are presumed not to be optional and may cause a building not to be treated as for use by the general public. Treas. Reg. § 1.42-11(b)(2); *see* III.F.3 below. However, payment for "support services" designed to enable elderly or disabled tenants to remain independent may be excluded from rents provided that the payments are funded by a governmental or charitable program and the funding of services is not separable from the funding of rent. Code § 42(g)(2)(B)(iii); Treas. Reg. § 1.42-11(b)(3)(ii)(A); PLR 9526009.

j. Rents do not include refundable fees associated with renting a low-income housing unit, such as security deposits. Audit Technique Guide (rev. Jan. 24, 2024).

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

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

a. Comment: In addition, legislation has been introduced that would treat projects for moderate-income seniors (individuals 62 years or older whose income is

140% or less of the income limitations described in Section 42(g)(1)) as qualified low-income housing tax projects under Section 42(g); however, this bill was never passed. H.R. 6295, 112 Congress (2012).

6. Similar rules that apply for purposes of determining whether a project is a "qualified residential rental project" under Section 142(d) also apply for purposes of defining a "qualified low-income housing project" under Section 42(g).

  a. The published HUD section 8 limits are used to determine the income limitations for the project. CCA 201046014.

  b. HERA amended Section 142(d) to permit bond financing of SRO units and student housing meeting the requirements of Sections 42(i)(3)(B)(iv) and (D).

7. Income determinations.

  a. Generally, must be made and certified at least annually. Treas. Reg. §1.42-5.

  b. The effective date of a tenant's income certification is the date the tenant moves into the unit, and all adult members of the household should sign the certification, unless impractical. *See* Audit Technique Guide (rev. Jan. 24, 2024). Certification upon move-in must be completed in the 120-day period ending on the date of move-in. *Id.* If the certification is more than 120 days old, the tenant must provide a new certification at move-in. *Id.* Income recertifications, if required, must be completed annually based on the anniversary of the effective date. *Id.* When additional adult individuals join the household, the effective day will remain the same until the unit is completely vacated. *Id.*

  c. For households occupying a unit at the time of acquisition by the owner, the initial tenant income certification is completed within 120 days before or after the date of acquisition using the income limits in effect on the day of acquisition. *Id.* The effective date of the tenant income certification for purposes of annual re-testing is the date of acquisition since there is no move-in date. *Id.* If the household occupies a unit at the time of acquisition, but the tenant income certification is completed more than 120 days after the date of acquisition, the household is treated as a new move-in. *Id.* The effective date of the income certification is the date the last adult member of the household signed the certification. *Id.* When the household moves into a unit after the building is acquired but before the beginning of the first year of the compliance period, the effective date of the income certification is the date the household moves into the unit. *Id.*

  d. For pre-credit-period move-ins, the incomes of the individuals occupying a unit are first tested for purposes of the next available unit rule under Section 42(g)(2)(D)(ii) and Section 1.42-15 at the beginning of the first year of the building's Credit Period. *Id.* Certification must be completed during the 120-day period ending on the beginning of the Credit Period. *Id.* If the effective date of the initial tenant income certification was 120 days or less before the beginning of the

Credit Period, it is not necessary to test again for purposes of the next available unit rule. *Id.*

e. Annual income certification is not required for projects that are 100% LIHTC. Section 42(g)(8).

f. Required supporting documentation generally consists of tenant's tax returns, W-2s or statements from third parties such as employers or agencies paying unemployment compensation (Treas. Reg. § 1.42-5(b)(1)(vii)) but may consist of tenant's signed sworn statement if tenant's assets do not exceed $5,000. Rev. Proc. 94-65, 1994-2 C.B. 798. If the tenant's assets do not exceed $5,000, the tenant's sworn statement may also be sufficient to show that the tenant is not receiving child support. Rev. Rul. 2004-82, 2004-2 C.B. 350. If a tenant is receiving housing assistance payments under Section 8 of the United States Housing Act of 1937, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable limit under Section 42(g). Treas. Reg. §1.42-5(b)(1)(vii). The IRS has relaxed this documentation requirement in order to encourage the owners of low-income housing units to rent on a temporary basis vacant units to certain displaced low-income individuals who reside in major disaster areas. Rev. Proc. 2007-54, 2007-2 C.B. 293.

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

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

i. <u>The Next Available Unit Rule</u>: A low-income unit will not lose its status as such if the income of its occupants rises above the applicable limits (50% or 60% of AMGI in the case of the 20-50 or 40-60 tests, or the imputed income limitation designated under AI), provided that the occupant's income was initially within those limits, that the unit remains rent-restricted, and that if the occupant's income rises above 140% of such limit (or 140% of the greater of 60% of AMGI or the imputed income limitation designated under AI, discussed further below), causing the unit to become a so-called "over-income unit", the project owner must rent all available units in the same building (of a size comparable to, or smaller than, the over-income unit) to occupants whose income does not exceed the applicable limits until such time as the percentage of low-income units in the building (excluding the over-income units) equals the percentage of low-income units on which the credit is based. The rule described above is known as the "next available unit rule." *See* Treas. Reg. § 1.42-15; *see also* CCA 200137028.

(i) In the case of deep rent skewed projects, the unit becomes over-income when it increases above 170% of the applicable income limitation (rather than 140%) and any available unit, regardless of size, is a comparable unit.

(ii) In a multiple building project, the "next available unit rule" is applied separately to each building. Treas. Reg. § 1.42-15(e).

(iii) For tax-exempt bond purposes, there is also a "next available unit rule," that is also applied on a building-by-building basis for buildings that are allocated low-income housing tax credits. *See* Code § 142(d)(3)(C).

(iv) Comment: A mixed-income project incorporating market-rent units can use a condominium structure to avoid the next available unit rule. By putting the market-rate units into one condominium, the other condominium constitutes a 100% low-income building which is not subject to the rule.

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

(vi) A comparable unit must be measured using the same method (floor space or number of bedrooms) as was used by the taxpayer to determine qualified basis for the credit year in which the comparable unit became available.

(vii) When a current resident moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit. Thus, if a previously qualified over-income tenant moves to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit and the vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident. Therefore, both the vacated unit and the newly occupied unit may qualify as low-income units, although the continued qualification of each is subject to the "next available unit rule." Treas. Reg. §1.42-15(d).

(viii) If any available comparable unit is rented to a nonqualified resident, all over-income units in the same building for which the available unit was a comparable unit lose their status as low-income units.

(ix) Not renewing a tenant's lease when a tenant's increase in income conflicts with the requirements of a local, state or other federal program (but does not conflict with Section 42 because of Sections 42(g)(2)(D)(i) or (ii)), does not mean that the building is not a qualified low-income building under Section 42(c)(2); but an owner is required to continue the tenancy of a tenant who satisfied the applicable income limitation upon initial occupancy unless good cause exists not to renew the lease. Office of Chief Counsel IRS Memorandum, POSTN-109692-15 (March 26, 2015).

(x) A unit is not available for purposes of the "next available unit rule" when the unit is no longer available for rent due to a reservation that is binding under local law. *See* CCA 200137028.

(xi) In the case of the Average Income Test, the next available unit rule must be complied with if the aggregate income of the occupants of a unit increases above 140% of the greater of (i) 60% of AMGI, or (ii) the imputed income limitation designated with respect to the unit, as set forth above. Code § 42(g)(2)(D)(iii); Regulations § 1.42-15(a). In the case of a deep rent skewed project, however, the next available unit rule isn't triggered until occupant income rises above 170% of the greater of (i) 60 percent of area median income and (ii) the unit's designated imputed income limitation. Code § 42(g)(2)(D)(iv). For instance, for a project that is not a deep rent skewed project, if a unit designated at 40% AMGI has a tenant who was income qualified at move-in, the next-available-unit rule will not apply with respect to that unit unless and until the tenant's income rises above 140% of 60% AMGI, not 40% of AMGI. On the other hand, if a unit in such a project is designated at 80% AMGI, then the next-available-unit rule will not apply until the initially qualifying tenant's income rises above 140% of 80% AMGI.

(xii) Under Sections 42(g)(2)(D)(iii) & (v), the over-income unit will cease to be treated as a low-income unit if any residential unit in the same building of a comparable or smaller size to the over-income unit is rented to new resident whose income is greater than either: (a) in the case of an available LIHTC unit with a designated income limitation level (e.g., 40%), such designated income limitation level (i.e., 40%), or (b) in the case of a market-rate unit, the income limitation level "at which the market-rate unit would have to be designated for the project to continue to meet" the 60% average income limitation requirement. As discussed in III.C.1.b above, Section 1.42-19 provides for restoring compliance with average income requirements by, for example, using a market-rate unit to replace a unit in a previously qualifying group of units so long as the new or current tenant qualifies under the new, lower imputed income limitation.

(xiii) As discussed above, under the final Average Income Regulations, the taxpayer need not rent the next available unit in any specific order but the order of designation may matter.

j. Revenue Procedure 2003-82 provides a safe harbor pursuant to which a unit can qualify as a low-income unit even if a tenant is over-income at the commencement of the Credit Period, provided that the tenant was at or below the applicable income limit at the latter of (i) the date the taxpayer acquired the building or (ii) the date of initial occupancy by the tenant. Rev. Proc. 2003-82, 2003-2 C.B. 10970. The safe harbor is helpful when the Credit Period occurs after the later of such dates because of either an election to defer commencement of the Credit Period until the year following placement in service or, in the case of an acquisition of an existing building, the requisite rehabilitation expenditures are not incurred until a year following the year of acquisition. The safe harbors apply only if the unit is rent-restricted and otherwise qualifies as a low-income unit (see III.E.1 below) from the later of the date of acquisition or initial occupancy until the beginning of the first year of the Credit Period and, in the case of an existing building, if there has been a credit allocation, binding commitment, or an issuance of tax-exempt bonds, by the end of the taxable year in which such later date occurs.

k. In the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, a low-income unit occupied by an over-income tenant at the time of acquisition continues to qualify as a low-income unit provided the extended use agreement ("EUA") entered into in connection with the original syndication of the project remains in effect at all times until a new EUA is entered into as part of the re-syndication of the project and the existing EUA requires that the project maintain the same percentage of low-income tenants and restricted rents for a period of at least 15 years following the expiration of the Compliance Period with respect to the original syndication. Audit Technique Guide (rev. Jan. 24, 2024). The state agency must also review the initial tenant income certification. If the household qualified at the time it moved in, then the unit is in compliance even if it is now over-income. *Id.* If the unit was determined to be an over-income unit under Section 42(g)(2)(D) of the Code at the time of the household's last recertification, then the owner of the project is subject to the so-called "next available unit rule" (unless the project is a 100% low-income housing tax credit project, in which case the next available unit rule does not apply).

l. In the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, an over-income unit in a mixed-income project will continue to qualify as a low-income unit if the over-income tenant is temporarily relocated during the rehabilitation of such tenant's unit, provided the over-income tenant returns to her original unit or occupies a different unit in the same building following the rehabilitation.

(i) See I.A.8 above for a discussion of the Audit Technique Guide's guidance on this topic.

m. For deep rent skewed projects (other than those that elect AI), the unit will not continue to qualify if any available low-income unit is rented to a tenant whose income exceeds 40% of AMGI. *See* PLR 9848005. For a deep rent skewed AI project, the unit will not continue to qualify if any available low-income unit is rented to a tenant whose income exceeds the *lesser* of (i) 40% or (ii) the imputed income designation for the unit.

n. AMGI may, of course, increase or decrease during the Compliance Period. Determinations of whether an occupant's income satisfies the applicable limit at initial occupancy and exceeds the 140% limit thereafter are made based on the AMGI at the time of such determinations. Rev. Rul. 94-57, 1994-2 C.B. 5. Thus, a decrease in AMGI will not cause a tenant's income to exceed the level required for initial occupancy but will lower the level at which the 140% limit is exceeded.

o. The income of all occupants of a unit, whether or not legally related, must be combined and then compared to AMGI of a family of the same size in determining if the tests are satisfied. Rev. Rul. 90-89, 1990-2 C.B. 8.

p. If a military service member occupies a unit in a qualified building located near qualified military installations, any amount paid to the member as a basic allowance for housing is not included in the member's income for purposes of determining whether the building qualifies for the LIHTC or whether the unit is a low-income unit.

8. Deep Rent Skewing. *See* Code §§ 42(g)(2)(D)(iv) and 142(d)(4)(B).

a. 15% of low-income units occupied by individuals whose income is not more than 40% of median income;

b. All low-income units are rent-restricted; and

c. Rent for each low-income unit does not exceed 1/2 of rent for other unrestricted units.

E. Multiple Buildings.

1. One of the more confusing aspects of Section 42 is that some provisions apply to "buildings" while others apply to "projects." Moreover, multiple buildings may be treated either as a single project or as multiple projects.

2. Generally, each building is treated as a separate project unless multiple buildings which are eligible to be treated as a single project are identified by the taxpayer before the close of the calendar year in which the first building is placed in service. Code § 42(g)(3)(D); *see also* Form 8609, line 8(b) and the related instructions. The identification period may be extended by the IRS when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that granting relief would not prejudice the interests of the government. PLR 201606023; PLR 201516061; PLR 201441002; PLR 201411015; PLR 201410034; PLR 201410033; PLR 201410032; PLR 201410031; PLR 201410027; PLR 201324014; PLR 201115008; PLR 200723017; PLR 200723023.

a. See III.A above for the definition of a "building."

b. Separate condominium units of a building may be treated as a single building for purposes of determining whether the building (and its structural components) is residential rental property or nonresidential real property under Code §168(e)(2). PLR 201103006.

c. Notwithstanding contrary language in Notice 88-91 (and the Audit Technique Guide), a building leased to a cooperative housing corporation should be a qualified low-income building. PLR 9538012; PLR 8941021.

3. Among the provisions of Section 42 which are applied on a project-wide basis and, therefore, may operate differently depending on whether multiple buildings are treated as a single project or separate projects are (a) the 10% carryover allocation computation under Section 42(h)(1)(E)(ii), (b) the rules for credit allocations for projects with multiple buildings, (c) the satisfaction of the 20-50, 40-60 or average income tests pursuant to Section 42(g), (d) the "vacant unit" rule (see III.F.5 below), and (e) the 25% limitations attributable to community service facilities. *See* II.C.2 above.

4. Multiple buildings may be treated as part of a single project if they contain similarly constructed units and are owned by the same person, located on the same or contiguous parcels of real estate and financed pursuant to a common plan. Treas. Reg. §1.103-8(b). However, buildings that could not be treated as a single project because of their lack of proximity may be so treated if 100% of the units in each building are rent restricted. Code § 42(g)(7).

a. <u>Note</u>: Although the statute appears clear on its face that the only requirement to qualify for this exception is that 100% of the units be rent restricted, the Audit Technique Guide suggests that 100% of the units must also be occupied by qualified low-income households. Audit Technique Guide (rev. Jan. 24, 2024). IRS personnel present at the ABA Forum in Washington, D.C. in May 2016 stated that the IRS' position is that 100% of the units must be rent restricted *and* occupied by qualified low-income households. A number of practitioners in the audience objected, arguing that the language of the statute is clear on its face. In a letter to the IRS dated March 27, 2014, the Tax-Credit Equity Financing Committee of the American Bar Association Forum on Affordable Housing and Community Development Law stated "The [Audit] Guide's statement that all units must be "Low-Income Units" results in the addition of a requirement that all units must be occupied by low-income persons. The clear wording of Section 42(g)(7) requires only that the units be rent-restricted and thus the change from "low income unit" [to] rent restricted is recommended."

b. <u>Comment</u>: In order to simplify the "scattered site" exception, the ABA Section of Taxation has suggested amending section 42(g)(7) to remove the rent restriction requirement and instead provide that buildings that could not be treated as a single project because of their lack of proximity be so treated if all the buildings in the project are owned by the same person and financed pursuant to a common plan. ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate (March 11, 2013).

c. Note: There is no comparable "scattered site" exception under the tax-exempt bond rules so that buildings which are not proximate may constitute multiple projects for those rules and a single project for purposes of the Credit.

d. Comment: There is, as yet, little guidance on the meaning of "similarly constructed units" which could be a concern for a project consisting of a high-rise building and townhouses or of buildings constructed at different times. Units need not be of the same size or have the same number of bedrooms to be "similarly constructed" so long as they are of similar quality and type of construction. See T.D. 7840, 1982-2 C.B. 38. Query: May "units" be similarly constructed even if the buildings in which the units are located are not similarly constructed?

5. If a building is part of a project consisting of multiple buildings, the following rules apply:

a. If a project includes multiple buildings that will commence their Credit Periods in different years and the taxpayer desires to treat all buildings as a single LIHTC project (by making a timely multiple building election), a sufficient number of units to satisfy the minimum set-aside test taking into account all units in the project must be placed in service, occupied and commence their Credit Periods no later than the end of the first year for which the LIHTC is claimed.

(i) Example 1: Assume a new construction project includes five buildings with ten units each (total of 50 units). The Project will not satisfy the 40-60 or AI minimum set-aside tests if only 1 of the 5 buildings is placed in service, occupied by qualified tenants and commences its Credit Period in 2024 and the other 4 buildings are placed in service, occupied and commence their Credit Periods in 2025 since the 2024 building represents only 20% of total units in the project. Under these facts, the taxpayer's options include (i) deferring the start of the Credit Period for the building placed in service in 2024 to 2025 or (ii) treating the building placed in service in 2024 as a separate LIHTC project and treating the 4 buildings placed in service in 2025 as a second LIHTC project for which a multiple building election is made.

(ii) Implications for multiple building projects that elect AI:

(a) 40% of all units must commence their Credit Period(s) in Year 1 and must have imputed income limitation designations that average to 60% or less of AMGI. This means that at least 40% of total units must be placed in service and both rent restricted and occupied by individuals whose income does not exceed the "imputed income limitation" designated with respect to such unit by the end of such year.

(b) Example 2: Assume the same facts as Example 1 above, but the taxpayer elects AI as the minimum set-aside test. In addition to the requirement that at least 40% of total units (i.e., 20 units) commence their Credit Period in Year 1, those units must have designations that average to no more than 60% of AMGI without looking to units that commence their Credit Period in Year 2. For example, if two buildings contain only 40% AMGI units, one building contains only 60% AMGI units and two buildings contain only 80% AMGI units, the two buildings with only 80% AMGI units would not be able to commence their Credit Periods in year 1 since those two buildings would not satisfy the average at 60% or less AMGI requirement.

b. Sequential Rule: Generally, a building in a multiple building project will only qualify as a low-income building if the project as a whole satisfies the applicable minimum set-aside test not later than the close of the first year of the Credit Period for such building. Code § 42(g)(3)(A). Under this rule, buildings must sequentially satisfy the minimum set-aside test based on the order the buildings are placed in service.

(i) Example: Assume a Project includes two buildings each of which contains 10 units. Building 1 includes 9 LIHTC units and 1 market rate unit. Building 2 includes 9 market rate units and 1 LIHTC unit. The taxpayer needs to treat both buildings as a single project since Building 2 would not qualify for LIHTC on a stand-alone basis. If Building 1 is placed in service first, the sequential rule is satisfied. However, if Building 2 is placed in service first, the Project does not satisfy the minimum set-aside test until such time as Building 1 comes online. Query: Is the taxpayer able to claim LIHTC in the first year of the Credit Period (assuming both Buildings 1 and 2 have the same first year) with respect to Building 2 for months prior to placement in service of Building 1? Technically, the answer would appear to be "no" but in practice most taxpayers do not delay claiming credits so long as the minimum set-aside test is satisfied by the end of the first year of the Credit Period.

(ii) The sequential rule is typically not an issue in an acquisition/rehab deal where both acquisition and rehabilitation credits "tack back" to the date of acquisition.

c. Bootstrap Rule: A taxpayer can elect to non-sequentially satisfy the minimum set-aside test. Section 42(g)(3)(B) of the Code provides a phased-in exception whereby a building (the "Prior Building") can rely on one or more buildings (the "Subsequent Buildings") placed in service after such building (the Prior Building) in order to satisfy the minimum set-aside test and qualify as a qualified low-income building. Section 42(g)(3)(B) provides that if a taxpayer elects to apply the phased-in exception, (i) "the taxpayer may take into account 1 or more additional buildings placed in service during the 12-month period described in

Section 42(g)(3)(A) with respect to the prior building only if the taxpayer elects to apply…with respect to each additional building taken into account [under this election]…the 12-month period applicable to the prior building." Code § 42(g)(3)(B)(i)-(ii). In examining Section 42(g)(3)(B) of the Code, the IRS MSSP Training Guide states that a taxpayer may elect to create a multiple building project and utilize the phased-in exception to satisfy the minimum set-aside test if the following two conditions are met: (1) The Subsequent Buildings must be placed in service no later than the end of the twelve (12) month period beginning on the date the Prior Building was placed in service (i.e., within twelve (12) months of the date the Prior Building was placed in service); and (2) Within the twelve (12) month period beginning after the date the prior building is placed in service, all the Subsequent Buildings and the Prior Building must collectively meet the minimum set-aside test. *See* MSSP Training Guide, IRC § 42 Low-Income Housing Tax Credit, Part IV Applicable Fraction, Chapter 12, Date for Meeting Requirement. In other words, once the taxpayer elects to utilize the Section 42(g)(3)(B) method to satisfy the minimum set-aside test, the taxpayer must use the placed in service date of the Prior Building as the beginning of the twelve (12) month period during which the Prior Building and the Subsequent Buildings, when taken together, must satisfy the minimum set-aside test. If a taxpayer makes this election and satisfies the above two conditions, "then the building relying on subsequent buildings for qualification as a low-income building [(i.e., the Prior Building)] is treated as placed in service on the most recent date any additional building was placed in service." MSSP Training Guide, IRC § 42 Low-Income Housing Tax Credit, Part IV Applicable Fraction, Chapter 12, Date for Meeting Requirement. Accordingly, by making the election, the taxpayer delays the Prior Building's placement in service date for purposes of determining the Credit Period and the compliance period for such building. Code § 42(g)(3)(B)(iii).

(i) Example: Assume Building 2 is placed in service on December 15, 2023 and Building 1 is placed in service on December 1, 2024. Building 1 is not fully leased until January 15, 2025. Building 1 can make a Section 42(f)(1) election to defer the start of its Credit Period to 2025. The taxpayer cannot make a Section 42(f)(1) election to defer the start of the Credit Period with respect to Building 2 to 2025 since it was placed in service in 2023. However, if the taxpayer makes a so-called "bootstrap election" under Section 42(g)(3)(B)(iii), the taxpayer can treat Building 2 as having been placed service on the date Building 1 is placed in service, i.e., December 1, 2024. Accordingly, Building 2 can make a Section 42(f)(1) election to commence its Credit Period in 2025. Note, the taxpayer would begin claiming credits on both Buildings 1 and 2 in 2025. The bootstrap election effectively allows a taxpayer to defer the start of the Credit Period for an additional year.

F. Definition of Low-Income Units.

1. Generally a low-income unit must:

a. be rent-restricted (see III.D.4 above);

b. be occupied by individuals who meet the applicable income limitations at the time of initial occupancy (see III.D.7 above concerning increases in tenants' income and the next available unit rule);

c. be suitable for occupancy under Regulations not yet issued that will take into account local health, safety and building codes; and

d. be used other than on a transient basis, which will generally be the case if the initial lease term is six months or longer, even if the tenant is permitted to occupy the unit on a rent-free basis for one month or less. PLR 9330013. *See also* PLR 200044020 (providing that units in an acquisition/rehabilitation project which are occupied by tenants with month-to-month tenancy and a documented long-term history of tenancy in the project will satisfy the requirement that low-income units be used on other than a transient basis, provided the tenants had initial leasehold terms of 6 months or longer with the prior owner of the project and that the new owner does not plan to change the use of the units). <u>Note</u>: While the IRS requires a lease term of at least 6 months, many state credit agencies require initial lease terms of 12 months.

2. Exceptions:

a. Transitional housing for "homeless individuals," as defined in the McKinney Act, is not subject to (1)(d) above, provided that:

(i) it is used exclusively to facilitate such transition; and

(ii) within the project, a government agency or nonprofit organization provides counseling and supportive services to such individuals.

<u>Comment</u>: The requirement of exclusive use precludes combining transitional housing with other types of affordable housing in the same building. Query: Could a taxpayer isolate transitional housing for homeless individuals and non-transitional affordable housing in separate condominium units that are treated as separate buildings for purposes of Section 42?

b. Single-room-occupancy ("SRO") units are not treated as failing to satisfy (1)(d) above simply because they are rented on a month-to-month basis, so long as they are suitable for occupancy and are actually used for occupancy on a non-transient basis. SRO units in groups with shared kitchen, living room and, in some cases, shared bathroom facilities which satisfied HUD Section 8 quality standards were ruled "suitable for occupancy." PLR 9452030. SRO units in groups with shared kitchen and bathroom facilities with minimum lease terms of 30 days were ruled to be used for occupancy on a non-transient basis. PLR 9814006. SRO units provided to homeless individuals whose residency privileges were conditioned on their participation in, and compliance with, the project owner's social service programs, when there was no lease agreement entered into between the "tenants" and the project owner, were ruled not to be used for occupancy on a non-transient basis. PLR 9811020 .

3. To qualify for credits under Section 42, units must also be "for use by the general public," meaning that units must be rented on a non-discriminatory basis in accordance with HUD Rules and Regulations. Treas. Reg. § 1.42-9. The IRS has ruled that a project which was open to all homeless individuals, but with a preference to homeless individuals with alcohol and/or chemical dependency, is for use by the general public. PLR 9814006. Any unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not for use by the general public. Treas. Reg. § 1.42-9(b). See discussion in III.D.4.i above regarding charges for services.

a. A project will not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants with special needs, who are members of a specified group under a Federal program or State program or policy that supports housing for such a specified group, or who are involved in artistic or literary activities. Code § 42(g)(9).

b. Section 42(g)(9) was enacted as part of HERA, which did not make a corresponding change to the general public use requirements for tax-exempt bond projects. Prior to enactment of HERA, the general public use requirement applicable to Section 103 was incorporated into Section 42. Section 42 does not explicitly require such incorporation. However, the legislative history makes clear that the term "residential rental property" under Section 42 was intended to have the same definition as it does under the tax-exempt bond rules. That definition, found in Section 142(d), contains a general public use requirement.

c. Because Section 42(g)(9) applies only for purposes of Section 42 and was not added to Section 142(d) for purposes of Section 103, questions arose as to whether a restriction or preference under Section 42(g)(9) could cause bonds to fail to be "qualified bonds" by reason of failing the Section 142(d) general public use requirement. Most practitioners assumed that Congress intended that Section 42(g)(9) restrictions would not cause a building to fail the general public use test under the bond rules, Rev. Proc. 2019-17, 2019-17 I.R.B. 1045, confirms that this is the case. It provides that a residential rental project (as defined in Section 142(d)) that includes occupancy restrictions or preferences that favor tenants described in Section 42(g)(9) does not fail the general public use requirement applicable to exempt facilities. Other exempt facilities, however, cannot avail themselves of this Revenue Procedure. Note that the Revenue Procedure appears to apply to any residential rental project under Section 142(d), whether or not it benefits from Section 42.

4. Student housing does not qualify for the low-income housing credit. However, a unit will not fail to qualify as a low-income unit merely because it is occupied by an individual who is: (I) a student and receiving assistance under title IV of the Social Security Act (42 USC 601 et seq.); (II) enrolled in a job training program receiving assistance under the Job Training Partnership Act (PL 97-300, 10/13/1982) or under other similar federal, state, or local laws; or (III) a student who was previously under the care and placement responsibility of a foster care program under part B or part E of title IV of the Social Security Act. Code § 42(i)(3)(D)(i). A unit will generally be considered to be occupied by low-income individuals if all of the occupants of such units are students who are married and file a joint income tax return or who are single parents and their children and such parents are not dependents of another individual and such children are not dependents of persons other than their parents. Code § 42(i)(3)(D). *See also* PLR 200339022 (ruling that a unit occupied by a single, 50-year old full-time law student, who satisfied the Section 42(g) income limitations and was not a "dependent" under Section 152, qualifies as a low-income unit).

5. Vacant Units.

   a. The "vacant unit rule" provides that a low-income unit will not lose its status as a low-income unit for purposes of the set-aside requirement, as well as for determining qualified basis, merely because it becomes vacant, provided reasonable attempts are made to rent the unit or the next available unit of comparable or smaller size to a qualified tenant before another unit in the project is rented to a nonqualifying individual. Treas. Reg. § 1.42-5(c)(1)(ix). A unit is not available for purposes of the vacant unit rule when the unit is subject to an agreement that is binding under state law. A "reasonable attempt" to rent a vacant unit requires utilizing "customary methods" of advertising apartment vacancies in the area of the project. Customary methods will vary from location to location, but may include displaying a banner and "for rent" signs at the entrance to the project, placing classified ads in local newspapers and contacting local Section 8 voucher holders listed with the public housing authority. Rev. Rul. 2004-82, 2004-2 C.B. 350.

   b. Unlike the next available unit rule which is applied on a building-by-building basis, the vacant unit rule is applied on a project-wide basis. *Id.* Thus, the vacant unit rule should apply when a tenant moves from one unit to another within the same "project" even if the units are in separate buildings. Rev. Rul. 2004-82, 2004-2 C.B. 350.

      (i) Query: Absent an election on Form 8609 to treat separate buildings as a single project, each building will be treated as a separate project. Multiple buildings may also be grouped in one or more projects, as described in III.E.4 above. Does the vacant unit rule apply if a tenant moves between two buildings which are in, or are treated as, two separate projects?

   c. During the period of tenant relocation in the context of an acquisition/rehabilitation and re-syndication of an existing LIHTC project, an unoccupied low-income unit is treated as an "out of compliance unit" rather than a vacant unit. The "non-compliance" is corrected when the unit is again suitable for occupancy. *See* Audit Technique Guide (rev. Jan. 24, 2024).

(i) Comment: Credit in the first year of the Credit Period is allowed for each full month a unit is in service based on qualified occupancy at the end of the month. Code § 42(f)(3)(B). Accordingly, any unit taken out of service for rehabilitation during the first year of the Credit Period is treated as out of compliance and thus no credits are available in the first year of the Credit Period with respect to such unit during the month (or portion thereof) it remains out of compliance.

(a) Example: A building with 10 low-income units is acquired on December 31, 2014 and rehabilitated over the following year, with the rehabilitation completed on or before December 31, 2015. The first year of the Credit Period is 2015. In the course of the rehabilitation, each unit is taken out of service and the tenant relocated offsite for 5 weeks, which, in the case of one unit stretches over 3 months. As no credit is allowed for the month or portion thereof that any unit is out of service, there will be 99 unit-months of credits in 2015 (out of a maximum 120 unit-months in the first year of the Credit Period).

(b) Query: Assume the same facts as above but one of the units is occupied from January 1, 2015 through August 30, 2015, at which time the household is relocated and the unit is offline for rehabilitation through the end of 2015. The household moves back to the rehabilitated unit on January 15, 2016. Can the taxpayer claim credits on the unit based on 8 months of qualified occupancy (January through August of 2015) even though the unit was (i) not rehabilitated during the time the qualified tenants occupied such unit and (ii) the unit was out of service at the end of the first year of the Credit Period (2015)? Is the unit only eligible for 2/3rds Credits?

G. Extended Use Requirements.

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

1. The commitment must be to maintain as low-income units for 15 years after the end of the Compliance Period (or such later date specified in the commitment) the percentage of units specified in the commitment.

2. The allocation of credits (or the amount of credits allowable for a bond-financed project) cannot exceed the amount necessary to support the percentage of low-income units specified in the commitment.

3. The commitment must:

   a. be enforceable by former, present and future tenants who meet the applicable income limitations;

   b. be binding on all successors of the taxpayer;

   c. be recorded pursuant to state law as a restrictive covenant;

   d. prohibit a disposition of any portion of the building to which the commitment applies without the disposition of the remainder of the building to the same transferee (*but see* PLR 200703024 holding that the foregoing prohibition may be made inapplicable if agreed to by the owner and the allocating agency as part of a plan to provide tenants with a right of first refusal in accordance with Section 42(i)(7), discussed further in VI.B.3 below.

   e. prohibit the refusal to lease to any prospective tenant because such prospective tenant holds a Section 8 voucher or certificate; and

   f. provide for a restriction on evictions and rent increases which applies during the extended use period and continues for the three years following a termination of the commitment unless a tenant exercises a right of first refusal to purchase the project. Rev. Rul. 2004-82, 2004-2 C.B. 350. Commitments entered into prior to January 1, 2006 that lack particular language to this effect will be treated as conforming provided that (i) the commitment contains "catch-all" language requiring the building owner to comply with the requirements of Section 42, (ii) the housing credit agency notifies the owner on or prior to December 31, 2005 that the restrictions on evictions and rent increases apply throughout the commitment period, (iii) the building owner includes in its annual certification to the agency a statement that the restrictions on evictions and rent increases were not violated (the agency is required to report a failure to make such a certification on Form 8823), and (iv) if the commitment is amended after December 31, 2005, the amendment includes language clearly providing that the restrictions on evictions and rent increases apply throughout the commitment period. Commitments entered into after December 31, 2005 must provide that the restrictions on evictions and rent increases apply throughout the commitment period and owners must certify annually to the housing credit agency that these restrictions have not been violated (a failure to make such a certification will be reported on Form 8823). Rev. Proc. 2005-37, 2005-2 C.B. 79.

4. The extended use requirements (and presumably all the other provisions of the Revenue Reconciliation Act of 1989) apply to projects receiving allocations after 1989, even if they also received allocations for prior years. Rev. Rul. 92-79, 1992-2 C.B. 10.

5. No Credit is allowable for a building in any year unless an extended use agreement is in effect at the end of the year. Code Section 42(h)(6)(A). Accordingly, an extended use agreement must be in effect no later than the end of the first year of the Credit Period. However, if it is determined that an extended use agreement was not in effect at the beginning of the year, Code Section 42(h)(6)(J) permits the owner to correct the problem within one year of the determination that an extended use agreement is not in effect. The one-year period begins when the owner is notified that an extended use agreement has not been properly executed and/or recorded. The Credit agency should provide written notification of noncompliance immediately and document the owner's receipt. If the noncompliance is corrected within the one-year period, the owner can claim LIHTC for past taxable years. If the noncompliance is not remedied within the one-year period, the owner loses LIHTC for past taxable years until the taxable year in which the extended use agreement is properly in effect. Audit Technique Guide (rev. Jan. 24, 2024).

6. Termination of Extended Use Commitment

a. The commitment shall terminate prior to the extended-use period:

(i) on the date the building is acquired by foreclosure (or instrument in lieu thereof);

(ii) if the housing credit agency is unable to timely present a "qualified contract" to purchase the low-income portion of the building (but termination under this provision or (i) above will not permit the eviction of low-income tenants or increases in their rents for 3 years following the termination); or

(iii) if, by its terms, the commitment is terminated or suspended when a tenant exercises a right of first refusal (see VI.B.3 below) to purchase the project. Rev. Rul. 95-49, 1995-2 C.B. 7.

b. In *Nordbye v. BRCP/GM Ellington*, the Court of Appeals for the State of Oregon held that a former tenant of a low-income housing project has the right to enforce an extended use commitment despite a "release agreement" between the owner of the project and the state housing credit agency to terminate the agreement early. 266 P.3d 92 (Or. Ct. App. 2011). The Court stated that the "release agreement" did not override a qualified low-income tenant's right to enforce the extended use agreement as created under Section 42(h)(6)(B)(ii). Additionally, the Court noted that neither of the situations explicitly identified in the Code that permit an extended-use period to be terminated early applied to the present situation. *See* III.G below. Following remand, however, when the case returned on appeal, the Court of Appeals held that the plaintiff lost standing when she was no longer eligible for the low-income housing and the case therefore became moot. *Nordbye v. BRCP/GM Ellington*, 349 P.3d 639 (Or. Ct. App. 2015).

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

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

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

7. Qualified Contracts. In May 2012, the IRS finalized and adopted final Regulations defining the qualified contract formula and many of the terms used therein. *See* Code § 42(h)(6)(F); Treas. Reg. § 1.42-18.

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

b. Must be a bona fide contract to acquire (within a reasonable time) the non-low-income portion of the project for fair market value and the low-income portion of the project, that is, the applicable fraction of the project specified in the extended use commitment, for the "low-income portion amount"; and

c. The fair market value of the non-low-income portion of the building should reflect the existing and continuing restrictions on the building set forth in the extended use commitment. The non-low-income portion also includes the fair market value of the land underlying the entire building, both the non-low-income portion and the low-income portion, regardless of whether the building is entirely low-income, as well as items of personal property not included in Eligible Basis that will be conveyed pursuant to the qualified contract. Treas. Reg. § 1.42-18(b)(3).

d. The low-income portion amount is an amount not less than the applicable fraction specified in the extended use commitment multiplied by the sum of:

(i) the "outstanding indebtedness" secured by, or with respect to, the building (defined in Treas. Reg. § 1.42-18(c)(3)),

(ii) the "adjusted investor equity" in the building (as defined in Treas. Reg. § 1.42-18(c)(4)),

(iii) other capital contributions (as defined in Treas. Reg. § 1.42-18(c)(5)) not reflected in (i) or (ii) above, minus

(iv) the amount of cash distributions from (or available for distribution from) the building.

Note: In response to comments concerned with project reserves distorting the low-income portion of the building, the final Regulations explicitly provide that cash available for distribution includes reserve funds so long as the reserve funds are not legally required by mortgage restrictions, regulatory agreements, or third-party contractual agreements to remain with the building following the sale. Treas. Reg. § 1.42-18(c)(6)(i)(B).

e. "Outstanding indebtedness" is defined as the remaining stated principal balance of any indebtedness secured by, or with respect to, the building that (i) does not exceed the amount of "qualifying building costs," (ii) is indebtedness under general principles of Federal income tax law, and (iii) is actually paid to the lender upon the sale of the building or is assumed by the buyer as part of the sale of the building. Treas. Reg. § 1.42-18 (c)(3). "Qualifying building costs" means costs included in the adjusted basis of depreciable property that qualifies as residential rental property, including costs incurred after the first year of the Credit Period. Treas. Reg. § 1.42-18(b)(4).

(i) Note: In response to comments, the IRS removed the requirement in the Proposed Regulations that discounted "outstanding indebtedness" having an interest rate below AFR. Prop. Treas. Reg. § 1.42-18(c)(3)(ii).

f. "Adjusted investor equity" means, with respect to any calendar year, the cash invested by owners for qualified building costs. Thus, equity paid for land, credit adjuster payments, tax credit application fees, operating deficits, and legal, syndication and accounting costs qualify as cash invested by owners for qualified building costs. Treas. Reg. § 1.42-18(c)(4)(i). Comment: If "outstanding indebtedness" exceeds "qualified building costs," seemingly "adjusted investor equity" must be zero. Also, to the extent that upward credit adjusters result from increases in qualified building costs, it does seem logical to exclude payment for such adjusters from adjusted investor equity.

(i) Adjusted investor equity is increased annually by a cost-of-living adjustment based on the Consumer Price Index calculated pursuant to a methodology consistent with inflation adjustments made under Section 1(f); and

(ii) Adjusted investor equity is taken into account only to the extent there existed an obligation to invest as of the commencement of the Credit

Period. Query whether there is a sufficient "obligation" to invest if the obligation is contingent upon conditions expected to occur after the commencement of the Credit Period or representations and warranties concerning the project or subject to adjustment if tax benefits are less than forecasted.

g. In *Canton Club East Partners Limited Divided Housing Association Limited Partnership v. Michigan State Housing Development Authority*, the plaintiff had sought to be released from its obligation to maintain a project as affordable housing for 30 years by requesting that the Michigan State Housing Development Authority (MSHDA) find a buyer to purchase the property at the qualified contract price within one year of the request. 116 AFTR 2d 2015-6943 (W. D. Mich. 2015). Plaintiff submitted a qualified contract request to MSHDA, including a calculation of the qualified contract price of $9,779,458, on February 20, 2014. MSHDA sent Plaintiff a letter stating that the one-year period to find a buyer commenced on February 20, 2014 and that the qualified contract price was $9,700,000. On February 19, 2015, MSHDA sent Plaintiff an agreement for the purchase of the property for $9,700,000. Plaintiff responded that the amount stated was not the correct qualified contract price and argued that because MSHDA had failed to secure a purchaser for the correct qualified contract price, Plaintiff was excused from compliance during the extended use period. MSHDA sought to re-list the property at the correct qualified contract price on an expedited basis but Plaintiff refused and filed a complaint asserting a claim under 28 U.S.C. § 1983, which creates a remedy for those denied rights, privileges or immunities secured by the Constitution and laws. Plaintiff asserted a § 1983 claim based on MSHDA's alleged violation of Section 42 of the Code. MSHDA argued that because Section 42 does not create an enforceable right that may support a cause of action under § 1983, Plaintiff had failed to state a claim. Relying on the Supreme Court's decision in *Gonzaga Univ. v. Doe*, 536 U.S. 273 (2002), in which the Supreme Court concluded that when Congress wants to create new rights enforceable by either § 1983 or an implied right of action, it must do so in clear and unambiguous terms, the Court held that Section 42(h)(6)(E) does not contain "clear and unambiguous" language indicating an intent on the part of Congress to create a new individual right and therefore may not serve as the basis for a § 1983 claim.

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

The proposed Regulations allowed the state housing agency to adjust the fair market value of the building if, after a reasonable period of time within the one-year offer of sale period, no buyer has made an offer. Prop. Treas. Reg. § 1.42-18(c)(1). In response to criticisms that this discretionary adjustment would distort property valuations and purchaser demand, the IRS changed this provision to allow the state housing agency and the owner of the project to agree to adjust the fair market value of the non-low-income portion of the building during the one-year offer of sale period. Treas. Reg. § 1.42-18(c)(1)(iii). However, if no agreement between state housing agency and the owner is reached, the fair market value of the non-low-income portion of the building determined at the time of the agency's offer of sale of the building to the public will remain unchanged. Moreover, the buyer and the owner, not the agency as provided in the Proposed Regulations, must adjust the amount of the low-income portion of the qualified contract formula to reflect changes in the components of the qualified contract formula such as mortgage payments which reduce outstanding indebtedness between the time of the agency's offer of sale to the general public and the building's actual sale closing date. Treas. Reg. §1.42-18(c)(1)(ii).

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

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

i. Note: On August 15, 2024, HUD issued Notice H 2024-XX, "Subject: Qualified Contract Loophole in the Low-Income Housing Tax Credit Program," requiring project owners seeking access to FHA Multifamily rental and Risk Share insurance programs to waive their right to use the Qualified Contract provision under Section 42, applicable to FHA Multifamily rental projects for which a firm commitment has not been issued and Risk Share insurance transactions with Firm Approval Letters issued on or after December 31, 2024.

j. Comment: Legislation has been introduced to permanently repeal the qualified contract option, as it allows projects to opt-out of the affordability period after just 15 years, instead of the required 30-year extended use period. However, this legislation has not been successful to date. *See, e.g.,* H.R. 3719, 118th Congress (2023-2024) (discussed further in IX.N below).

IV. ALLOCATION OF CREDIT

A. Allocation Required.

In order to be eligible for the credit, any building not financed with tax-exempt bonds must receive an allocation of credits from the state housing credit agency and the amount of the credits claimed with respect to a project cannot exceed the amount allocated. Code

§ 42(h)(1)(A). Note that this general rule contemplates a separate allocation for each building in a project.

B. Timing and Duration of Allocation.

1. General. Although Section 42(h)(1)(B) provides that the allocation must be made "not later than" the year the building is placed in service, the intent is that allocations be made in the year of placement in service. Conf. Rep. to P.L. 100-647, Code § 1002(1)(14)(A); Notice 89-1, 1989-1 C.B. 620.

2. Binding commitment exception. An allocation may be made subsequent to the placing of a project in service if, on or before the placed in service date, the housing credit agency had made a binding commitment to allocate a specified dollar amount of credits to the project in a specified later taxable year. Code § 42(h)(1)(C); *see* PLR 8941035; *see also* I.B.4.a above.

a. Note: There is no provision for project-based binding commitments, which must be made on a building-by-building basis.

3. Exception for increase in Qualified Basis. If, after a project receiving an allocation is placed in service, it is determined that the Qualified Basis of the project is in excess of that contemplated in the original allocation, the allocation may be increased to reflect such excess not later than the close of the first year to which the additional credits apply. Code § 42(h)(1)(D).

a. Any increase in Qualified Basis after the first year of the Credit Period must be attributable to an increase in the percentage of low-income units, rather than an increase in Eligible Basis.

b. Credits for the increase in Qualified Basis are determined based on 2/3 of the "applicable percentage" used for the original credit.

4. Carryover Allocations: 10% Test. An allocation made prior to the year a building is placed in service will nevertheless be valid if the building is placed in service by the end of the second succeeding calendar year following the year in which the allocation is made (see I.A.5.b above) regarding placement in service) and, as of the date which is 12 months after the date that the allocation was made, the taxpayer's basis in the project is more than 10% of the reasonably anticipated basis in the project as of the close of such second succeeding calendar year. Code § 42(h)(1)(E); Treas. Reg. § 1.42-6. Allocations made under this 10% rule are referred to as "carryover allocations." State credit agencies frequently require satisfaction of the 10% test in advance of these statutory deadlines.

a. "Basis in the project" is determined under Sections 1012 and 1016. It is not the same as Eligible Basis and thus includes costs allocable to land and commercial space. Treas. Reg. § 1.42-6(b)(1). Because Section 1016 applies, reasonably anticipated basis adjustments for depreciation or for the rehabilitation tax credit should be taken into account. However, the 30% increase in Eligible Basis for projects in difficult development areas or qualified census tracts is not taken into account. Treas. Reg. § 1.42-6(b)(2)(ii).

b. Basis in the project includes all items that are properly capitalizable as part of the basis of land or depreciable property. Treas. Reg. § 1.42-6(b)(2)(i). Thus, financing, syndication or organizational costs generally will not count. Compliance monitoring fees will count only if they are capitalizable with respect to land or depreciable property. Preamble to T.D. 8520 (March 2, 1994). Tax credit application and allocation fees are not includible in a building's Eligible Basis. Rev. Rul. 2004-82, 2004-2 C.B. 350.

c. Deposits or nonrecoverable costs will count toward basis in the project, provided they are properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project. Treas. Reg. § 1.42-6(b)(2)(i).

(i) Comment: Although neither Section 42(h)(1)(E) nor Section 1.42-6(b)(2)(i) require the taxpayer to be treated as the owner of the project in order to have basis in the project and be eligible to obtain a carryover allocation, state agencies may impose such a requirement (e.g., Massachusetts conditions the issuance of a carryover allocation on the receipt of evidence demonstrating that the taxpayer has satisfied the 10% rule and ownership of the project by the taxpayer).

d. Construction costs are added to basis when paid or incurred, depending on whether the taxpayer uses the cash or accrual method of accounting. Treas. Reg. § 1.42-6(b)(2)(iii). The accounting method of a pass-through entity controls for this purpose. Treas. Reg. § 1.42-6(e)(1); Notice 89-1.

e. Reasonable development fees, including fees to a related party, count to the extent they could be included in basis under the accrual method of accounting, taking into account the economic performance rules of Section 461(h). Treas. Reg. § 1.42-6(b)(2)(iv).

f. Basis taken into account for purposes of the 10% rule includes basis in land or buildings that was not incurred in anticipation of a tax-credit allocation, such as the basis in land or buildings acquired years prior to the making of a tax credit application. Treas. Reg. §§ 1.42-6(b)(1) and (4), Ex. 1.

g. Under Section 263A(f), interest is required to be capitalized only during the "production period" which generally corresponds to the period of physical construction activity. Thus, Section 263A does not support capitalizing interest incurred with respect to raw land prior to the commencement of construction for purposes of the 10% test. In contrast, carrying costs other than interest are required to be capitalized even if construction has not yet commenced. *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995). Pre-construction interest may be capitalized if an election to do so is made under Section 266. This election must be made annually. Treas. Reg. § 1.266-1(c)(2)(i). Note that under the "avoided cost" method for calculating construction interest in Treas. Reg. § 1.263A-9, interest on indebtedness incurred to acquire land or an existing building may, during the construction period, be allocated to construction expenditures.

h. Comment: The exclusion of relocation costs from Eligible Basis is uncertain, especially if a Section 266 election is in effect. Some states will allow such costs if the accountants are willing to include them in the cost certification. See discussion above regarding the inclusion of Bond issuance costs under the *23rd Chelsea Associates* case; MSSP Training Guide, IRC § 42 Low-Income Housing Tax Credit, Part IX Appendix, Acquiring Occupied Building: Tenant Relocation Costs.

i. By the date that is 1 year from the date the allocation is made, the agency must verify satisfaction of the 10% test, either by obtaining the certification of the taxpayer (under penalties of perjury) along with supporting documentation or by obtaining certifications of counsel or accountants regarding satisfaction of the 10% requirement. Code § 42(h)(1)(E)(ii); Treas. Reg. § 1.42-6(c); Rev. Rul. 92-40, 1992-1 C.B. 4.

j. Section 1.42-6(d) sets forth specific information that must be included in a valid carryover allocation. *See also* Notice 89-1.

k. For purposes of the 10% rule, a partnership is a "taxpayer" so that a partner who acquires an interest in the partnership after satisfaction of the 10% rule but before a project is placed in service may enjoy the benefits of this rule. PLR 9044037. (Note that the TCJA's repeal of Section 708(b)(1)(B) regarding technical terminations obviates the need for the Ruling's assumption with regard to that section.) *See also* Treas. Reg. §1.42-6(e)(2) and Rev. Rul. 91-38, 1991-2 C.B. 3.

l. Projects located in Presidentially-declared major disaster areas are generally entitled to six additional months to satisfy the 10% requirement and an additional year to satisfy the placed in service requirement, provided that such additional time is approved by the state housing credit agency. Rev. Proc 2014-49, 2014-37 I.R.B. 535 (superseding Rev. Proc. 2007-54, 2007-2 C.B. 293; Rev. Proc. 95-28, 1995-1 C.B. 704).

m. Comment: As noted above, it is not clear whether pre-paid rent under a long-term lease should count toward satisfaction of the 10% test. Some practitioners take the position that pre-paid rent must actually be paid, in cash, in order to count toward the 10% test while others are willing to treat pre-paid rent evidenced by a note as counting toward the 10% test provided some portion of the pre-paid rent (e.g., a minimum of 10%) is actually paid in cash. Still others take the position that pre-paid rent, even if paid in cash, does not count toward the 10% test.

n. *See* Paul, "Securing Carryover Allocations of Low-Income Housing Tax Credits," 13 The Real Estate Tax Digest 79 (1995).

5. Project-based Allocations. Section 42(h)(1)(F) permits allocations to be made on a project basis rather than on a building-by-building basis if the following three requirements are met:

a. the allocation is made for a calendar year no earlier than the first calendar year for which an allocation may be made for any building in the project and no later than the end of the calendar year in which the last building in the project is placed in service;

b. the allocation only applies to buildings placed in service during or after the calendar year in which the allocation is made; and

c. the portion of such allocation for any building in the project is specified by the end of the calendar year in which the building is placed in service.

Project-based allocations may offer valuable flexibility when an allocation is sought for a project with a specified qualified basis but the number of buildings in the project or the distribution of low-income units among those buildings is uncertain. For purposes of (c) above, a rehabilitated building is deemed placed in service at the same time it is placed in service for purposes of Section 42(e)(4)(A). *See* PLR 9506016; *see also* I.A.5.b above. As noted above, there is no provision authorizing project-based binding commitments.

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

7. Timing Considerations.

a. A non-calendar year taxpayer that places a 9% Credit deal in service prior to receipt of a carryover allocation should be aware that the carryover allocation must be effective no later than the earlier of (i) the 60th day after the close of the taxpayer's year or (ii) the close of the calendar year in which such taxable year ends. Treas. Reg. § 1.42-1T(e).

(i) Example: Taxpayer's fiscal year ends October 31. Taxpayer places a new construction project in service on May 1, 2024. The Project is fully leased as of September 30, 2024 and Taxpayer intends for the first year of the Credit Period to commence with Taxpayer's fiscal year that commences November 1, 2023 and ends October 31, 2024. Assuming Taxpayer has received an allocation of 2024 9% Credits, Taxpayer must receive either (A) Form 8609 or (B) a valid carryover allocation, in either case effective on or before December 30, 2024, i.e., the earlier of the 60th day following the close of Taxpayer's October 31 fiscal year end and December 31, 2024. Some State Credit Agencies date all carryover allocations as of December 31st. Accordingly, extra care should be taken by any non-calendar year taxpayer to ensure the allocating document is effective by the requisite date.

b. A 9% Credit deal that intends to claim acquisition credits must obtain either (i) a carryover allocation or (ii) binding commitment by the close of the year in which acquisition occurs.

C. Determination of State Ceilings.

Section 42(h)(3) requires housing credit agencies to allocate credits based on a State Ceiling, which requires determining the population figures for any calendar year on the basis of the most recent census estimate of the resident population of a State (or issuing authority) released by the U.S. Census Bureau before the beginning of the calendar year.

1. The State Ceiling for each year is the sum of the following components:

a. For calendar year 2025, the amount is the greater of (1) $3.00 multiplied by the State population, or (2) $3,445,000. Rev. Proc. 2024-40, 2024-45 I.R.B. 1100 (Oct. 22, 2024) (in calendar year 2024, the amount is the greater of (1) $2.90 multiplied by the State population, or (2) $3,360,000. Rev. Proc. 2023-34, 2023-48 I.R.B. 1287 (Nov. 9, 2023)); s*ee also* Notice 2024-25, 2024-12 I.R.B. 712 (2024).

b. The amount of credits returned during the calendar year (the "returned credit component"). This component will include credits issued pursuant to carryover allocations in the previous year where the taxpayer did not meet the 10% requirement as of the applicable date. Treas. Reg. § 1.42-6(a)(2)(ii).

c. The amount of credits, if any, allocated by the Secretary to the State from a "national pool" of unused credits from other states (the "national pool component"). Treas. Reg. § 1.42-14(e). Only states which allocated their entire ceilings in the preceding year, and which apply by May 1 of the current year, are eligible to receive allocations from the national pool. The IRS most recently announced amounts of unused housing credit carryovers allocated to qualified states in Rev. Proc. 2024-41, 2024-47 I.R.B. 1122 (Nov. 15, 2024) for calendar year 2024. The unused credit ceiling for the preceding calendar year (the "unused carryforward component") is the excess for the calendar year, if any, of the sum of the population component, returned credit component, and national pool component for the calendar year over the aggregate credit dollar amount allocated for the calendar year reduced by the credit dollar amount allocated from the unused carryforward component for the calendar year. Treas. Reg. § 1.42-14(a)(1); Treas. Reg. § 1.42-14(b). Note that this calculation prevents unused credits from being carried forward for more than one year.

(i) Note: In November 2019, the IRS provided guidance to qualified states regarding how to request an allocation of unused housing credit carryover under Section 42(h)(3)(D)(iii). This new guidance requires allocation requests to be made by emailing a PDF copy of the request to the IRS, rather than by mailing a hard copy of the request, as required by previous guidance. *See* Rev. Proc. 2019-45, 2019-48 I.R.B. 1215 (11/25/2019) (superseding Rev. Proc. 92-31, 1992-1 C.B. 775).

d. Note: The IRS has determined that a sub-award grant from a state agency to a developer under Section 1602 is excluded from the gross income of the recipient and exempt from taxation, does not reduce the tax basis of a qualified low-income building, is not a federal grant for purposes of Section 42(d)(5)(A), and does not reduce the depreciable or Eligible Basis of the building. PLR 201440013 (June 24, 2014).

2. Stacking Rules: Credits are treated as allocated by a state in a given year first from the carryover component relating to unused credits from the preceding year, then from the sum of the current year population, returned credit, and national pool components. Treas. Reg. § 1.42-14(g).

3. Credits for bond-financed projects do not count against the ceiling because those projects are already limited by the bond volume cap rules. Code § 146; *see* IV.H.1.

4. For projects which receive a binding commitment (see I.B.4 above) Credits are counted against the ceiling in the year that the allocation (i.e., Form 8609 or a carryover allocation) is made (which may be a different year than when the binding commitment was entered into). *See* IRS Information Letter 2001-0092 (November 2, 2001).

D. Allocation Procedures: Qualified Allocation Plans.

1. Credits are not allowable for any project unless:

a. allocations are made pursuant to a qualified allocation plan;

b. proposed projects are subject to comment by the chief executive officer of the local jurisdiction in which the project is to be located; and

c. the amount of any allocation does not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as low-income housing.

Comment: In the case of bond-financed projects, the governmental unit which issues the bonds is responsible for making the determinations in (a)-(c) above.

2. Qualified allocation plans must:

a. be subject to public approval (e.g., hearing);

b. set forth criteria used to determine housing priorities (e.g., production of new family housing, production of new elderly or special needs housing, or preservation of expiring use projects);

c. give preference to projects that will serve the lowest income tenants for the longest period;

d. give preference to projects located in qualified census tracts which contribute to a concerted community revitalization plan;

e. provide a procedure that the agency will follow in monitoring for noncompliance with the plan and in notifying the IRS of such noncompliance (see IV.E, regarding monitoring procedures);

f. provide selection criteria for specific projects that include location, housing needs and project characteristics, sponsor characteristics (including whether the project involves the use of existing housing as part of a community revitalization plan), tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project;

g. require that a comprehensive market study be conducted for all projects prior to making a credit allocation, which study shall be conducted at the developer's expense by a third party approved by the agency; and

h. require the agency to make available to the general public a written explanation for any allocation of a housing credit dollar amount which is not made in accordance with the established priorities and selection criteria of the agency.

3. Analysis of Financial Feasibility.

a. Must be made three times:

(i) at the time of the application for credits;

(ii) when the allocation is made; and

(iii) when the project is placed in service.

b. Analysis shall take into account all sources and uses of funds, including syndication proceeds and the reasonableness of developmental and operational costs, and the taxpayer must certify the full extent of other subsidies.

c. To complete the analysis of financial feasibility when a project is placed in service, the agency must receive from the taxpayer a schedule of project costs and, for projects with more than 10 units, the schedule of project costs must be accompanied by a Certified Public Accountant's audit report on the schedule, which audit report must be unqualified (an agency may also require an audited schedule of project costs for projects with fewer than 11 units). Treas. Reg. § 1.42-17(a)(5).

4. Historically, courts have shown deference to a state housing agency's interpretation of its qualified allocation plan and allocations of credits made thereunder. For example, in *In the Matter of New Jersey Housing and Mortgage Finance agency 2009 Final Cycle of Low-Income Housing Tax Credit Awards*, the Superior Court of New Jersey stated that in order to successfully challenge and set aside the New Jersey housing agency's allocation of tax credits under its qualified allocation plan, a project had to prove that the agency's determination was "arbitrary, capricious and unreasonable." No. A-5049-09T2, 2013 BL 321137 (N.J. Super. Ct. App. Div. Apr. 25, 2013). Moreover, the Court noted that withdrawing funds from projects that had already received allocations and relied on the agency's decision in response to a challenge would substantially impair those projects and the rights of third parties. Similarly, in *Tgr Affordable Hous. v. De La Vivienda De P.R.*, the Court of Appeals of Puerto Rico affirmed that the Puerto Rico housing agency's denial of an application could stand where it was based on the exercise of its sound judgment in light of the evaluation criteria in the duly adopted qualified allocation plan and there was no evidence that the agency had acted arbitrarily, unreasonably or without rational basis. PR 2014 App. LEXIS 3764 (P.R. Ct. App. Sept. 15, 2014).

   a. Note: The Supreme Court set forth a doctrine requiring courts to defer to an executive branch agency's reasonable regulatory interpretation of ambiguous statutory language in *Chevron U.S.A. v. National Resources Defense Council*, 467 U.S. 837 (1984). This decades-long precedent was recently overturned in June 2024 with the decision in *Loper Bright Enterprises v. Raimondo*, No. 22-451, 603 U.S. (2024). It is still unclear what impact this will have on the interpretation of any agency decisions moving forward.

5. An interested party may challenge a state housing agency's allocation of credits as having a discriminatory or disparate impact on certain minority groups. In 2015, the United States Supreme Court held that disparate impact claims are cognizable under the Fair Housing Act. *Tex. Dep't of Housing & Cmty. Affairs v. The Inclusive Cmtys. Project, Inc.*, 135 S. Ct. 2507 (2015). However, on remand of this case to the U.S. District Court for the Northern District of Texas, Dallas Division, the court found that the plaintiff, The Inclusive Communities Project, Inc., had not proved a prima facie case that a challenged practice caused a discriminatory effect and therefore dismissed the disparate impact claim. *The Inclusive Cmtys. Project, Inc. v. Tex. Dep't of Housing & Cmty. Affairs*, No. 3:08-CV-0546-D (N.D. Tex. Aug 26, 2016). In 2020, HUD issued a final rule in 85 Federal Regulations 60288 (Sep. 24, 2020) establishing a uniform standard for determining when a housing policy or practice with a discriminatory effect violates the Fair Housing Act. Under the 2020 rule, liability may be established under the Fair Housing Act based on a specific policy's or practice's discriminatory effect on members of a protected class under the Fair Housing Act even if the specific practice was not motivated by a discriminatory intent, if the plaintiff can show (1) that the challenged policy or practice is arbitrary, artificial, and unnecessary to achieve a valid interest or legitimate objective such as a practical business, profit, policy consideration, or requirement of law; (2) that the challenged policy or practice has a disproportionately adverse effect on members of a protected class; (3) that there is a robust causal link between the challenged policy or practice and the adverse effect on members of a protected class, meaning that the specific policy or practice is the direct cause of the

discriminatory effect; (4) that the alleged disparity caused by the policy or practice is significant; and (5) that there is a direct relation between the injury asserted and the injurious conduct alleged. Unfortunately, many housing practitioners find this rule to be much more restrictive for tenants than the one initially espoused in the 2015 case.

a. In Revenue Ruling 2016-29 the IRS determined that when a state housing credit agency's QAP strongly favored applications for projects with affirmative local support, the outcome was allocations that perpetuated residential racial and economic segregation. In that case the local agency erroneously believed that local support was required in order to award credits to a project. The IRS explained that the Code requires the local jurisdiction to have a "reasonable opportunity" to comment on a proposal to allocate housing credits to a project in the jurisdiction, but localities should not have veto power over a project.

b. In 2016, the IRS stated that locating LIHTC projects in QCTs exacerbates concentrations of poverty and said that section 42(m)(1)(B)(ii)(III) grants a preference to such placement only if "there is an added benefit to the neighborhood in the form of the project's contribution to a concerted community revitalization plan." In such Notice, the IRS requested public comment on this issue to be submitted by February 2017, but no further developments have been made. Notice 2016-77, 2016-52 I.R.B. 914.

E. Compliance Monitoring.

1. Agencies must specify in their qualified allocation plans a procedure for monitoring a project for noncompliance. Pursuant to Section 1.42-5, the procedure must include requirements for (i) recordkeeping and retention of records, (ii) certification and review of the project by the agency to ensure, among other things, that the project satisfies the applicable minimum set-aside test, that it is suitable for occupancy, taking into account local health, safety and building codes, and that the owner has received an annual income certification from all low-income tenants, (iii) physical inspection of the project, including a requirement that the agency conduct an on-site inspection of all buildings in the project by the end of the second calendar year following the year the last building in the project is placed in service and at least once every three years thereafter, including an inspection of a random selection of units (the number of units is specified in the chart provided in Section 1.42-5(c)(2)(iii) and varies based on total units in a project) and a review of the rent records and low-income certifications for the tenants in those units, and (iv) notification of noncompliance. Additionally, specific to a physical inspection, if none of the randomly selected units are located in a particular project building, the building itself must still be inspected. IRS's Summary of Comments and Explanation of Provisions (84 FR 6076).

2. In order to satisfy the minimum standards established by Section 1.42-5 for compliance monitoring, an agency has the right to require specific documentation from owners of low-income projects and, if an owner fails to provide an agency with the requested documentation such that the agency is prevented from determining whether a project is in compliance with Section 42, the agency can properly treat the project as being out of compliance with Section 42. CCA 199944019. An electronic storage system may be used to satisfy the minimum standards of Section 1.42-5. Rev. Rul. 2004-82, 2004-2 C.B. 350.

3. As part of the compliance monitoring standards imposed by Section 1.42-5, an agency must have the right to perform on-site inspections of any low-income housing project at least through the end of the applicable Compliance Period. Treas. Reg. § 1.42-5(d)(1). In conducting its inspections, the agency must determine (a) whether the buildings are suitable for occupancy under local health, safety, and building codes; or (b) whether the buildings and units satisfy the uniform physical condition standards for public housing established by HUD. An agency may use the HUD uniform physical condition standards to perform an on-site inspection and a violation of this standard alone is sufficient to establish that a unit is unsuitable for occupancy. CCA 201042025. However, if a violation is found, the taxpayer may raise as an affirmative defense that under the application of a local health, safety, or building code to the facts, local law reaches a favorable result for the taxpayer.

4. There is currently a Physical Inspection Alignment Program created under HUD's Real Estate Assessment Center (REAC) to streamline the inspection process of rental housing properties that receive support from multiple government programs. Such protocol is a generally accepted practice for physical inspection of LIHTC projects required under Section 1.42-5(c)(2)(iii)(C)(4) and (5) so long as (i) both vacant and occupied low-income units are included in the population of units from which units are selected for inspection, (ii) the inspection complies with the procedural and substantive requirements of the REAC protocol, including the requirements of the most recent REAC Uniform Physical Condition Standards inspection software, or software accepted by HUD, (iii) the inspection is performed by HUD or HUD-certified REAC inspectors, and (iv) the inspection results are reviewed and scored within HUD's secure system without any involvement of the inspector who conducted the inspection, and HUD makes its inspection report available.

  a. Note: The Audit Technique Guide (rev. Jan. 24, 2024) includes a Checksheet for the Physical Inspection of LIHC Projects.

5. Under Section 42(l)(3), each agency which allocates any housing credit amount to any building for any calendar year shall submit to the IRS an annual report specifying (A) the amount of housing credit amount allocated to each building for such year, (B) sufficient information to identify each such building and the taxpayer with respect thereto, and (C) such other information as the Secretary may require. The penalty under Section 6652(j) shall apply to any failure to submit the report required. Because Section 42(l)(3) specifies a requirement for only one annual report, it is not possible to fine an agency multiple times for one year. However, if the report is inaccurate or incomplete (e.g., missing required forms that make up the report) or late, the agency has not satisfied its duty under Section 42(l)(3), and it may be fined $100, regardless of the fact that an annual report was submitted. CCA 200913013 (February 20, 2009). *See* also CCA 201046014.

6. **6.** If upon review, the IRS determines that an agency is not meeting its compliance monitoring requirements or that the agency is not making allocations of credit pursuant to a qualified allocation plan (as defined in Section 42(m)(1)(B)) that meets the requirements under Section 42(m)(1)(A), then the IRS has the authority to reduce the amount of low-income housing credit allocated by an agency to a building to zero. CCA 200913013 (February 20, 2009).

F. Set-Aside for Non-profit Organizations.

1. Ten percent of each state's credit ceiling must be allocated to projects in which a "qualified nonprofit organization" owns an interest (directly or through a partnership) and "materially participates" (within the meaning of Section 469(h)) throughout the Compliance Period. Code § 42(h)(5). The ownership and material participation tests may be satisfied by the use of a for-profit corporation wholly owned by one or more qualified nonprofit organizations. Note that a corporate general partner or managing member, including a state law limited liability company that elects to be taxed as a corporation for federal income tax purposes, that is owned by a for-profit and non-profit would not satisfy this requirement. Accordingly, in a deal where a for-profit and non-profit are joint venturing and the allocation is made from the non-profit set-aside, the for-profit and non-profit should hold their interests through separate co-general partners or managing members.

2. Credits allocated from the non-profit set-aside and subsequently returned do not retain their non-profit set-aside character. Treas. Reg. § 1.42-14(h).

3. The organization may be exempt under either Sections 501(c)(3) or 501(c)(4), must have as one of its exempt purposes the fostering of low-income housing and may not be affiliated with or controlled by a for-profit organization. *See* Code § 42(h)(5)(C).

a. For this purpose, a non-profit organization is not considered "affiliated with" a wholly owned for-profit subsidiary. *See* S. Rep. No. 3209, 101st Cong., 2d Sess., p. 20 (1990).

b. Organizations seeking exemption under Code §501(c)(3) may have as their charitable purposes relief of the poor or distressed, combating economic deterioration or urban blight, lessening the burdens of government or, occasionally, historic preservation. Treas. Reg. § 1.501(c)(3)-1(d)(2); Rev. Rul. 70-585, 1970-2 C.B. 115. Demonstrating an "exclusively" charitable purpose may be problematic for sponsors of mixed-income projects that are not located in blighted areas. In Rev. Proc. 96-32, 1996-1 C.B. 717, the IRS provided a "safe harbor guideline" for when an organization will be considered charitable with respect to a mixed-income project if the following requirements are satisfied:

(i) At least 75% of units are occupied by tenants at or below 80% of median income and, *inter alia*, either the 40-60 test or the 20-50 test is satisfied. The 75% test may not be satisfied by elderly or handicapped tenants who do not meet the income test. Up to 25% of the units may be rented at market rates to tenants who have incomes in excess of the low-income limit.

(ii) Actual occupancy by poor and distressed residents is achieved after a reasonable start-up period for new construction. For existing projects requiring construction or rehabilitation, a reasonable transition period is allowed for an organization to place the project in service. Whether an organization's transition period is reasonable is determined by reference to all relevant facts and circumstances. For projects that do not require substantial construction or substantial rehabilitation, a one-year transition period to satisfy the actual occupancy requirement will generally be considered to be reasonable. If a project operates under a government program that allows a longer transition period, this longer period will be used to determine reasonableness. Note: There is no provision for a transition period to increase rents for tenants with incomes in excess of the applicable limits to "market" rates.

(iii) The housing is affordable to charitable beneficiaries, which is deemed satisfied by the adoption of a rental policy that either follows government imposed rental restrictions or otherwise provides for relief of the poor and distressed.

(iv) If the project consists of multiple buildings, they must share the same grounds, each building must satisfy the three preceding components of the safe harbor, or each building must be for sale or rental "exclusively" to persons at or below 80% of median income.

Rev. Proc. 96-32 further provided that organizations which do not meet the safe harbor may nevertheless be exempt either if they provide relief to the poor and distressed based on a facts and circumstances test or they serve another exempt purpose such as combating community determination, lessening the burdens of government, eliminating discrimination or prejudice, lessening neighborhood tensions, or relieving the distress of the elderly or physically handicapped.

c. Note: The relationship between Section 42 and the formation of tax-exempt entities under Sections 501(c)(3) and 501(c)(4) has evolved significantly since 42(h)(5)(C) was first enacted. Generally, to maintain tax-exempt status while serving as a general partner with for-profit limited partners (or as a member of an LLC with for-profit members), the non-profit organization should have control over the partnership (or LLC) and specific provisions should be included in the partnership agreement or the operating agreement which give the non-profit's charitable purposes priority over maximizing profits for the for-profit partners or members. *See, e.g.,* Rev. Rul. 2004-51, 2004-1 C.B. 975; Rev. Rul. 98-15, 1998-1 C.B. 718; PLR 200436022; PLR 9736039. In addition, with certain limited exceptions, the assets of the non-profit organization must not be placed at risk to the potential benefit of a for-profit developer and/or private investor. In PLR

9731038 (May 7, 1998), the IRS held that protections provided by a non-profit general partner for the benefit of for-profit limited partners, including a completion guaranty, an environmental indemnification and a tax credit adjuster, would not cause the organization to lose its tax-exempt status, emphasizing that there was little risk under all those obligations and that payments under the tax credit adjuster would be treated as capital contributions by the non-profit organization.

(i) Today, when evaluating a nonprofit entity participating in a low-income housing tax credit deal, many affordable housing practitioners rely on an internal memorandum released by the IRS in 2007 by Robert Choi, Acting Director EO Rulings and Agreements, which provides a framework for processing by the IRS of applications for exemption under Sections 501(c)(3) or (4) where an otherwise qualified applicant will participate as a general partner in a LIHTC partnership with for profit entities. The memorandum superseded, but is often considered in conjunction with, a 2006 IRS memorandum by Joseph Urban, then Acting Director EO Rulings and Agreements. Among the more noteworthy requirements or criteria set forth in the memorandum are the following:

(a) The applicant must explain how the charitable purposes of the applicant will be accomplished, consistent with Rev. Proc. 96-32.

(b) A final partnership agreement or operating agreement need not be provided with the application.

(c) The applicant must make representations to the effect that the charitable purposes of the general partner take priority over any duty to maximize profits for the limited partners.

(d) A conflict-of-interest policy must be adopted.

(e) The applicant must review a Phase I environmental report and exercise due diligence to minimize risks concerning environmental indemnification.

(f) There must be a fixed price construction contract with a bonded contractor.

(g) Operating deficit guaranties must be limited to either or both of 5 years from break-even or six months of operating expenses including debt service.

(h) Tax credit adjusters must either limit payment under each adjuster provision to an amount not in excess of the aggregate amount of developer and other fees (payable and deferred) to the applicant (or any affiliate) in connection with the project or provide that payments on account of such adjusters be treated as capital contributions which are distributable prior to any other distribution upon a sale or refinancing.

(i) The nonprofit sponsor must secure a right of first refusal in accordance with Code § 42(i)(7).

(j) Repurchase obligations may not exceed the amount of capital contributions, which, apparently, does not permit investors to recover their "loads".

(k) For most actions requiring the consent of the limited partners, the operative documents must provide that such consent shall not be unreasonably withheld.

(l) Removal of the general partner shall only be made for cause and after notice and a reasonable period to cure.

(ii) Comment: General partner applicants must identify a specific proposed housing project to be operated by the limited partnership but do not need to file a copy of a final limited partnership agreement upon execution. Many of the requirements are intended to prevent private inurement in joint ventures between nonprofits and for-profits and have had a material effect on the provisions included in partnership agreements for LIHTC transactions that include nonprofits, particularly if the nonprofit was the sole general partner. Note that failure to meet a particular factor listed may not adversely affect an application where the applicant can otherwise describe how it will satisfy the particular concern described in the factor.

(iii) Note: For a discussion of common issues that arise when a LIHTC project sponsor (a nonprofit entity whose charitable purpose is to develop affordable housing) provides certain guarantees to for-profit entities to obtain financing to make a LIHTC project financially viable, *see* Eric Mittereder, *Pushing the Limits: Nonprofit Guarantees in LIHTC Joint Ventures, 22 J. Affordable Housing & Commun. Dev. L.*, 79-100 (2013) (Eric worked on this article during his summer clerkship with Klein Hornig LLP in 2012, and Alana Paris, as co-author of the 2024 Edition of this Outline, gratefully acknowledges the continuing impact of Eric's tax mentorship even after his passing in March 2024).

4. Tax credits allocated from the non-profit set-aside may be subject to disallowance if ownership or "material participation" of the nonprofit organization terminates during the Credit Period. CCA 201352009; Audit Technique Guide (rev. Jan. 24, 2024). In Chief Counsel Advice 201352009, the IRS disallowed credits for a taxable year where a project owner failed to maintain the involvement of a qualified nonprofit organization in a project previously allocated credits under the Code § 42(h)(5)(B) non-profit set-aside, as of the close of a taxable year. The IRS indicated that a recapture of credits is not appropriate for violation of the nonprofit set-aside because such a violation does not result from or cause a reduction in qualified basis. Credits may be disallowed for the year in which such violation occurs or continues, but after expiration of the Credit Period, there are effectively no Credits to disallow and no tax penalty for the violation. However, the IRS stated that the project owner would be able to claim credits for the taxable year in which the violation is corrected (assuming the project owner is otherwise eligible to claim credits for that taxable year in question). In a letter dated March 27, 2014 to the IRS, the ABA Forum expressed concern that the approach adopted in the CCA and the updated Audit Technique Guide, which the ABA Forum believes is inconsistent with the statutory language, could have a negative effect on projects involving nonprofit organizations. In the letter, the ABA Forum noted that "Nothing in the text of Section 42 or the legislative history provides the tax treatment for a failure to maintain the involvement of a qualified nonprofit organization in a project throughout the Compliance Period [and] unless the credit allocation is invalid because the state agency violated Section 42(h)(5) and credits are therefore disallowed under Section 42(h)(1), there is no basis for finding that a taxpayer who receives credits from the nonprofit set-aside [sic] will lose those credits if the requirements of Section 42(h)(5) are not met throughout the Compliance Period." In the letter, the ABA Forum argued that the nonprofit set-aside is a requirement placed upon the state allocating agency and should be deemed satisfied when the agency makes a determination in good faith that a project will satisfy the requirements of Section 42(h)(5)(B) throughout the Compliance Period based on the commitments required of the taxpayer in the extended use agreement.

a. Query: Many states have historically allocated more than the statutorily required 10% of their housing credit amount to projects involving qualified nonprofit organizations. It remains to be seen whether the approach taken in the CCA and the Audit Technique Guide will act as a disincentive to states to allocate more than the statutory minimum to projects involving qualified nonprofit organizations given the potential risk that such credits will be disallowed if the requirements of Section 42(h)(5)(B) are not satisfied throughout the Compliance Period.

b. The updated Audit Technique Guide, citing to the legislative history, provides the following guidelines in defining material participation:

(i) Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer;

(ii) Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else's decisions or periodic consultation with respect to general management decisions is not sufficient.

(iii) Participation must be maintained through the year. Periodic consultation is not sufficient.

(iv) Regular on-site presence at operations is indicative of material participation.

(v) Providing services as an independent contractor is not sufficient.

c. Comment: The Audit Technique Guide notwithstanding, the "material participation" standards in Section 469(h) are not easily applied to nonprofits. In instances where corporations are required to materially participate in an activity, Section 469(h) contemplates participation by one or more shareholders owning 50% or more of the stock. Nonprofits, on the other hand have no shareholders and, thus, can only participate through employees, which is not contemplated in Section 469(h), Sections 1.469-5 or 1.469-5T.

5. Note: Participation by a nonprofit organization may have favorable state or local tax consequences. For example, the Massachusetts Department of Revenue held that the purchase of building materials and supplies was exempt from MA sales tax when, during the entire construction period, the project was owned by a limited partnership the partners of which were owned by the same nonprofit corporation (created by the Catholic Archdiocese) and, upon completion, a for-profit entity was admitted to the partnership as an investor limited partner. Mass. Ltr. Rul. 01-13 (November 15, 2001); *see also* M.G.L. ch. 64H, §6(f). In addition, in Letter Ruling 01-13, during the construction phase, the project ownership structure included taxable subsidiaries of nonprofit corporations. The for-profit nature of those corporations did not prevent the Department of Revenue from ruling the sales tax exemption applied to the purchases, where the nonprofit corporation ultimately was the owner of 100 percent of the taxable corporations' stock. Thus, this ruling suggests that electing corporate status, in lieu of pass-through status, on Form 8832 and electing to be treated as other than a tax-exempt controlled-entity under Section 168(h) should not impact the Massachusetts sales-tax analysis. Some states may also provide property tax relief for affordable housing with nonprofit sponsors. *See* Paul, "Emerging Tax Considerations for Non-Profit Sponsors of Affordable Housing," 12 The Real Estate Tax Digest 181 (1994).

G. Special Rules.

1. Each agency may allocate only to buildings within its jurisdiction.

2. In the event allocations exceed the ceiling, projects that received allocations last lose them first.

3. The first-year convention (see I.A.1 above) does not apply in determining the amount of credit allocated to a particular project.

H. Bond Financed Projects.

1. The 50% Test.

a. Buildings which are financed with tax-exempt bonds may be eligible for low-income housing credits without an allocation of credits from the state housing credit agency. If 50% or more of the aggregate basis of any building and the land on which the building is located is financed with tax-exempt bonds, low-income housing credits attributable to the entire Eligible Basis of the building may be allowed without an allocation of credits from the applicable state agency. Code § 42(h)(4)(B). If less than 50% of the aggregate basis of any building and the land on which such building is located is financed with tax-exempt bonds, only low-income housing credits that are attributable to the bond-financed portion may be claimed without an allocation of credits from the applicable state agency. Code § 42(h)(4)(A).

b. In computing the 50% test, the basis of any building is determined by using the building's cost basis under Section 1012, rather than its adjusted basis under Section 1016, and is determined without regard to any Eligible Basis adjustment allowed for buildings located in high-cost areas under Section 42(d)(5)(B). PLR 199917046. Furthermore, "building" is not limited to Section 1250 property but includes all property (including Section 1245 property and depreciable land improvements) financed with the proceeds of the tax-exempt bonds, as well as any functionally related and subordinate facilities. PLR 200035016. Note: Although the MSSP Training Guide indicates that relocation costs are not includible in Eligible Basis, as noted, the Tax Court recently held that bond issuance costs attributable to the construction period are includable in Eligible Basis and the IRS failed to appeal such decision. *See* MSSP Training Guide, IRC § 42 Low-Income Housing Tax Credit, Part IX Appendix, Acquiring Occupied Building: Tenant Relocation Costs.

c. Generally, a taxpayer cannot separately meet the 50% test in Section 42(h)(4)(B) with respect to the acquisition and the rehabilitation of a single building. PLR 200035016. However, an IRS letter ruling suggests that a taxpayer may separately meet the 50% test with respect to rehabilitated property which is treated as a "separate new building" under Section 42(e)(1) when the existing building received a previous allocation and none of the rehabilitation expenditures treated as a "separate new building" were previously included in the basis of the existing building. PLR 200335030. This ruling did not address whether the basis in the land on which the rehabilitated property was located should be included in the calculation of the 50% test as required by Section 42(h)(4)(B). Note: In Private Letter Ruling 200335030, the IRS also ruled that the tax-exempt financing did cause the existing building to be "federally subsidized" despite the fact that such financing was attributable solely to the rehabilitated property.

d. Informally, the IRS has taken the position that bond proceeds must actually be drawn and expended in order to count toward the 50% test. The mere issuance of bonds that are taken into account for volume cap purposes is not sufficient. When a building is completed late in the year, but cost requisitions are not paid until the following year, the 50% test would not be satisfied and credits would not be available until the year following completion. *See also* PLR 201049018.

e. Income from the temporary investment of the sale proceeds of tax-exempt bonds that accrues through the date when a project is placed in service may be counted as bond proceeds for purposes of satisfying the 50% test under Section 42(h)(4)(B). Rev. Rul. 2002-21, 2002-1 C.B. 793. PLR 200022042; PLRs 200109011-014.

f. A critical question in this context is how long tax-exempt bonds must remain outstanding in order to enable a building to be treated as bond-financed. The IRS has ruled that tax-exempt bonds which are redeemed on or after the date that a building is placed in service may nevertheless be treated as financing such building for purposes of Section 42(h)(4). PLR 9853036; PLR 200324025; PLR 200324042 (March 6, 2003); PLR 200334011. The result is the same even if the redemption occurs prior to the end of the first year of the Credit Period, as, for example, when the Credit Period begins in the year after placement in service. PLR 201049018. This PLR also indicates that the expenditures of bond proceeds after placement in service but prior to the end of the first year of the Credit Period counts toward the 50% test. Furthermore, the IRS has ruled that tax-exempt bonds which are outstanding at the end of the first year of the Credit Period of a building and which are used to repay construction expenditures or take out a construction loan made with respect to that building would be treated as financing such building for purposes of Section 42(h)(4). PLR 201049018; PLR 199912023; PLR 9816018.

a. Comment: Legislation has been put forth in the U.S. House of Representatives that would lower the 50% basis threshold for tax-exempt financed deals to just 25%, however, such legislation has not passed to date. *See* IX.N below.

2. A Building which is financed with tax-exempt bonds is considered "federally subsidized" (unless the taxpayer elects to reduce the Eligible Basis by the amount of the bond proceeds) and, therefore, is eligible only for low-income housing credits with a present value equal to 30% of the low-income portion of the building.

3. In order to generate low-income housing tax credits, tax-exempt bonds must be taken into account under volume cap provisions of Section 146 and principal payments on the financing provided with the tax-exempt bonds must be applied within a reasonable period of time to redeem the bonds. The ceiling on private activity bonds for calendar year 2025 is the greater of (1) $130 multiplied by the State population, or (2) $388,780,000. Rev. Proc. 2024-40, 2024-45 I.R.B. 1100 (Oct. 22, 2024). The increase in the bond cap indirectly increases the amount of low-income housing credits available, since projects financed by private activity bonds qualify for credits without an allocation from the state's credit volume cap.

a. Note: The IRS has informally taken the position that, when tax-exempt bonds which are subject to the volume cap are refunded with new bonds which do not require a new volume cap allocation but which continue to be tax-exempt under the refunded bonds' original volume cap allocation, the new tax-exempt bonds are not treated as "taken into account" under the volume cap provisions of Section 146 and thus the new tax-exempt bonds do not generate low-income housing credits. This position, which seems questionable, is only of concern when a refund occurs prior to placement in service. *See* IV.H.1.e above.

4. Scattered site projects are not eligible for financing with tax-exempt bonds unless each scattered site qualifies as a "qualified residential rental project" under the bond rules. *See* Code §142(d); Treas. Reg. §1.103-8(b)(4)(ii); *see also* III.D.4 above. A single building project may qualify as a qualified residential project eligible for tax-exempt bond financing under Section 142(d) even if the low-income and market rate units in such building are owned by different taxpayers, allowing one taxpayer to retain the economic benefits available from the market rate units. PLR 200601021 (January 6, 2006). Apparently, the requirement that multiple buildings have the same owner (*see* Treas. Reg. §1.103-8(b)(4)(ii)) was not a concern because, for bond purposes (other than the bond next available unit rule), this was a single building. These ruling paves the way for attracting tax credit investors to 80-20 projects, while preserving the investment in the market-rate units for economic investors.

5. A building financed with the proceeds of tax-exempt bonds previously could not be used on a transient basis and must contain "separate and complete facilities for living, sleeping, eating, cooking and sanitation." Treas. Reg. § 1.103-8(b)(8)(i). However, Section 142(d)(2)(D) of the Code now provides that a unit will not fail to be treated as a residential unit merely because the unit is an SRO unit within the meaning of Section 42 of the Code. Accordingly, SRO units may be financed with tax-exempt bond proceeds even though such units provide shared eating, cooking and sanitation facilities.

6. Units are deemed to be rented or available for rental on a continuous basis for purposes of Section 1.103-8(b)(5)(i), and continuously occupied by low-income tenants for purposes of Section 1.103- 8(b)(5)(ii), during the period the Project is being renovated, where due to safety and engineering reasons, repairs required that the units be vacated during the renovation and the developer entered into replacement leases which permit the low-income tenants to reoccupy the low-income units upon completion of the renovations, thus effectively prohibiting developer from re-leasing the low-income units to other prospective tenants. PLR 200923008.

7. Not all costs includable in Eligible Basis are "good" costs for bond purposes. For example, costs associated with a community service facility or roads and other infrastructure improvements used by nonresidents are not "functionally related" to housing and thus are not "good" costs for bond purposes. Many bond counsel also take the position that developer fees are not "good" costs if the developer is a related party. In addition, under the Inflation Reduction Act, if energy property is financed with the proceeds of tax-exempt bonds, Sections 48(a)(4) and 48E(d)(2) require a 15% reduction in the amount of energy credits. <u>Note</u>: In order to avoid this "haircut", the Bond documents must provide that no portion of the Bond proceeds will be used to finance energy property.

8. *See* Paul, "Tax-Exempt Financing for Multi-Family Housing: A Primer," 15 The Real Estate Tax Digest 215 (July 1997).

I. Correction of Administrative Errors.

1. As mandated by Section 42(n)(4), Section 1.42-13 provides rules for corrections of "administrative errors and omissions" by agencies with or without IRS approval. Such approval is generally required if the error is not corrected by the end of the year in which it is made and the correction affects the amount of the credit allocation or the state's credit ceiling or carryover. Treas. Reg. §1.42-13(b)(3)(iii).

2. Pursuant to Section 1.42-13(b)(3)(vi), automatic approval is granted by the IRS if: (i) the correction is not made before the close of the calendar year of the error or omission and the correction is a numerical change to the housing credit dollar amount allocated for the building or multiple-building project; (ii) the administrative error or omission resulted in an allocation document (including a carryover allocation) that either did not accurately reflect the number of buildings in a project or the correct information (other than the amount of credit allocated on the allocation document); (iii) the administrative error or omission does not affect the agency's ranking of the building(s) or project and the total amount of credit the agency allocated to the building(s) or project; and (iv) the agency corrects the administrative error or omission by following the procedures established by the IRS. The drafter of this regulation has indicated informally that, in determining whether the correction is a numerical change to the housing credit dollar amount allocated for the building or multiple-building project, the IRS intends that this language be read very broadly and takes the position that virtually every correction is a numerical change to the housing credit dollar amount (i.e. if the wrong address is listed for a building, to correct it requires a numerical change because arguably the amount allocated to the correct building was $0.)

3. To correct an administrative error or omission which has been granted automatic approval by the IRS pursuant to Section 1.42-13(b)(3)(vi), the agency is required by Section 1.42-13(b)(3)(vii) to: (i) amend the allocation document to correct the administrative error or omission and indicate on the amended allocation document that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii)"; (ii) if correcting the allocation document requires including any additional B.I.N.(s) in the document, the document must include any B.I.N.(s) already existing for buildings in the project and, if possible, the additional B.I.N.(s) should be sequentially numbered from the existing B.I.N.(s); (iii) if applicable, amend Schedule A to Form 8610 and attach a copy of this schedule to Form 8610 for the year in which the correction is made, indicating on Schedule A that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii)"; (iv) if applicable, amend Form 8609 and attach the original of this amended form to Form 8610 for the year the correction is made, indicating on Form 8609 that it is making the "correction under Treas. Reg. §1.42-13(b)(3)(vii); and (v) mail or otherwise deliver a copy of any amended allocation document and any amended Form 8609 to the affected taxpayer.

4. *See*, *e.g.,* Treas. Reg. §1.42-13(c), PLR 201527017 (administrative error occurred when incorrect allowable credit amount and maximum qualified basis amount were listed on Form 8609), PLR 201451018 (state agency committed administrative error when Forms 8609 incorrectly attributed credits from that year's credit ceiling to buildings placed in service the prior year), PLR 201311007 (state agency failed to update Carryover Allocation to reflect new location of project), PLR 201237013 (state agency incorrectly tracked and double counted certain returned low-income housing tax-credit dollar amounts leading to allocations of credits in excess of state ceiling), PLR 201104024 (state agency committed an administrative error when it made a supplemental allocation of credits in excess of state ceiling), PLR 200419016 (in a project-based allocation, incorrect credit dollar amount listed on the Forms 8609 issued with respect to the buildings in the project (although project's aggregate credit figure was accurate)), PLR 200226035 (state agency incorrectly determined the final amount of credits to be allocated based on the review of the reasonableness of development costs in the year of allocation rather than in the year that the building was placed in service), PLR 199924033 (state agency applied new developer fee limits to project after carryover allocation was executed and project was placed in service), PLR 9842023 (incorrect Eligible Basis calculations for each building in project), PLR 9701014 (incorrect number of buildings in project), PLR 9609028 (failure to include developer fee in project costs), PLR 9602007 (mathematical error in carryover allocation), PLR 9512012 (ineligible costs included in basis), PLR 9240011 (carryover allocation issued to prior owner of project), and PLR 9712003 (invalid rate lock election), for examples of correctable administrative errors.

V. RECAPTURE OF CREDIT

A. Recapture Events During Compliance Period.

1. Sale or disposition of interest in project.

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

(i) A lead-in declaration stating: "By this letter I am making the notification prescribed by § 42(j)(6)(B)(i) of the Internal Revenue Code.";

(ii) The taxpayer's name, address, and taxpayer identification number;

(iii) The name (if any), address, and Building Identification Number of each building to which the taxpayer's disposition relates (if a taxpayer received a credit from a pass-through entity but does not know any of the preceding information, the taxpayer must provide the name and employer identification number of the pass-through entity from which the taxpayer received the credit);

(iv) To the extent known, the name, address, and taxpayer identification number of any person(s) to whom increases in tax result as a consequence of the credit recapture; and

(v) A concluding declaration stating: "Under penalties of perjury, I declare that I have examined this letter and the representations made therein, and to the best of my knowledge and belief, they are true, correct, and complete."

b. Prior to the revision of the Regulations under Section 708 in 1997 (see II.B.2.c above), dispositions of partnership interests were generally treated as recapture events (unless (a) and (b) above were satisfied). Exceptions were provided for: (i) "de minimis" transfers of up to one-third of partner's "greatest total interest" in the project through the partnership at any point in time (Rev. Rul. 90-60); (ii) dispositions of interests in large partnerships (see V.C below) (iii) the transfer of partnership interests from a parent corporation to its wholly-owned subsidiary (PLR 9737006); and (iv) the transfer of partnership interests to a trust upon the death of a partner (assuming the partnership agreement provided that the death of a partner would not cause the partnership to terminate) PLR 9801028 . Although not specifically addressed in PLR 9801028, it is likely that this exception to the recapture rules also applies to a transfer of partnership interests to the deceased's estate.

(i) <u>Query</u> whether a reduction in a partner's distributive share of credits by virtue of a reallocation of tax losses under the Section 704 rules is a "disposition" for this purpose. *See* Treas. Reg. § 1.47-6; *but see* PLR 8651050 (to the effect that a reallocation of income and gain to a general partner pursuant to Section 704(b) does not change the limited partners' share of "general profits" for the purpose of triggering recapture of rehabilitation credits allowable under Section 47).

c. In Private Letter Ruling 199924064, the IRS held that, in the context of transfers between members of an affiliated group, the disposition of interests in several partnerships which resulted in the deemed contribution of Section 42 property to new partnerships under Section 1.708-1(b)(1)(iv) would not be treated as a disposition of Section 42 property resulting in recapture of low-income housing tax credits under Section 42(j). In reaching this conclusion, the IRS stated that little guidance is available to illustrate when, under Section 42(j), a reduction in qualified basis of a building with respect to a taxpayer has occurred or when there has been a disposition that requires the posting of a bond to avoid recapture. The IRS therefore relied upon the analogous application of provisions concerning the recapture of the investment tax credit ("ITC"), including Section 1.47-3(f)(1) which provides for an exception to the ITC recapture rules in the case of a mere change in form of conducting a trade or business. The IRS expressed no opinion, however, regarding the application of Section 1.708-1(b)(1)(iv) to the technical termination of a large partnership. *See* V.C below; *see also* PLR 200445015 (transfer of partnership interest to fourth-tier subsidiary in a series of Section 351 transactions did not result in a recapture event, transferor was deemed to hold the interest constructively after the transfer); PLR 200018022; PLR 2000121016.

d. The sale of bare legal title to a project owned by a partnership to its general partner was not considered a disposition or change in ownership of its interest in the project and did not trigger recapture. PLR 9903005. *See also* PLR 200029044; PLR 200206037 (February 8, 2002). PLRs 200232018-20; PLRs 200233013-15.

e. The termination of a building's extended use period upon foreclosure, or an instrument in lieu of foreclosure, was not considered to be the disposition of a building or an interest therein. CCA 201146016. Therefore, while the disposition of a building upon foreclosure may ultimately result in recapture, neither the disposition of the building nor the related termination of an extended use period on foreclosure results in the automatic recapture of credits.

2. Failure to qualify as a qualified low-income building. <u>Note</u>: For recapture purposes, disqualification literally seems to be determined on a building-by-building basis even though qualification may have been determined with respect to other buildings in the same project.

3. Reduction in number of low-income units without disqualification may result in partial recapture, i.e., reduction in Qualified Basis. A reconfiguration of the type of units (i.e., from one and two bedrooms to three bedrooms), where the number of units, percentage of low-income units, and rent charged were not changed, did not result in recapture. PLR 9846008. Recapture will be triggered if a decrease in Qualified Basis results from an audit by the IRS of a taxable year subsequent to a closed taxable year. CCA 201136023. The IRS may recalculate a taxpayer's Qualified Basis in a closed taxable year in order to make a determination of Qualified Basis in an open taxable year as well. *Bentley Court II Limited Partnership, et al. v. Comm.*, TC Memo 2006-113 (5/31/2006).

4. Failure to repay loan from a non-profit organization subject to the at-risk rules described in VII.C below.

5. No recapture upon casualty if project reconstructed within reasonable period. CCA 200134006 (August 24, 2001), states that (i) the meaning of casualty loss for tax credit recapture purposes should be consistent with the tax principles for a casualty loss under Section 165, (ii) the state agency must report to the IRS the reduction in qualified basis resulting from a casualty loss, and (iii) there is no support for the taxpayer continuing to claim credits for units which are out of service due to a casualty loss (unless the units are located in a federally declared disaster area). If a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, which is a reasonable period, then there is no recapture and no loss of credits. If the owner had failed to restore the building by the end of the taxable year, no credits would be allowed for the entire taxable year, even if the reasonable period (or reasonable restoration period) to restore the building extends into the next taxable year. CCA 200913012 (February 20, 2009).

   a. Note: The IRS further ruled that reconstruction completed within two years of the casualty was within a reasonable period based on general tax principles under Section 165. If the building's qualified basis is not restored within the reasonable period (or reasonable restoration period), then the building will be subject to recapture under Section 42(j)(1) in the taxable year in which the disaster occurred and the owner cannot claim credits on the building for that taxable year. The owner also will lose all credits claimed during the restoration period. CCA 200913012. In Revenue Procedure 2007-54 the IRS announced that an owner of a building that is beyond the first year of the Credit Period would not be subject to recapture or loss of credit if the building's qualified basis suffered a reduction because of a disaster that caused the President to issue a major disaster declaration, provided the building's qualified basis is restored within a reasonable period. The IRS has determined that it is appropriate to extend the restoration period provided under Rev. Proc. 2007-54 for qualified low-income buildings located in the GO Zone. Notice 2007-66. Section 42(j)(4)(E) only provides recapture relief for casualty events; it does not provide the allowance of credits during the period of time that the building is being restored due to casualty events not covered under Rev. Proc. 2007-54. CCA 200913012. Rev. Proc. 2014-49 modifies and supersedes Rev. Proc. 2007-54. In Rev. Proc. 2014-49 and Rev. Proc. 2014-50, the IRS provided updated guidance about temporary relief from requirements including carryover allocations, recapture, compliance monitoring, buildings in the first year of the Credit Period, the amount of credit allowable to a building that has been restored and emergency housing for qualified rental housing developments financed by low-income housing credits or tax-exempt bonds in designated major disaster areas. Most recently, in response to the ongoing COVID-19 pandemic, the IRS extended the reasonable restoration period for certain projects.

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

B. Amount Subject to Recapture.

1. "Accelerated portion of the credit", that is, the excess of the credits claimed over the credits that would be allowable if they were claimed ratably over the 15-year Compliance Period. (No recapture of unused credits.)

   a. Comment: The ABA Section of Taxation has suggested that the Compliance Period be changed to a ten-year period coinciding with the Credit Period and the extended use period be extended to twenty (20) years after the close of the Compliance Period. These changes would simplify compliance issues and resolve issues related to accelerated credit recapture. ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate (March 11, 2013).

2. Interest determined under Section 6621 as if accelerated portion had been deficiency in each year for which it is recaptured (however, there is no deduction for such interest, even for corporations).

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

C. Large Partnerships.

The following rules apply only to a partnership which has more than 35 partners (with spouses counted as only one partner) unless the partnership elects not to have these rules apply:

1. Treated as the "taxpayer" for purposes of recapture determination; dispositions of partnership interests are not taken into account.

2. Recapture allocated in proportion to income sharing percentages for the year of recapture, even if those percentages differ from the sharing percentages for the year of credit.

VI. RIGHTS OF FIRST REFUSAL

A. Rights of first refusal, generally.

1. Section 42(i)(7) provides that "no federal income tax benefit" shall be disallowed because a qualified nonprofit organization, government agency, tenants' organization or resident

management organization has a "right of first refusal" ("ROFR") to purchase the "property" at the end of the Compliance Period.

2. Query: Does the "property" include reserves and other personal property? A purchase option does not come within this provision because, unlike a "ROFR," an option entitles the holder to force a sale of the project. See 136 Cong. Rec. E 2925 (1990). The ROFR must be exercisable for a fixed price not less than the sum of: (i) the principal amount of all indebtedness encumbering the property other than indebtedness incurred within the 5-year period ending on the date of purchase; and (ii) the amount of federal, state and local income taxes attributable to such sale.

   a. Query: Should interest accrued on indebtedness within the 5-year period be treated as "indebtedness incurred"?

   b. There is no statutory requirement that a ROFR be limited in duration. However, most, if not all, investors insist on a time limit, e.g., 12 to 36 months after the expiration of the Compliance Period. As a result, investors may have an incentive to "wait out" the ROFR in order to realize potential economic upside on sale.

3. Note: On May 9, 2016, a group of national developers and organizations that support nonprofit housing development submitted a letter to the IRS requesting that guidance regarding the exercise of the ROFR be included on the 2016–2017 Priority Guidance Plan. The letter asked the IRS to clarify that (1) a third-party offer from a party related to the nonprofit for less than fair market value should be sufficient to trigger the ROFR, arguing that this trigger would effectuate the law's intent and arguing that the limited partner's status as a partner should be protected, (2) the reference in Section 42(i)(7) includes partnership assets other than the real estate, including reserves, and (3) the ROFR could be exercised by the purchase of the partnership interest or the purchase of the property. See Nonprofit Housing Organizations Comments on Notice 2016-26, Recommending Right of First Refusal Project for 2016–2017 Priority Guidance Plan, May 9, 2016.

4. Note: There have been a number of bills introduced in both chambers of Congress to make changes to the statutory ROFR under Section 42(i)(7). In 2021, the Ways and Means Committee in the U.S. House of Representatives introduced a markup of the infrastructure and community development sections of the Build Back Better Act which included the below changes to the ROFR (introduced as H.R. 5376, the items listed below did not make it into the final version of the bill, enacted as Pub. L. No. 117-169, and discussed further in IX.N.1 below:

   a. The ROFR would be replaced with a purchase option for either the property or the investor's partnership/membership interest.

   b. The definition of "property" would be expanded to include all or any of the assets held for the development, operation, or maintenance of a building. This definition would presumably cover cash reserves and personal property.

c. The amendments in the bill make clear that (1) the option or ROFR shall be exercisable with or without the approval of the project owner (including any partner, member, or affiliated organization of the owner), and (2) a ROFR shall be exercisable in response to an offer to purchase the property or partnership interests, including an offer from a related party.

d. The Federal, state, and local exit taxes are taken out of the minimum purchase price definition. Accordingly, under this bill, the minimum purchase price would be an amount equal to "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)." In the case of a purchase of a partnership interest, the minimum purchase price would be an amount not less than the interest's ratable share of the principal amount of outstanding debt.

e. The amendments to the ROFR would retroactively apply to agreements entered into prior to the enactment of the amendments. With that being said, the bill makes clear that the amendments are not intended to supersede any express language contained in any agreements with respect to the ROFR or purchase option.

B. ROFR Cases

1. Homeowner's Rehab, Inc. In *Homeowner's Rehab, Inc. v. Related Corporate V SLP, L.P., 479 Mass. 741*, 99 N.E.3d 744 (June 15, 2018), the Massachusetts Supreme Judicial Court ("SJC") affirmed the Superior Court's decision to grant the motion for summary judgment made by the general partner of a LIHTC partnership and its majority owner, the nonprofit sponsor. The SJC held that, under the agreements governing the ROFR, interpreted in light of their intent and the purpose of Section 42(i)(7), consent of the special limited partner was not required for the sponsor to exercise its ROFR to purchase the LIHTC project where the nonprofit sponsor solicited the triggering offer from another nonprofit organization with a similar mission. The SJC interpreted the ROFR agreements applicable to the project and held that, to trigger the sponsor's ROFR, the partnership must have decided to accept a third party offer but that the offer need not be a "bona fide" offer. In other words, a pre-arranged offer made by an accommodation party for the purpose of triggering the sponsor's ROFR was valid under Section 42(i)(7). The partnership agreement provided that limited partner consent was not required for a sale pursuant to the ROFR. Thus, the Court held that the general partner had the authority, without limited partner consent, both to (i) trigger the sponsor's ROFR by soliciting an offer from a third-party accommodation party and (ii)to accept the offer and issue the disposition notice to the special limited partner required under the agreements.

   a. In so holding, the Court noted that (i) at the end of the Compliance Period, most investor limited partners seek to exit a LIHTC project, typically by selling their interest to the nonprofit general partner or sponsor, and (ii) Section 42(i)(7) specifically contemplates such sales, as it allows nonprofit organizations to purchase a LIHTC project at the end of the compliance period at a statutorily prescribed minimum price, which price may be less than fair market value, without undermining tax ownership. In addition, it found that the goal of section 42(i)(7) was to facilitate the transfer of LIHTC properties to nonprofits.

2. Senior Housing Assistance Group (SHAG). The question in Senior Housing Assistance Group v. AMTAX Holdings 260, LLC, W.D. Wash. No. C17-1115 RSM, was whether Senior Housing Assistance Group ("SHAG") had validly triggered and exercised its Section 42 rights of first refusal to purchase four LIHTC projects in Washington State (the "disputed projects"). The Court held that SHAG had not, as a matter of contract law (without addressing Section 42(i)(7)) validly triggered and exercised its four ROFRs. The Court found that (i) without unambiguous contrary intent, use of the term "ROFR" indicated the grant of a standard, common-law ROFR and (ii) in case of the SHAG's ROFRs there was no unambiguous intent to treat the ROFRs as options. The SHAG Court seemed to recognize that its interpretation made the four ROFRs very unlikely to be used, given the short exercise period (2 years) and because a bona fide offer was unlikely (or even impossible) during that period given the fact that SHAG was likely to exercise its right to purchase at the below-market price pursuant to Section 42(i)(7).

    a. Comment: Short exercise periods are relatively common, and the Section 42(i)(7) price may be below the fair market value. Thus, the decision, if adopted more broadly, would have significant negative implications for the exercisability of 42(i)(7) ROFRs. The Court did not seem troubled by the potential that its holding could render Section 42(i)(7) ROFRs useless. The Court was also concerned about SHAG's role as both ROFR-holder and project-owner general partner. As holder of the ROFRs, it stood to benefit from triggering of the ROFRs, which compromised SHAG's ability to consider and form true willingness to accept an offer, since it desired – and even sought out – offers to trigger the ROFR. The decision may suggest that having a nonprofit wear two hats in this way is inadvisable. That said, many LIHTC deals involve a ROFR in favor of a nonprofit that is also the sponsor, developer and sole or majority member of the general partner/managing member. Notably, the Court did not reach the matter of whether the traditional requirements of rights of first refusal were necessary under Section 42(i)(7). Failure to address Section 42 arguably makes the case less compelling than the Massachusetts case discussed above.

3. SunAmerica Housing Fund 1050 v. Pathway of Pontiac, Inc., et al. In *SunAmerica Housing Fund 1050 v. Pathway of Pontiac, Inc*., et al, 129 AFTR 2d 2022-1738 (DC MI, 2/4/2021) the U.S. District Court of the Eastern District of Michigan held that the general partners breached their fiduciary duty to the limited partners. The Court found that the project owner failed to receive a bona fide offer sufficient to trigger the exercise of the Section 42(i)(7) ROFR held by the nonprofit sponsor where the general partners never intended to sell the project. However, the United States Court of Appeals for the Sixth Circuit reversed the District Court's grant of summary judgment to the SunAmerica and remanded the case to the district court for further proceedings consistent with that opinion. 129 AFTR 2d 2022-1744, 33 F4th 872 (CA6, 5/10/2022).

4. Riseboro Community Partnership Inc. v. SunAmerica Housing Fund 682. In *Riseboro*, the U.S. District Court of the Eastern District of New York held that a nonprofit Section

42(i)(7) ROFR holder could not force a project owner to sell the property after the Compliance Period without meeting the common law conditions precedent. In reaching its holding, the Court rebutted the nonprofit ROFR holder's argument that Section 42(i)(7) of the Code gave it a unilateral right to purchase the property.

   a. As a threshold issue, the Court noted that the Stockholm LP Partnership Agreement provided that its terms shall be "construed and enforced in accordance with the State of New York." The Court reasoned that this provision required it to begin its interpretation of the "ROFR" with the term's definition under New York law. In reviewing the common law definition, the Court found that a ROFR, unlike an option, did not give its holder the power to compel a sale of the property. Rather, the exercise of the ROFR was conditioned on the receipt of an offer and a decision by the property owner to sell. The Court also asserted that, based on the legislative history, the U.S. Congress intended to incorporate the common law meaning of "right of first refusal" into Section 42(i)(7). Applying the common law meaning to the case, the Court determined that the ROFR held by Riseboro was not an option.

   b. In reaching its decision, the Court also rebutted Riseboro's arguments to treat the ROFR as a unilateral right to force a sale of the property. First, Riseboro argued that it would be "senseless" to construe Section 42(i)(7) within the common law meaning because no third party would make an offer knowing that Riseboro could exercise the ROFR to purchase the property at a below-market price. Accordingly, Riseboro reasoned, the third-party offer triggering the exercise of the ROFR would never materialize. The Court rejected these arguments.

5. Centerline/Fleet Housing Partnership, L.P. v. Hopkins Court Apartments, L.L.C. The Supreme Court of New York, through the Fourth Department of its Appellate Division, held that positive capital accounts are excluded for purposes of calculating the option price for a project. In reaching its holding, the Court rejected the limited partner's arguments that proceeds from the sale of the project must be included in the liquidation proceeds to the partners.

   a. Comment: We note that the Court in the *Centerline/Fleet Housing Partnership* decision did not analyze Section 704(b) and the Treasury Regulations thereunder in reaching its decision.

C. Treatment of Project Reserve Accounts

1. Treatment of project reserve accounts upon release or at investor exit can be contentious. Developers prefer that reserves remain with the partnership to support the project and its tenants, while investors may prefer to have reserves distributed through the cash waterfall.

VII. LIMITATIONS ON CREDIT

In a letter to Low Income Housing Tax Credit Project owners dated October 16, 2019, the California Tax Credit Allocation Committee (TCAC) reminded such owners that since 1997

California Regulations have generally required that "all unexpended funds in project reserve accounts" remain with the project "to be used for the property and/or its residents." See Cal. Code Regs. Tit. 4, § 10327(c)(7). One exception is that the operating reserve may be released following achievement of a minimum annual debt-service coverage ratio of 1.15 for three consecutive years following stabilized occupancy, exclusively to pay deferred developer fees. In its October 2019 letter, TCAC noted that (i) many partnership agreements include language that does not reflect this regulatory requirement, (ii) TCAC will be closely reviewing agreements, (iii) it will not issue Forms 8609 without compliant language, and (iv) it may also issue program sanctions for violations of the requirement.

A. Regular Section 38 Rules Apply.

1. There is a one-year carryback and twenty-year carryforward for unused Credits. Code § 39.

2. The TCJA repealed the corporate alternative minimum tax. Effective January 1, 2023, the IR Act establishes a 15% minimum tax on book income applicable to corporations with average adjusted financial statement income for a three-taxable-year period ending with the current taxable year of more than $1 billion. The 15% minimum tax is applied to a corporation's financial statement net income before taxes. The IR Act provides an adjustment to allow accelerated depreciation to reduce financial statement income and allows for general business credits, such as the LIHTC, new markets tax credit, historic tax credit and renewable energy tax credits, to be taken against this minimum tax.

B. Section 183 and Similar Limitations Do Not Apply.

1. The "not for profit" rules of Section 183 do not apply to disallow losses, deductions or credits attributable to the ownership and operation of a qualified low-income building for which credits are otherwise allowable. Treas. Reg. § 1.42-4(a).

2. Although other principles of tax law such as "sham," "economic substance" or "ownership" analyses may limit such tax benefits (*see* Treas. Reg. § 1.42-4(b)), most Congressionally mandated tax incentives, such as the low-income housing tax credit, are not circumscribed by such principles. *See, e.g.,* Treas. Reg. § 1.701-1-2(d), Ex. 6.

3. Section 42(i)(7) provides that "no federal income tax benefit" shall be disallowed because a qualified nonprofit organization, government agency, tenants' organization or resident management organization has a ROFR to purchase the "property" at the end of the Compliance Period. *See* VI above for a detailed discussion of ROFRs.

C. Application of At-Risk Rules.

1. Generally, regular investment tax credit rules apply. `If the at-risk rules apply, a taxpayer may deduct a loss from an activity only to the extent of the aggregate amount with respect to which the taxpayer is considered "at risk." Code § 465(a)(1). For partnerships or S corporations, limitations are applied at the partner or shareholder level. Importantly, the at-risk limitations do *not* apply to widely held C corporations and accordingly are rarely, if ever, a concern for a LIHTC property.

2. PLR 9207027 (Nov. 19, 1991) deals with a partnership which included partners that were and were not subject to the "at risk" rules and which invested in several projects, some of which utilized financing that did not satisfy those rules. In order to achieve equal tax benefits for all partners, the partnership agreement provided for special allocations pursuant to which the partners subject to the at risk rules received a higher share of benefits from projects which utilized only qualifying financing and the other partners received a higher share of benefits from projects which did not utilize only qualified financing. These special allocations were recognized as valid under Section 704(b).

3. There is as yet no specific guidance concerning the transfer of a project from an owner not subject to the at risk rules to a taxpayer who is subject to those rules. The issue is whether the specific "step into the shoes rule" or the rule fixing Eligible Basis as of the end of the first year of the Credit Period would trump application of the at risk rules.

D. Application of Passive Activity Rules.

1. Widely-held C corporations are not subject to the passive activity rules under Section 469 and, accordingly, are rarely, if ever, applicable to a LIHTC project.

VIII. MASSACHUSETTS LOW-INCOME HOUSING TAX CREDIT

A. Timing and Amount of Credit.

1. EOHLC or its successor agency (the "Department") may authorize low-income housing tax credits on an annual aggregate limit, which, for tax years beginning on or after 2023, is equal to the total sum of (i) $60 million, (ii) unused Massachusetts low-income housing tax credits, if any, for the preceding calendar years, (iii) any Massachusetts low-income housing tax credits returned to the Department by a qualified Massachusetts project, and (iv) $5 million to preserve and improve existing state or federally-assisted housing. M.G.L. ch. 62, § 6I(b)(1); *see also* 2023 Mass. Acts Chapter 50, Section 23 (enacted Oct. 4, 2023); Technical Information Release 24-4: Provisions in the 2023 Tax Relief Legislation, published by the Department on May 20, 2024. Prior to the 2023 Act, the amount in clause (i) was scheduled to decrease to $20 million for tax years beginning on or after January 1, 2026. However, the Act provides the new amount of $60 million without reference to any future decrease.

2. Under legislation approved in 2004, the Department may allow applicants to elect to receive the award in the form of a loan (in an amount not to exceed (as determined by the Department) the expected equity yield from a hypothetical sale of the credits), rather than state tax credits. However, the Department has indicated informally that it has never offered, and does not expect to offer, applicants the option to receive the award in the form of a loan.

3. The Massachusetts low-income housing tax credit is taken in annual installments over five years. A full year of credit may be claimed in the year the project first becomes a qualified project, i.e., when the project satisfies the minimum set-aside test provided an early election is timely made. The credit shall be subtracted from the amount of state tax otherwise due for each taxable period and shall not be refundable. Any amount of the

available Massachusetts low-income housing tax credit which exceeds the tax due for a taxable year in the Credit Period may be carried forward to any of the five subsequent taxable years. The credit can be claimed by both individuals and corporations. M.G.L. ch. 62, § 6I(c)(3); M.G.L. ch. 63, § 31H(c)(3). Any qualified Massachusetts project for which the Department has issued an eligibility statement is eligible for an allocation of Massachusetts low-income housing tax credit. *See* 760 CMR 54.04(1).

4. With the exception of unused Massachusetts low-income housing credits which may be carried forward, and except for credits claimed under Regulations promulgated by the Department consistent with the rule set forth in Section 42(f)(2) (allowing credits for the first year of the Credit Period to be reduced if the building is in service less than 12 months of the first year, with the unused portion of the first-year credit allowed in the 11th year), a qualified Massachusetts project shall not be eligible for any Massachusetts low-income housing tax credits for more than 11 taxable years. M.G.L. ch. 62, § 6I(h); M.G.L. ch. 63, § 31H(h).

B. Allocation of Credit.

1. A project must be a qualified Massachusetts project. M.G.L. ch. 62, § 6I(c)(1); M.G.L. ch. 63, § 31H(c)(1). The requirement that a person claiming the Massachusetts low-income housing credits must be allocated a federal low-income housing tax credit with respect to a project has been repealed.

2. The Department shall determine eligibility for and allocate the Massachusetts low-income housing tax credit in accordance with the standards and requirements set forth in Section 42 of the Code. M.G.L. ch. 62, § 6I(b)(2); M.G.L. ch. 63, § 31H(b)(2). The total Massachusetts low-income housing tax credit available to a project shall be authorized and allocated by the Department based on the project's need for the credit for economic feasibility. M.G.L. ch. 62, § 6I(c)(2); M.G.L. ch. 63, § 31H(c)(2).

   a. Note: Although projects eligible for the Massachusetts low-income housing tax credit must satisfy the 40-60 Test, the 20-50 Test or the Average-Income Test, the amount of the Massachusetts low-income housing tax credit does not depend on the amount of Eligible Basis or qualified basis.

3. The Department must allocate the total available low-income housing tax credits among as many qualified Massachusetts projects as fiscally feasible, with the goal of increasing Massachusetts' stock of affordable housing units. M.G.L. ch. 62, § 6I(b)(3); M.G.L. ch. 63, § 31H(b)(3).

4. The existence of a ROFR to purchase the project after the close of the Compliance Period on the terms provided in Section 42(i)(7) shall not cause a Massachusetts low-income housing tax credit to be denied with respect to the project. M.G.L. ch. 62, § 6I(c)(6)(i) and (ii); M.G.L. ch. 63, § 31H(c)(6)(i) and (ii); *see* VI.B.3 above.

5. All or any portion of the Massachusetts low-income housing tax credits issued to a project may be sold, transferred or assigned to parties who are eligible to receive the credits. M.G.L. ch. 62, § 6I(f)(1); M.G.L. ch. 63, § 31H(f)(1). In order to be eligible to

receive the credits, the transferee need not be a partner in the partnership which owns the project for which Massachusetts credits are being transferred. The transferee is no longer required to be entitled to claim a federal low-income housing tax credit with respect to a project in Massachusetts that has received an allocation of state credits. 760 CMR 54.07(1).

6. On March 8, 2006, the Department of Revenue issued LR 06-2 interpreting certain provisions of the Massachusetts historic rehabilitation tax credit that parallel the Massachusetts low-income housing tax credit rules. In particular, the DOR ruled that (i) a partner who is otherwise allocated .01% of a partnership's profits, losses, deductions and gains may nonetheless be allocated 100% of the partnership's historic credits and (ii) a partner that is an exempt organization under Section 501(c)(3) is, if allocated historic credits, eligible to transfer such credits. The DOR held that an exempt organization is an eligible transferor since exempt organizations are subject to Massachusetts tax on their unrelated business taxable income (UBTI) (even if they do not actually have UBTI and pay tax) and therefore constitute "taxpayers" within the meaning of the Massachusetts historic tax credit statute.

7. Note: Because state taxes are generally deductible for federal corporate income tax purposes, an allocated state tax credit does not provide dollar-for-dollar tax savings. For example, a Massachusetts corporate taxpayer in a 21% federal tax bracket will reduce its combined Federal and Massachusetts tax liability by only 79 cents for every dollar of the Massachusetts credit. However, a state tax credit that has been transferred (as opposed to allocated among those with a direct or indirect ownership interest in the asset generating the credit) is more valuable because it is treated differently. In this case, the IRS has ruled that the use of a certificated credit to discharge the transferee's state tax liability will nevertheless be treated as a "payment" of state taxes which may be deducted from federal taxable income (a non-transferable credit is merely a reduction of state tax liability, which is ineligible for the federal deduction). CCA 200445046 (Massachusetts low-income housing and historic rehabilitation credits); PLR 200348002. In CCA 201147024, the IRS examined the tax consequences of the sale of certain Massachusetts state tax credits, including the Massachusetts low-income housing credit. While noting that receipt of the state tax credits by the taxpayer who originally qualifies for the credits is not a taxable event, the IRS stated that when a credit is transferred to another taxpayer for value, the original recipient must recognize gain because the transaction is a sale for federal income tax purposes. For purposes of calculating such taxable gain, the original recipient's basis in the state tax credits is zero since the taxpayer did not purchase the credit. Moreover, the original recipient's taxable gain on the sale of the state tax credits constitutes capital gain (typically short-term unless the credit is held for a year and a day), unless the credits fall within one of the statutory exclusions in Section 1221(a). Correspondingly, the purchaser of the state credits receives a cost basis in the credits equal to the consideration paid for the credits plus any transaction costs incurred in acquiring the credits (unless excluded as de minimis costs under Section 1.263(a)-4(e)(4)). Finally, the IRS concluded that when the purchasing taxpayer buys the state tax credits for less than their face value, the taxpayer must recognize gain when the tax credits are ultimately used to satisfy a state tax liability. *See also* CCA 200211042 (concluding that the use of state tax credits generates gain to the extent the face value of the credits exceeds the transferee's basis in the credits); *see also* VIII.B above.

8. In 2016, Section 6I(b) of the Massachusetts Low-Income Housing Tax Credit was revised to include a credit against Massachusetts income tax liability for property owners who donate existing housing or other structures to be converted to housing to a qualified nonprofit that is committed to preserving the property's long-term affordability (the "Donation Tax Credit" or "DTC"), which creates a new option for utilizing the existing Massachusetts LIHTC. *See* M.G.L. ch. 62, § 6I(b)(4). The DTC is worth 50% of the donated value (as determined by the Department, which may increase the amount of available credit to not more than 65% if deemed necessary for the project's viability) and is subtracted from the amount of state tax otherwise owed. Though modeled on the federal charitable contribution deduction, unlike the federal charitable contribution deduction, which is claimed at the time the property is donated, the DTC cannot be claimed until an Eligibility Statement is issued by EOHLC.

C. Recapture of Credit.

1. If a portion of any federal low-income housing tax credits taken on a project receiving Massachusetts low-income housing tax credits is required to be recaptured, the Massachusetts low-income housing tax credit authorized by the Department with respect to such project shall also be recaptured. The amount of state credits recaptured shall be equal to the amount of state low-income housing tax credits previously claimed times a fraction, the numerator of which shall be the amount of recaptured federal low-income housing tax credits and the denominator of which shall be the amount of federal low-income housing tax credits previously claimed. M.G.L. ch. 62, § 6I(d)(2); M.G.L. ch. 63, § 31H(d)(2).

a. <u>Comment</u>: Oddly enough, this means that a reduction in federal qualified basis can trigger recapture of the Massachusetts low-income housing tax credit, even though the amount of federal qualified basis may not have been taken into account in determining the amount of Massachusetts low-income housing tax credits allocated to the project. Additionally, any Massachusetts low-income housing tax credit allocated to the project and not yet claimed shall be disallowed upon recapture, regardless of whether the project comes back into compliance and is eligible to claim federal LIHTC in future years.

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

IX. COLLATERAL TAX ISSUES

A. Partnership Allocations.

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

1. Credits Generally. Low-income housing tax credits, unlike credits for historic rehabilitations, are not considered "investment tax credits." *See* Code § 38(b)(1)(5). Consequently, low-income housing tax credits are allocated in the same manner as the allocation of depreciation deductions with respect to the Qualified Basis on which these credits are claimed. *See* Treas. Reg. § 1.704-1(b)(4)(ii); *see also*, Chief Counsel Advice 200812023. Capital accounts are not reduced by the amount of these credits. In contrast, historic rehabilitation tax credits are allocated in proportion to the partners' share of profits and result in a charge to the partners' capital accounts.

2. Minimum Gain. Partnership allocations of depreciation must be respected under Section 704(b) (or Section 704(c)) in order for allocations of low-income credits to work as intended. A careful analysis of minimum gain is required in all LIHTC deals, particularly when depreciation and other deductions drive the capital accounts of the partners negative. Such analysis must show, in effect, that in a taxable disposition of the project for no consideration other than satisfaction of the debt to which it is subject, sufficient gain would be recognized to zero out the negative capital accounts of the partners.

    a. Note: Minimum gain may be generated even if the partners' capital accounts are positive. Accordingly, a minimum gain analysis is necessary even if the partners will not go negative during the Credit Period. Partner nonrecourse minimum gain (colloquially referred to as "bad" minimum gain) trumps a positive capital account. Accordingly, losses (and LIHTC) may be reallocated even if a limited partner has a positive capital account if partner nonrecourse debt minimum gain is generated.

3. Partner Nonrecourse Debt. If the partnership has loans from a partner or affiliates of a partner, including obligations concerning deferred development fees payable to such affiliates, and if the anticipated losses of the partnership, including depreciation, are sufficient to create partner minimum gain, the losses and accompanying credits may be subject to reallocation to the partner who made, or whose affiliate made, such loans. Such a reallocation is generally not required when the lending affiliate owns less than 80% of a partner taxed as a corporation. To prevent potential reallocations, it is not uncommon for a project sponsor to divest itself of more than 20% of the ownership of the general partner when the project sponsor will have loans to, or deferred fees payable from, the partnership.

    a. Note: In order to utilize the 79/21 disaffiliation structure, the general partner or managing member must be a corporation or taxed as a corporation (i.e., make an election under the check-the-box Regulations to be taxed as a corporation).

4. Nonrecourse Carveouts. Chief Counsel Memorandum 201606027 concluded that the existence of certain "bad boy guaranties" would cause a loan that was otherwise nonrecourse to become recourse. CCA 201606027. The guaranties at issue created

liability to the general partner if the general partner took certain actions that would negatively affect the partnership, such as admitting insolvency in writing, voluntarily declaring bankruptcy, or acquiescing in an involuntary bankruptcy. The CCA caused concern among practitioners as the nonrecourse carve-outs at issue are fairly standard in the industry. However, during the following month, the IRS acknowledged that the inclusion of the nonrecourse carve-out provisions in loan agreements was a common practice in the commercial real estate industry, and seemingly reversed its earlier guidance. CCA AM2016-001. In the subsequent memorandum, the IRS stated that because it was not in the economic interests of the borrower or guarantor to commit the enumerated bad acts, and because the borrower or guarantor was the party in control of whether such acts occurred, it was unlikely the bad act would occur and, thus, the contingent payment obligation should be disregarded under Section 1.752-2(b)(4). Accordingly, unless the facts and circumstances of a particular situation dictate a different conclusion, this type of nonrecourse carve out provision generally will not cause a liability which is otherwise nonrecourse to be considered recourse until the contingency actually occurs.

5. <u>Loans with a Built-In Forgiveness Feature</u>. The IRS may treat a loan of federal funds with a built-in forgiveness feature as a federal grant rather than a loan and thus exclude the amount of such loan from credit basis. *See Erickson Post Acquisition Inc.*, TC Memo 2003-218, non-acq A.O.D. 2006-001. If a loan with a built-in forgiveness feature is treated as a grant, it is likely to be income to the partnership. Partnership agreements in tax credit transactions often provide that grant income is allocable entirely to the general partner to avoid any reduction to the limited partner's tax benefits. However, if project losses are expected to exceed the capital contributions of the investor limited partners, such an income allocation, which would result in a positive capital account for the general partner, may adversely affect the allocation of losses and credits to the investor limited partners. *See* Paul, "IRC Section 704(b) Strategies for Low-Income Housing Partnerships" 14 Real Estate Tax Digest 165 (June 1996).

B. Depreciation of LIHTC Projects.

In late 2017, the U.S. Congress passed an act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, originally introduced in Congress as the Tax Cuts and Jobs Act, which significantly modified the Code. H.R. 1, 115th Congr. (2017), as amended by the Bipartisan Budget Act of 2018, H.R. 1892 115th Cong. (2018) and the Consolidated Appropriations Act, 2018, H.R. 1625, 115th Cong. Div. U, Title II, §§ 201–207 (2018) (the "TCJA"). The TCJA makes the most extensive changes to the U.S. tax code of any act since that enacting the 1986 Internal Revenue Code, including significant changes to provisions regarding depreciation.

1. Bonus Depreciation.

a. Section 168(k) of the Code provides for a special first-year depreciation allowance in excess of normal depreciation amounts for certain property. This extra first-year depreciation is known as "bonus depreciation."

b. The TCJA substantially amended the rules under section 168(k). Under former law, taxpayers generally received an additional depreciation deduction (bonus depreciation) of 50% of the adjusted basis of qualified property placed in service in the taxable year (phased down to 40% in 2019 and 30% in 2020). Bonus depreciation was unavailable for used property.

(i) Note: Prior law (including the phase-down) applies to property acquired before Sept. 28, 2017, even if it is placed in service after Sept. 27, 2017.

c. The TCJA extended bonus depreciation for qualified property. Under Section 168(k)(2), the term "qualified property" means, in part (as most relevant to LIHTC projects) property (i) which has a recovery period of 20 years or less, (ii) was not previously used by the taxpayer (or a related person) before the taxpayer purchased it, and (iii) which is placed in service before January 1, 2027.

(i) Significantly, 20 year property includes personal property and site improvements (not capitalized as part of the building).

d. Section 168 allows 100% bonus depreciation (i.e., full expensing) for property that is both acquired and placed in service after Sept. 27, 2017, generally reducing the percentage that may be expensed for property placed in service as follows: (i) in 2023, to 80%, (ii) in 2024, to 60%, (iii) in 2025, to 40%, and (iv) in 2026, to 20%. Accordingly, absent a legislative change, bonus depreciation is entirely eliminated for property placed in service starting in 2027.

e. Bonus depreciation applies by default, and accordingly, a taxpayer must affirmatively elect out under 168(k)(7) if it does not wish to claim bonus depreciation.

f. Since 2019, the IRS has published a series of Regulations applicable to Section 168, which have addressed and resolved some areas of uncertainty to the LIHTC industry.

(i) For example, Section 168(g)(1)(B) requires that tax-exempt use property under section 168(h)(6) be depreciated under the alternative depreciation system (ADS). Property required to be depreciated under ADS is not eligible for bonus depreciation. The Final Regulations make clear that the IRS will view only the tax-exempt entity's proportionate share of the property as determined under Section 168(h)(6) as tax-exempt use property ineligible for bonus depreciation. Treas. Reg. § 1.168(k)-2(b)(2)(ii)(B), T.D. 9874, 84 Fed. Reg. 50108 (September 24, 2019).

g. Note: If the LIHTC building also generates historic tax credits, the taxpayer must elect out of bonus depreciation with respect to any qualified improvement property in order to preserve historic tax credits. This is not an issue (i.e., the taxpayer does not need to elect out of bonus depreciation) in a typical LIHTC project since the type of property eligible for bonus depreciation (site work and personal property) cannot generate qualified rehabilitation expenditures.

h. Comment: LIHTC follows depreciation. Taking bonus depreciation may cause an investor (the limited partner) to run out of capital during the Credit Period and could result in a reallocation of LIHTC to the general partner, particularly in bond-financed projects.

2. Limitation of Deduction of Interest Expense and Exception for the Electing Real Property Trade or Business.

a. Under now-current law, the deduction for "business interest" under section 163(j) generally is limited to the sum of "business interest income," 30% of "adjusted taxable income," and floor plan financing interest. "Business interest" (for debtors) and "business interest income" (for creditors) include only interest of a trade or business (including residential rental projects). For taxable years beginning before January 1, 2022, "adjusted taxable income" means in essence the taxable income of the taxpayer attributable to the trade or business in question determined without regard to deductions for depreciation, depletion, and amortization. For taxable years beginning on or after January 1, 2022, "adjusted taxable income" is determined by taking into account depreciation, depletion, and amortization, resulting in a lower ceiling on the business interest deduction.

b. Disallowed interest may be carried forward indefinitely.

c. A taxpayer that operates a "real property trade or business" may make an irrevocable election to opt out of the business interest limitation. *See* Code §§ 163(j)(1) (limit on "business interest"), (6) ("business interest" is interest "properly allocable to a trade or business"), (7)(A) ("trade or business" does not include, inter alia, an "electing real property trade or business") & (7)(B) (definition of electing real property trade or business). The consequence of such an election is that the taxpayer's residential rental property, nonresidential real property and qualified improvement property used in such real property trade or business must be depreciated using the alternative depreciation system as in effect when the property was placed in service. *See* Code § 168(g)(8). Thus, the making of this election generally will result in an increase to the project's cost-recovery period from (i) 27.5 years to 30 years for residential rental property either (A) placed in service after 2017 or (B) placed in service prior to January 1, 2018 if such property is held by an electing real property trade or business and the property was not depreciated under the alternative depreciation system pursuant to Sections 168(g)(1)(A) through (E) prior to January 1, 2018 or (ii) 39 years to 40 years for nonresidential real property placed in service after 2017. *See* Rev. Proc. 2019-08. The election can be made by a "real property trade or business," which is "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business." Code § 469(c)(7)(C). The typical LIHTC partnership should qualify as a real property trade or business for purposes of the election.

d. Query whether passive holding of equity interests in LIHTC partnerships by an investment fund could be characterized as a real property trade or business such that interest expenses incurred in connection with the acquisition or holding of the interests (e.g., bridge loan interest) could be deducted under section 163(j).

C. Deferred Development Fees.

1. Bona Fide Debt. Any debt obligation, including an obligation to pay a deferred developer fee, must be respected as bona fide debt in order to be included in the basis of the project for credit and depreciation purposes. *See Corbin West Limited Partnership v. Comm'r*, T.C. Memo 1999-7 (January 15, 1999). At a minimum, this means that the obligation must have a definite maturity date and the partnership must be able to establish that it is likely to be paid on or before such date. *See* TAM 200044004, discussed in II.C.11 above.

    a. Comment: If the intent is for a deferred developer fee to generate "good" partnership nonrecourse debt minimum gain, the obligation should be secured by a mortgage on the project and the general partner's/managing member's obligation to contribute capital to pay off any deferred fee that remains outstanding at the end of the Compliance Period should be eliminated.

    b. A partnership was not allowed to include the amount of a developer's fee to be paid to its general partner in its basis calculation for claiming a rehabilitation tax credit because, under the terms of the partnership agreement, the partnership was obligated to pay the developer's fee "only to the extent of available cash" and a note evidencing the obligation to pay the fee was not executed until after the end of the year in which the partnership sought to include the full amount of the fee. *Brassard v. United States*, 183 F. 3d 909 (8th Cir. 1999).

2. Matching Income and Deductions. Generally, Section 267 requires a matching of the year in which a fee paid by a partnership to a partner or "related person" is deducted by the payor and the year in which it is included in the income of the payee. For this purpose, any partner and any owner of more than 5% of a corporate partner is a "related person." Code § 267(e)(1)(B) and (3)(B). This matching requirement is not a problem if the payee is a tax-exempt organization and the fee does not represent unrelated business taxable income. *See* PLRs 9438030 and 8938002, holding that development fees are not unrelated business taxable income. In LIHTC deals, developers, particularly for-profit developers, are often cash-basis taxpayers and accordingly, depreciation attributable to the deferred portion of the developer fee will be suspended until paid. However, LIHTC are not deferred.

D. Partnership Anti-Abuse Regulations.

1. Treasury Regulations provide that if a partnership is formed or availed of in connection with a transaction, the principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of provisions of the Code dealing with the taxation of partnerships ("Subchapter K"), the IRS can recast the transaction to achieve tax results that are consistent with that intent. Treas. Reg. § 1.701-2(b). The use of partnerships to take advantage of low-

income housing tax credits does not appear to trigger these anti-abuse Regulations. The Regulations include an example involving a general partnership of three partners formed to own and operate a building qualifying for low-income housing tax credits, utilizing nonrecourse financing. The partnership agreement provides for a special allocation of all depreciation and tax credits to two partners in high tax brackets and none to the third partner which has net operating loss carryforwards in a manner that satisfies the Section 704(b) Regulations. The transaction in this example is stated not to be inconsistent with the intent of Subchapter K and not subject to recasting by the IRS. Treas. Reg. §1.701-2(d), Example 8. Note: Although not specifically addressed in the example, if the partner who is not allocated credits and depreciation made a capital contribution, satisfaction of the Section 704(b) rules should require a deficit restoration obligation from the other two partners.

E. Economic Substance.

1. Codification. Pursuant to Section 7701(o), entitled the "Clarification of Economic Substance Doctrine" a transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Under Section 7701(o), a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction. The legislative history of the Act states that tax benefits designed by Congress to effectuate a Congressional purpose or plan are not intended to be disallowed through Section 7701(o). It is not intended that a tax credit (for example, Section 42 low-income housing credit, Section 45 production tax credit, Section 45D new markets tax credit, Section 47 rehabilitation credit, Section 48 energy credit, and other such tax benefits which may be determined by the IRS) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the tax credit was intended to encourage. *See* footnote 344 of the Joint Committee's special report on the Health Care and Education Reconciliation Act of 2010.

2. In *Historic Boardwalk Hall, LLC, et al. v. Commissioner*, 136 T.C. No. 1 (January 3, 2011), the Tax Court determined that an LLC/partnership that was formed by a state agency and historic tax credit investor, to allow the historic tax credit investor to invest in the rehabilitation of a historic building and obtain Section 47 credits, had objective economic substance, notwithstanding that the investment was not expected to produce a profit apart from the credits.

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

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

On December 30, 2013, the IRS issued Rev. Proc. 2014-12 which provides a safe harbor for tax credit partnerships allocating historic tax credits to partners. Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (as revised on January 8, 2014). The IRS will not challenge a partnership's allocation of historic tax credits to its partners if the partnership satisfies the requirements of the safe harbor. The safe harbor includes requirements for many common features of tax credit deals, including (i) the timing and amount of the tax credit investor's contribution to the partnership, (ii) the amount and duration of the tax credit investor's interest in the partnership's income, gain and loss, (iii) the terms and funding of guarantees to the tax credit investor and (iv) the terms and availability of purchase and sale rights (e.g.,. call options). Per its terms, the Revenue Procedure does not apply to allocations of federal credits other than Section 47 historic tax credits (such as low-income housing tax credits) or to state credit transactions and "does not indicate the circumstances under which the IRS may challenge allocations of such other credits." *Id*. at §3. To date, most low-income housing tax credit investments have not been structured to comply fully with this safe harbor.

F. Federal Tax Treatment of State Tax Credits.

1. In the Virginia historic tax credit cases, various investors and a promoter formed a partnership (the "Fund"), which invested in operating partnerships that undertook historic rehabilitations qualifying for a state tax credit, which they allocated to the Fund in

consideration of capital contributions. Under the terms of the Fund partnership agreement, the investors contributed cash in exchange for the allocation of state tax credits allocated to the Fund by the operating partnerships. The investors also executed option agreements granting the Fund an option to repurchase the investors' interests for their fair market value for a period of one year. Investors were admitted to the Fund between November, 2001 and April, 2002 and all were bought out by the Fund in May, 2002, claiming large capital losses. The marketing materials disseminated to the investors in connection with the transactions stated that investors would not receive any material distributions of cash flow or net proceeds from a sale of the project and would not be allocated material amounts of federal income tax credits or partnership items of income, gain, loss, or deduction. Any return on investment was dependent entirely upon the allocations of the state credits and the capital loss generated upon the sale of the investors' interests.

2. In Chief Counsel Advices 200704028 and 200704030 released on January 26, 2007, the Chief Counsel advised the IRS to recast the purported allocations of state credit by the Fund. The Chief Counsel determined that the partnership allocations of the state credits to investors should not be respected for federal tax purposes based on three theories. Applying the anti-abuse Regulations, the Chief Counsel determined that the partnerships involved were formed in connection with transactions, a principal purpose of which was to reduce substantially the present value of the partners' aggregate tax liability in a manner inconsistent with the intent of Subchapter K. Treas. Reg. §1.702-2. The Chief Counsel also argued that (i) no partnership existed for tax purposes because there was no joint profit motive between the developer and the investors and (ii) the disguised sale rules under Section 707(b) applied to the transfer of the credits to the investors. Accordingly, the Chief Counsel urged the IRS to disregard the partnerships or the status of the investors as partners and recast the transactions for federal tax purposes as a sale of state credits by the Fund to the investors, fully subject to gain recognition, and to disallow any capital losses on the transaction.

3. In Virginia Historic Tax Credit Fund 2001 LP, (2009) TC Memo 2009-295, after the IRS conceded that it would not ignore the Fund as a partnership, the Tax Court ruled that the investors were partners for federal income tax purposes under the principles of *Commissioner v. Culbertson*, 337 U.S. 733 (1949) and *Commissioner v. Tower*, 327 U.S. 280 (1946) and that the allocation of state credits to them were not sales of such credits, either in substance or under the disguised sale rules of Section 707(b).

4. The Court of Appeals for the Fourth Circuit reversed the Tax Court in *Virginia Historic Tax Credit Fund 2001 LP et al. v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), recharacterizing the Fund's exchanges of state tax credits for investor contributions as "disguised sales" under Section 707. The Fourth Circuit's opinion raises a number of questions.

  a. To find a "disguised sale," the Court had to determine that the allocation of credits to investors in the Fund, was a "transfer of property" from the Fund to its investors for purposes of Section 707. Arguably this finding is contrary to the position of the IRS in Income Tax and Accounting 200211042, to the effect that the issuance of a state tax credit is simply a reduction in the recipient's state tax liability and is not includible in income or otherwise treated as a payment (of cash or property) from the state. *See also* PLR 200951024 and CCA 201147024. ITA 200211042 further provides that the existence of a right of transferability, without more, does not change this tax treatment or cause the issuance of the credit to be treated as the receipt of "property." The Fourth Circuit does not mention this analysis or explain why the result would be different if a state credit is issued to a partnership and allocated among its partners.

b. The Fourth Circuit also claims not to address whether there was a disguised sale between the Fund and the operating partnerships by reason of Fund's capital contributions to the operating partnerships and the related allocation of credits from the operating partnerships to the Fund. "It bears emphasizing that we are not deciding whether tax credits always constitute "property" in the abstract. Rather, we are asked to decide only whether the transfer of tax credits acquired by a non-developer partnership to investors in exchange for money constituted a "transfer of property" for purposes of §707." The logical basis for a distinction between the allocations of state credits to the Fund and by the Fund is unclear. If the distinction is based on the relatively short-lived investor interests in the Fund, perhaps the Court should have said so.

5. In *George H. Tempel*, 136 T.C. No. 15 (2011), the Tax Court held that transferable state tax credits were capital assets, rejecting the Commissioner's argument that the reduction of state tax liability was the equivalent of a right to ordinary income. The Tax Court further held that taxpayers had no basis in the credits and that the holding period began when the credits were granted and ended when they were sold.

6. In Chief Counsel Advice 201147024, the IRS determined that the sale of Massachusetts Low-Income Housing Tax Credits, as well as other state tax credits, to a third party by the original recipient is a taxable event. Accepting the conclusion of ***Tempel***, the IRS stated that the original recipient of the Massachusetts tax credit has no tax basis in the credit and would recognize capital gain on the sale of a nonrefundable credit, unless the credit falls within a statutory exclusion in Section 1221(a). Moreover, the purchaser of the Massachusetts Low-Income Housing Credit will take a cost basis in the credit and will have to recognize gain on his or her use of the credit if he or she purchased the credit for less than its face value.

7. In *Route 231, LLC, et al.*, TC Memo 2014-30, a state tax credit investment fund, Virginia Conservation, was admitted to Route 231, LLC, with a 1% interest and the remaining interests were held 49.5% each by John Carr, the tax matters partner, and another individual. Virginia Conservation contributed $0.53 per $1.00 of credit for a total of $3,816,000 to the LLC and received an allocation of $7,200,000 of state credits, approximately 97% of the total credits. The remaining credits were allocated to Mr. Carr.

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

b. The Tax Court rejected the argument that Route 231 did not transfer property to Virginia Conservation for purposes of Section 707(a)(2)(B)(ii) because the Virginia tax credits "retained their character as potential reduction of taxes." Relying on *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 at 140 (discussed in IV.E.4 above) the Court effectively concluded that a disproportionate allocation of credits in exchange for a contribution of money was, in substance, a disguised sale of those credits. Notably, the Court did not conclude (or apparently consider) that the allocation of credit to Mr. Carr, who made no related cash contribution, was a disguised sale.

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

8. In *SWF Real Estate LLC, et al.*, TC Memo 2015-63, a state tax credit investment fund, Virginia Conservation, was admitted to SWF Real Estate, LLC ("SWF") with a 1% interest and the remaining 99% interest was owned by Yellowfish Investments, Inc. Virginia Conservation contributed $0.53 per $1.00 of credit for a total of $1,802,000 to SWF and received an allocation of $3,400,000 of credit. The Tax Court rejected the argument that SWF did not transfer property to Virginia Conservation for purposes of Section 707(a)(2)(B)(ii) because the Virginia tax credits "were valuable and imbued with essential property rights because they induced Virginia Conservation to invest in SWF, and both SWF first and then Virginia Conservation had the right to use the Virginia tax credits on their State tax returns, benefit from the Virginia state tax credits through a reduction of State tax liability, and exercise control over the Virginia tax credits to sell or transfer them in the State tax credit marketplace." Relying on *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 at 140 (discussed in IV.E.4 above), the Court effectively concluded that a disproportionate allocation of credits in exchange for a contribution of money was, in substance, a disguised sale of those credits.

9. *See* Day, *State Tax Credits Can Be a Real Drag*, Bloomberg BNA Tax Mgmt. Real Est. J. (2016).

G. Imputed Interest.

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

1. In Revenue Ruling 98-34, 1998-2 C.B. 118, the owners of a HUD-subsidized housing development did not realize income when they received a below-market HUD second mortgage made under the Multifamily Assisted Housing Reform & Affordability Act of 1997 and used the proceeds to retire a portion of an existing federally-insured first mortgage loan. The refinancing was effected to facilitate a reduction in rental assistance which would have caused the project to be unable to service the existing first mortgage loan.

2. If the project in Revenue Ruling 98-34 were a tax credit project, this refinancing would no longer cause it to become "federally subsidized," and will not result in a reduction of credits. *See* I.B.3 above.

3. Comment: When a loan is made in exchange for property, e.g., seller-financing in connection with a purchase of real property, Section 7872 does not apply and interest is imputed under Section 1274, which contains no exception for loans from governmental or charitable organizations. Thus, if a below-market note is issued to a charitable or governmental entity as the seller of property, a portion of the stated principal amount of the note will be recharacterized as interest and the cost basis of the property will be reduced accordingly. Similarly, a "significant modification" of a loan (within the meaning of Section 1.1001-3) from a governmental or charitable organization will result in cancellation of debt income if the modified loan does not bear interest at or above the AFR. CCA 199943037.

4. Modification of Assumed Debt. It is not unusual in the context of a re-syndication for the acquirer to assume existing debt as part of the acquisition. Often, the terms of such existing debt are modified in connection with the acquisition, for example, the term of the debt may be extended or the interest rate reduced, sometimes retroactively.

a. Note: If the interest rate is reduced retroactively (i.e., accrued interest is effectively forgiven), the debtor will likely recognize cancellation of debt ("COD") income. A "significant modification" of a debt instrument is treated as a deemed exchange of the original debt ("old debt") for a new debt instrument ("new debt") that differs materially either in kind or extent. Treas. Reg. §1.1001-

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

H. Property Taxes and Related Issues.

1. Depending on state or local law, a low-income housing project may be assessed using the capitalization of income method that takes into account restricted rents, but does not take into account federal low-income housing credits received by the project’s owner. *See, e.g. Willow Bend Estates, LLC v. Humphreys County Board of Supervisors*, No. 2012-AI-00575-SCT, 2013 BL 287653 (Miss. Oct. 17, 2013); *Stillwater Housing Associates v. Rose*, 254 P.3d 726 (Okla. Civ. App. 2011); *Cottonwood Affordable Housing v. Yavapi County, et al.*, 72 P.3d 357 (Ariz. Tax 2003); *Cascade Court Limited Partnership v. Noble*, Wash. Ct. App., No. 42539-I-I (April 4, 2001). *But see*, *Gillian Franks v. Town of Essex*, 2013 V.T. 84 (Vt. Sup. Ct. 2013) (existence of a housing-subsidy covenant does not automatically reduce the property’s value for *ad valorem* tax purposes but instead should be individually considered in determining a property’s fair market value); *Beechwood II, L.P. v. Clermont County Bd. of Revision*, 2011 Ohio 5449 (Ohio Ct. App. 2011) (while federal low-income housing tax credits can be valued as separate from the underlying real estate, taxpayer has the burden of showing the allocation of the purchase price to assets other than the realty); *Brandon Bay Ltd. Partnership v. Payette County*, 2006 WL 695529 (Idaho 2006) (appraisal properly took into account both federal low-income housing credits and restricted rents); *Huron Ridge LP v. Township of Ypsilanti*, 2005 WL 1798589 (Mich. Tax Tribunal 2005); *Town Square Ltd. Partnership v. Clay County Board of Equalization*, 704 N.W.2d 896 (S.D. 2005); *Spring Hill, L.P. v. Tennessee State Bd. of Equalization*, 2003 WL 23099679 (Tenn. Ct. App. 2003); *In Re Appeal of Green Pines Ltd.*, 576 S.E.2d 316 (N.C. 2003) (appraisal properly valued project using market rents because the rent restrictions were voluntarily assumed by the project in order to take advantage of available federal and state tax incentives).

a. Note: The value of remaining federal low-income housing tax credits may be taken into account when valuing a party’s secured claim in a low-income project in a bankruptcy proceeding. *See, e.g., In re Lewis and Clark Apartments, LP*, 479

B.R. 47 (B.A.P. 8th Cir. 2012*); In re Creekside Senior Apartments, LP, et al., Debtors*, 477 B.R. 40 (B.A.P. 6th Cir. 2012), *aff'd In re Creekside Senior Apartments, LP, et al., Debtors*, 489 B.R. 51 (B.A.P. 6th Cir. 2013). Both courts held that as the right to tax credits is not a separate asset but instead a covenant that runs with the underlying property, the value of the credits and any related rent restrictions should be taken into account in valuing the project property.

2. State courts have found that the involvement of for-profit limited partners in providing low- and moderate-income housing does not prevent property owners from qualifying for a real estate tax exemption. *See In re Blue Ridge Housing of Bakersville LLC*, 738 S.E.2d 802 (N.C. Ct. App. 2013) (project owned 0.01% by a 501(c)(3) nonprofit corporation qualified for an *ad valorem* property tax exemption for nonprofit organizations providing low and moderate income housing in North Carolina); *McLennan County Appraisal District v. American Housing Foundation*, Tex. App., No 10-08-00416-CV, 3/9/11 (providing low- and moderate-income housing is specifically considered a charitable function under Texas Tax Code, and limited partnerships that own such property may qualify for a real estate tax exemption if a charitable organization organized under Internal Revenue Section 501(c)(3) owns 100 percent of the general partner interest). *But see, Gulf Coast Housing Partnership, Inc. v. Bureau of the Treasury of the City of New Orleans, et al.*, 129 So.3d 817 (La. App. 4th Cir. 11/27/2013) (Louisiana low-profit limited liability companies wholly-owned by a Delaware 501(c)(3) nonprofit corporation were subject to *ad valorem* property taxes on immovable property located in Louisiana where the property was titled to the limited liabilities companies and not clearly dedicated to public purposes).

I. Tax-Exempt-Use Property.

1. Participation by a tax-exempt organization in a project may cause all or a portion of the property to be treated as "tax-exempt-use property" under Section 168(h). Section 168(g)(1)(B) of the Code requires tax-exempt use property to be depreciated using the alternative depreciation system (ADS). As a result, if property placed in service prior to 2018 is treated as tax-exempt-use property, it will have to be depreciated over a 40-year recovery period rather than over a 27.5 year recovery period. Because the TCJA changed the ADS recovery period for residential real property, for tax-exempt use property placed in service after 2017, the recovery period is 30 years. *See* Code § 168(g)(2)(C). Section 470 generally limits losses with respect to tax-exempt use property, but does not apply to projects to which Section 42 applies. In general, property owned by a partnership in which a tax-exempt entity is a partner constitutes tax-exempt-use property, at least in part. The portion of such property treated as tax-exempt-use property is the highest percentage of partnership income or gain (other than Section 704(c) gain) which the tax-exempt entity may receive. For these purposes, a "tax-exempt controlled entity", which is defined as any corporation of which tax-exempt entities own 50% or more of the stock, is treated as a tax-exempt entity, unless it elects under Section 168(h)(6) to have its tax-exempt owner treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the controlled entity. Thus, to avoid tax-exempt use property concerns, a tax-exempt organization should own its interest in a partnership indirectly through a taxable corporate subsidiary which elects under Section 168(h)(6) to have the tax-exempt parent treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the taxable subsidiary. This will ensure that no portion of the project would be treated as tax-exempt-use property. Note: The election must be made by the due date of the tax return for the first taxable year for which the election is to be effective. Treas. Reg. § 301.9100-7T(a)(2)(i). *See also* PLR 201411009; PLR 201340006 (October 18, 2013); PLR 201249003; PLR 201230002; PLR 199933043 (noting that the IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that they acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government).

a. During a discussion of Tax Credit Hot Topics during the May 2016 ABA Forum held in Washington, D.C., a general consensus emerged that a for-profit subsidiary corporation formed by a housing authority cannot make a Section 168(h)(6)(F)(ii) election. Because its sole shareholder, the housing authority, cannot recognize UBTI, the election and the related treatment of income from the subsidiary as UBTI would be unenforceable against the housing authority. Additionally, a corporate subsidiary of a housing authority likely would not qualify as eligible to make the election under the definitions of tax-exempt entity and tax-exempt controlled entity in Sections 168(h)(2) and (h)(6)(F)(iii) because it would likely be treated as an instrumentality and entities that are tax-exempt without regard to their status as tax-exempt controlled entities cannot make the election. However, a housing authority likely could create an affiliate exempt from tax under Sections 501(c)(3) or (c)(4), including a supporting organization described in Section 509(a)(3), which, in turn, could form a for-profit wholly-owned subsidiary, which for-profit subsidiary could be treated as a tax-exempt controlled entity that may make a valid election. The for-profit subsidiary of the of the Section 501(c)(3) or (c)(4) entity should not be treated as an instrumentality of a State or political subdivision because (1) all of its activities are subject to income tax and (2) a majority of the board of directors of the corporation are selected by the Section 501(c)(3) or (c)(4) organization, which is not a State or political subdivision thereof. *See* Code § 168(h)(2)(D).

2. In addition, at the May 2024 ABA Forum on Affordable Housing, a representative from Treasury indicated that government sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, are tax-exempt controlled entities within the meaning Section 168(h)(6)(F)(i). Query: Does ownership of an investor fund by a GSE cause all or a portion of a LIHTC partnership's property to be ineligible for federal energy and/or historic rehabilitation credits and/or bonus depreciation?

J. Reportable Transactions: Disclosure Requirements and Excise Taxes.

1. Disclosure Requirements. Section 6011 and the Regulations thereunder impose reporting requirements on certain categories of transactions and may apply to an investment in a low-income housing transaction. The disclosure requirements apply to "reportable transactions" which include, among other things, transactions in which there is "contractual protection", that is a transaction in which a taxpayer or a related party (as defined in Section 267(b) or 707(b)) is entitled to a full or partial refund (or a reduction) of fees paid to a person who provides a statement (written or oral) about the tax consequences of the transaction (or for whose benefit a statement is made or provided to the taxpayer or related party) if all or part of the intended tax consequences from the transaction are not sustained. Treas. Reg. § 6011-4(a). These transactions must be reported by any taxpayer whose income tax or informational return reflects a tax benefit from the transaction and who would be entitled to a full or partial refund of fees. There had been concern that investments in low-income housing tax credit transactions would be subject to these disclosure requirements because of the "contractual protection" often provided by tax credit adjuster and other transaction guaranties. The IRS, however, has ruled that transactions in which there is a refundable or contingent fee "related to" low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, 2007-1 C.B. 517.

2. Excise Taxes. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), enacted on May 17, 2006, created Section 4965, which designates certain transactions as prohibited tax shelter transactions and imposes excise taxes on a tax-exempt organization and its managers if the organization becomes a party to a "listed transaction" or a "prohibited tax-shelter transaction." Code § 4965(a)(1). Although a "prohibited tax-shelter transaction." includes a transaction with contractual protection under Section 1.6011-4(b)(4), the IRS has ruled that transactions in which there is a refundable or contingent fee "related to" low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, 2007-1 C.B. 517.

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

K. Electronic Filing and Form 8609.

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

L. Hurricane and Other Disaster-Related Relief.

1. Projects located in federally-declared major disaster areas or individuals identified for assistance by FEMA are frequently offered temporary relief from Section 42 requirements, including relief related to certain income limitation requirements, carryover allocations, recapture, compliance monitoring, requirements related to the first year of the Credit Period, the amount of credit allowable to a building that has been restored, emergency housing for qualified rental housing developments financed by low-income housing credits or tax-exempt bonds, and so on. *See, e.g.*, Notice 2022-52, 2022-43 I.R.B. 337; Rev. Proc 2014-49, 2014-37 I.R.B. 535 (superseding Rev. Proc. 2007-54, 2007-2 C.B. 293; Rev. Proc. 95-28, 1995-1 C.B. 704); *see also* Notice 2013-64, 2013-42 I.R.B. 438; Notice 2013-40, 2013-25 I.R.B. 1254 (as amplified by Notice 2013-47, 2013-31 I.R.B. 120); Notice 2012-68, 2012-48 I.R.B. 574; Notice 2012-7, 2012-4 I.R.B. 308; Notice 2011-83, 2011-43 I.R.B. 593; Notice 2011-74, 2011-41 I.R.B. 496; Notice 2011-65, 2011-34 I.R.B. 173.

M. Form 8823 and IRS Audit Technique Guide

1. IRS Form 8823, Low- Income Housing Credit Agencies Report of Noncompliance or Building Disposition, which is used by state housing agencies to fulfill their responsibility under Section 42(m)(1)(B)(ii) to notify the IRS of noncompliance with the low-income housing tax credit provisions or any disposition of a building, was last revised in 2023.

2. Note: Before reporting noncompliance to the IRS, state agencies must provide the taxpayer with a period of time, not to exceed 90 days from the date of the notice to the owner identifying the noncompliance, to correct the noncompliance. This period of time may be extended by the state agency for up to a total of 6 months upon a determination of good cause for granting such extension. Within 45 days of the conclusion of the period of correction, the state agency must report the noncompliance to the IRS using Form 8823. Audit Technique Guide (rev. Jan. 24, 2024).

3. The Audit Technique Guide provides taxpayers with an extensive discussion of frequent and potential pitfalls of noncompliance, including discussions on, for example, the authority of state agencies to determine a building is no longer participating in the program, deferred developer fee documentation, units occupied by on-site managers, maintenance personnel and security guards, emergency housing relief, deep rent skewing, general public use requirements, casualty losses in federally declared disaster areas, partial disallowance of credit during the Credit Period, and other pertinent issues. *Id.*

N. Legislative Updates.

1. The most recent legislative changes that were *enacted* affecting the LIHTC program were made as part the Inflation Reduction Act of 2022 (P.L. 117-169) (previously H.R. 5376). Specifically, Public Law 117-169 allows developers that combine LIHTC with either the Section 48 energy investment tax credit/Section 48E clean electricity investment tax credit or the Section 45L energy efficient homes credit to realize the full benefits of those credits without reducing Eligible Basis for purposes of Section 42. *See* Code § 50(c)(3) (stating that basis adjustments to investment credit property shall not apply for purposes of determining eligible basis under Section 42); 45L(e) ("This subsection shall not apply for purposes of determining the adjusted basis of any building under section 42.").

Although there were many more proposed changes to Section 42 when the bill was first introduced as H.R. 5376, many of those proposals were ultimately removed. Note: While Eligible Basis is not required to be reduced by the amount of the Section 48 energy investment tax credit, Section 48E clean electricity investment tax credit or Section 45L energy efficient homes credit, depreciable basis must continue to be reduced by 50% of the Section 48 energy investment tax credit/ Section 48E clean electricity investment tax credit and 100% of the Section 45L energy efficient homes credit.

2. The most recent *proposed* legislative changes were introduced on March 7, 2023, by the 118th Congress as S. 680, the DASH Act (Decent, Affordable, Safe Housing for all Act). Since its introduction, no actions have been taken to further this Act. However, the proposals contained therein applicable to the LIHTC program reflect common recurring issues in the LIHTC industry today. The proposed changes include:

- **a.** lowering the bond threshold on developments that combine LIHTCs with tax-exempt bond financing from 50% to 25%;
- **b.** increasing the amount of tax credits states receive in 2023 from $2.75 per person to $3.90 per person, and then to $4.875 per person in 2024 (not including an inflation adjustment that would apply in 2024), and adjusting for inflation thereafter;
- **c.** requiring that at least 8% of a state's annual allocation authority be reserved for buildings serving extremely low income households;
- **d.** designating Indian areas and rural areas as difficult to develop areas (DDAs);
- **e.** allowing state housing finance agencies (HFAs) to provide a 30% basis boost to properties utilizing 4% credits and tax-exempt bond financing if deemed necessary for financial feasibility;
- **f.** providing a 50% basis boost for projects that reserve dedicated space for providing qualified supportive services;
- **g.** removing the requirement that state HFAs notify local jurisdictions of proposed LIHTC projects in such jurisdictions and removing the requirement that HFAs give jurisdictions reasonable opportunity to comment on the project;
- **h.** repealing the qualified contract option; and
- **i.** modifying and clarifying the right of first refusal rules.

3. Revised Partnership Audit Rules. The Bipartisan Budget Act of 2015 (BBA), enacted into law on November 2, 2015. H.R. 1314, 114 Cong. Title XI, § 1101 (2015), replaced longstanding rules governing partnership audits, enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), with a new centralized regime, generally for tax years beginning after December 31, 2017. Congress has amended the new audit provisions twice, by the omnibus appropriations bills for 2016 and 2018. *See*

Consolidations Appropriations Act, 2016, H.R. 2029, 114th Cong. Div. Q, Title IV, § 411 (2015) (Div. Q. of the Act is the "Protecting Americans From Tax Hikes Act of 2015"); Consolidated Appropriations Act, 2018, H.R. 1625, 115th Cong. Div. U, Title II, §§ 201–207 (2018) (the "2018 Technical Corrections"). The audit rules are codified as subchapter C of chapter 63 of the Code, sections 6221 through 6241.

a. The new audit rules were intended to make partnership audits more efficient by avoiding multi-tier audits and determinations at the partner level. *See* Notice 2016-23, 2016-12 I.R.B. They provide generally that adjustments to items of income, gain, loss, deduction, or credit of a partnership are determined, and related tax attributes are assessed and collected, at the partnership level, not the partner level. In addition, the rules require a partnership to designate a partnership representative, which must be a person with a substantial presence in the United States. Bipartisan Budget Act § 6223. Generally, a partnership may elect out of the new regime if it meets certain criteria regarding the number and nature of its partners.

b. The 2018 Technical Corrections, among other things, (i) provide for the "push-out" of payments to partners in "tiered" partnership structures, (ii) clarify the scope of partnership audits, (iii) address the determination of an imputed underpayment, (iv) add a process for modifying imputed underpayments without having partners file amended returns (often referred to as the "pull-in" procedure), (v) address the statute of limitations, (vi) clarify rules regarding nonpayment of an imputed underpayment, and (vii) provide for payment of deposits to suspend interest.

c. The IRS has published Regulations implementing the new audit rules under Subchapter 63C of the Code, as amended by the Bipartisan Budget Act of 2015, P.L. 114-74 the Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113, and the Consolidated Appropriations Act of 2018, P.L. 115-141.

d. The new partnership audit rules permit a partnership to make a "push-out" election, to cause the audit adjustments to be allocated to the partners in the year subject to audit, rather than have the partnership pay such adjustment, which could result in current partners bearing the economic burden of the adjustment rather than former partners who were partners in the year subject to audit.

(i) <u>Comment</u>: It is advisable for partnership and operating agreements to include a contractual obligation pursuant to which (i) each partner/member (including former partners/members who held an interest during the year under audit) be required to make a capital contribution or indemnity payment to the partnership/company in the event a push-out election is not made and the partnership/company is liable for the adjustment and (ii) the foregoing obligation survives the liquidation of the partnership/company or any partner's/member's transfer of its interest.

O. GAO Report

1. The United States General Accounting Office (GAO) issued a report on July 15, 2015, stating that Congress should designate HUD as a join administrator of the LIHTC program. It asserted that HUD should provide oversight to HFAs, because it already relies on HFAs to implement its programs and has processes and procedures in place to conduct oversight. It also recommends that HUD analyze the effectiveness of LIHTC while the IRS continues to be responsible for monitoring taxpayer compliance and enforcing tax law. GAO argues that IRS does not have the staff or budget to properly oversee the program and joint administration would "better align program responsibilities with each agency's mission and more efficiently address existing oversight challenges." GAO Report, GAO-15-330, July 15, 2015.

2. GAO issued a subsequent report on May 11, 2016, reviewing oversight of the LIHTC program. The 2016 report mentions the July 2015 report and reiterates its suggestion that HUD play a larger role in oversight of LIHTC. GAO contends that the IRS has a limited ability to identify noncompliance issues and potential recapture events because it does not possess the data to do so, whereas HUD already maintains a number of databases with relevant information that it analyzes for a variety of purposes. The report concludes by recommending that (1) the IRS collaborates with allocating agencies and the Department of Treasury to clarify rules regarding reporting noncompliance, (2) the Small Business/Self-Employed Division of the IRS participates in the Rental Policy Working Group's physical inspection alignment initiative, and (3) the IRS evaluates how it could utilize HUD's REAC databases for reviewing noncompliance information. GAO Report, GAO-16-360, May 11, 2016.