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THE LOW -INCOME HOUSING CREDIT

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

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**HIGHLIGHTS OF
2009 EDITION**

The American Recovery and Reinvestment Act of 2009 was signed into law (P.L. 111-5) by the President on February 17, 2009. As part of the economic stimulus package, the Act amended several business tax provisions of the Internal Revenue Code. This Outline highlights the key change in the Section 42 Low Income Housing Tax Credit, namely the introduction of the LIHTC Exchange program. Pg. 50.

The Housing and Economic Recovery Act of 2008 ("HERA") was signed into law by the President on July 30, 2008. The LIHTC and other housing related programs were modified through the Housing Tax Incentives title of the Act. This Outline highlights key changes to the Section 42 Low Income Housing Tax Credit. Generally, the changes are effective for projects placed in service after the date of enactment, July 30, 2008. For a separate summary of the HERA changes to the Low-Income Housing Tax Credit, see www.eapdlaw.com or Paul and Garciano, Low-Income Housing Tax Credit Highlights from the Housing and Economic Recovery Act of 2008, 25 Real Estate Finance, Number 4 (December 2008), page 9.

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I. TIMING AND AMOUNT OF CREDIT

A. Ten Year Period.

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

1. The first-year credit is reduced to reflect the number of months of qualified occupancy (determined as of the last day of each month) during the first year. Note that although first-year occupancy is determined at the end of each month, a unit must be in service for the full month to qualify for credits. Code §42(f)(2)(A)(i); Rev. Rul. 2004-82, IRB 2004-35.

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

3. Credit Period for costs of acquiring existing building generally does not begin until the building has been substantially rehabilitated. Code §42(f)(5). For projects consisting of the acquisition of an occupied building and a substantial rehabilitation of the building, the taxpayer may claim first-year credits for both rehabilitation and acquisition costs based on the number of full months of occupancy of the acquired building during the year the rehabilitation expenditures are placed in service, provided the tenants are certified as qualified tenants within a reasonable period following the acquisition of the building. Code §42(e)(4)(B); PLR 200044020 (August 3, 2000). Comment: Absent an election to defer the start of the Credit Period (see A.5., infra), this rule may result in a loss of credits for investors admitted after acquisition but prior to completion of the rehabilitation when all events occur in the same year.

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

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

5. Comment: Election to defer Credit Period may be useful:

a. to avoid "wasting" of credits prior to syndication (see A.3., supra);

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

c. to avoid reduction of credits to 2/3 of applicable percentage for units first occupied by eligible tenants after year of placement in service, see C.3., infra; and

d. to cause federally funded grants to be made prior to Compliance Period (defined in D., infra) and thereby avoid basis reduction. See B.3.e., infra.

6. Placed 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 (July 24, 1992); CCA 200137044, Question 1 (June 28, 2001).

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 Code §42(e)(3)(A) is met in less than a 24-month period, the taxpayer may elect to place the rehabilitation expenditures in service at the close of that shorter period of time. PLR 200044020 (August 3, 2000).

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

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

B. Amount of Credit.

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

a. Rehabilitation expenditures are treated as "new buildings" provided that they are allocable to or substantially benefit one or more low-income units and that the amount of such expenditures incurred within any 24-month period equals the greater of 20% of the adjusted basis of the building or an amount sufficient to cause the "Qualified Basis" resulting from such expenditures to equal or exceed $6,000 per low-income unit, adjusted from 2008 for inflation. Code §42(e), as amended by the Housing and Economic Recovery Act of 2008 ("HERA"). Expenditures for common areas may provide the requisite substantial benefit. PLR 9338013 (June 23, 1993).

b. Rehabilitation expenditures on buildings acquired from governmental entities need only be $6,000 per low-income unit to qualify as a "new building." Code §42(e)(3)(B).

c. The IRS has ruled that when a developer of a condominium project in which the units had been developed and held for sale sells condominium units to an unrelated partnership which intends to hold the units as low-income housing, the units are "new buildings" in the hands of the partnership, provided that no depreciation had been claimed by the developer with respect to the units. PLRs 9101006 (Jan. 4, 1991) and 9120021 (Feb. 19, 1991).

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2. An annual amount over the Credit Period intended to have a present value equal to 30% of Qualified Basis (the "30% Present Value Credit"), or approximately 3-4% annually, for

a. new buildings receiving other federal subsidy; or

b. existing buildings.

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

a. For this purpose, pursuant to HERA, "federal subsidy" means only tax-exempt financing. Below-market federal loans will not cause a building placed in service after July 30, 2008 to be treated as federally subsidized**.**

b. If a building owner elects to reduce eligible basis 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 for the taxable year in which the building is placed in service on Form 8609. Treas. Reg. § 301.9100-7T(b). The IRS may grant a reasonable extension of time to the taxpayer to make the election if taxpayer acted reasonably and in good faith. See PLR 200726020 (June 29, 2007); PLR 200725021 (June 22, 2007). PLR 200725020 (June 29, 2007).

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

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

e. **Comment:** The so-called "IRP Decoupling" program pursuant to which HUD continues Section 236 interest subsidy payments following repayment of a Section 236 loan and these payments are applied to reduce the effective interest rate on a new loan now

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should not be included in the definition of "federal subsidy" and would seem to be compatible with both the 70% and 30% Present Value Credit. In addition, to the extent that these payments fund deductible interest expense (and not capitalized construction-period interest), they should not be treated as the type of federal grants that reduce eligible basis.

f. If a city or a project sponsor receives a federal grant and then lends the grant funds at a market rate for use in a project, the loan proceeds do not constitute either a grant or a below-market federal loan. See PLR 8813024 (Dec. 30, 1987) and Code §42(i)(2)(D). Cf. TAM 200523023 (June 10, 2005) (general partner's loan of federal grant funds at a below-market rate treated as a below-market federal loan). Note: Loans from project sponsors which are treated as related persons with respect to the project ownership entity may raise additional issues. See. IX.A.3, infra.

g. Credits are allowed for buildings receiving Section 8 moderate rehabilitation assistance under Section 8(e)(2) of the United States Housing Act of 1937 including assistance received under the McKinney Homeless Assistance Act as in effect on October 26, 1990, provided the buildings are placed in service after July 30, 2008. Code §42(c)(2), as amended by HERA. Buildings placed in service before that date which receive rental assistance payments pursuant to the renewal of Section 8 Housing Assistance Payment contracts under § 524 of the Multifamily Assisted Housing Reform and Affordability Act of 1997 are ineligible to receive credits if the original contract was authorized under the Section 8 moderate rehabilitation assistance program. PLR 200044013 (July 31, 2000).

h. The fact that rehabilitation expenditures are made with respect to an existing building previously financed with tax-exempt bonds will not cause the rehabilitation expenditures to be treated as "federally subsidized," provided that no "material modification" is made to the tax-exempt financing. See Treas. Reg. 1.1001-3 for rules regarding material modifications. Thus, those rehabilitation expenditures may qualify for the 70% Credit. See H. Rep. No. 99-841, 99th Cong. 2d Sess. II-89 (1986). Based on this legislative history, the IRS has ruled that the purchase of existing buildings subject to tax-exempt bonds did not taint either rehabilitation expenditures on those buildings or newly constructed buildings on land that secured the bonds. PLR 9601005 (Sept. 26, 1995).

(i) The IRS has refused to extend the foregoing legislative history to permit the proceeds of tax-exempt bonds used to acquire and rehabilitate a multiple building project to be

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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. PLR 9528002 (March 20, 1995). Similarly, the IRS has taken the position that when the rehabilitation and acquisition of a building are financed by the issuance of tax-exempt bonds and taxable bonds, both of which close on the same date and use the same bank trustee, allocating the proceeds of the tax-exempt bonds solely to the acquisition costs of the building will not enable the rehabilitation costs of the building to avoid the federal subsidy taint. If, however, the acquisition and rehabilitation financings are independent transactions, the taint of the tax-exempt financing will not extend to the rehabilitation expenditures. PLR 200035016 (May 30, 2000).

(ii) See also, PLR 9001046 (Oct. 11, 1989), revoked by PLR 9011017 (Dec. 18, 1989) in which the IRS appeared to approve and then reject a tracing of federal subsidy proceeds.

(iii) See Paul, Of (Low-Income) Housing Bondage: Will Cross-Collateralization Cause Federal Subsidy Taint? 14 Real Estate Tax Digest 39 (Feb. 1996).

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

C. Determination of Applicable Percentage.

The annual credits are expressed as a percentage of Qualified Basis, referred to as the "applicable percentage," that over a 10-year period has a present value equal to 70% or 30% of Qualified Basis, as the case may be. Applicable percentages are announced monthly in the same revenue rulings that announce "applicable federal rates." For projects placed in service before Dec. 31, 2013 (i.e. on or before Dec. 30, 2013), the applicable percentage for 70% present value credits will be the greater of the published monthly rate or 9%. Code §42(b)(2).

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

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

b. at the election of the taxpayer, the month in which the taxpayer and the housing credit agency enter into a binding agreement as to the dollar amount of annual credits to be allocated. Code §42(b)(2)(A)(ii)(I), Treas. Reg. §1.42-8(a) and Notice 89-1 provide that this binding agreement must:

(i) be in writing;

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

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

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

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

c. In the case of a bond-financed project for which no allocation is made, at the election of the taxpayer, the month in which the bonds are issued may be used. Code §42(d)(2)(A)(ii)(II) and Treas. Reg. §1.42-8(b).

d. Elections under 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 Code §§42(b)(2)(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 Treas. Reg. §1.42-8(a)(1);

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(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 closing of the month to which the election relates.

2. The applicable percentages determined under elections described in 1.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, infra,) 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 (December 27, 1996).

3. 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 D., infra), however. 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.

D. Compliance Period.

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

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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 a building determined as of the close of the first year of the Credit Period, subject to certain modifications. See II.C., infra.

2. Portion of Eligible Basis constituting Qualified Basis (the "Applicable Fraction") is determined annually and is the lesser of

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

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

Note: A unit is not a low-income unit until it is actually occupied by low-income tenants. Qualified occupancy is not required for placement in service of a unit but is required for inclusion of the unit in Qualified Basis. During the first year of the Credit Period, the applicable fraction is determined on a monthly basis. A unit will be treated as a low-income unit (and therefore includable in the monthly applicable fraction) provided that the unit has been in service for the full month and is occupied by a qualified tenant by the end of the month. Rev. Rul. 2004-82, IRB 2004-35.

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

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

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

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5. A unit occupied by a resident manager or a full-time, resident security officer is not a residential rental unit for purposes of Code §42 and thus is excluded from both the numerator and denominator of the fractions used to calculate qualified basis. Rev. Rul. 92-61, 1992-2 C.B. 7; Rev. Rul. 2004-82, 2004-35 IRB (August 30, 2004); PLR 9538015 (June 16, 1995); see also PLR 9330013 (April 29, 1993) (similar treatment of units occupied by maintenance personnel but different treatment of model units which were held to be "residential rental units" included not only in Eligible Basis but also in the denominator of the fraction used to calculate Qualified Basis).

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

B. Existing Buildings.

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

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

b. 10 years must have elapsed since the later of

(i) the date the building was last placed in service; or

(ii) the date of the most recent substantial improvement to which 60-month amortization under Code §167(k) or pre-1987 ACRS applied.

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 Section 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)(iii)(II). Comment: In determining whether a person and/or a partnership is related to a partnership, Code § 707(b)(1) looks to whether there was ownership of either a capital interest or a profits interest. There is no guidance on the meaning of the term "profits interest" in this

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context. Thus, if a general partner is given a greater than 50% interest in the proceeds from a sale of property (following the repayment of all the capital contributions of the limited partner), or is paid an unreasonably large incentive management fee (i.e. 60% of gross cash receipts with no dollar cap), the general partner might be treated as having a more than 50% profits interest with respect to such partnership.

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

2. Waivers and exceptions to the 10-year rule.

a. Pursuant to Code § 42(d)(6), as amended by HERA, the 10-year requirement in 1.b. above is automatically waived for federally-assisted or state-assisted projects.

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

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

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

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

(i) Placements in service by government entities and qualifying nonprofit organizations, if the 10-year rule had been satisfied at the time of such placements in service. See PLR 200652015 (December 29, 2006); PLR 8851046 (Sept. 27, 1988); PLR 8834054 (May 27, 1988).

(ii) Placements in service by mortgagees, provided the mortgagees transfer the property within 12 months, if the 10-year rule had been satisfied at the time of such placements in service. Comment: If a state housing finance

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agency, other governmental entity or qualifying nonprofit organization forecloses on property, it ought not to be subject to the requirement that it resell the property within 12 months, but there is no authority directly on point.

(iii) In the case of a single family home, placement-in-service by individual owners who used the building only for a principal residence.

(iv) Placement-in-service by persons who acquired the property either with a carryover basis from their transferors or with a stepped-up basis by reason of inheritance. Terminations of partnerships occurring on or after May 9, 1997 provide the "new" partnership with a carryover basis in property of the terminated partnership. Treas. Reg. § 1.708-1(b)(4)(iv), Example (ii). Thus, such a termination is disregarded for purposes of the 10-year rule. PLR 200614019 (April 7, 2006); PLR 200508009 (February 25, 2005); PLR 200502019 (January 14, 2005).

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

d. In PLR 200204006 (January 25, 2002), the IRS held that a Code §743(b) adjustment to basis was not a placed-in-service event for purposes of Code §42(d)(2)(B)(ii)(I). See also PLR 200614019 (April 7, 2006).

e. A foreclosure of purchase-money debt secured by partnership interests (which resulted in a termination of the old partnership and formation of a new partnership under Code §708), and the subsequent sale by the new partnership to the taxpayer within 12 months of foreclosure satisfied the 10-year rule pursuant to the exception provided for mortgagees in possession for less than 12 months. PLR 200235018 (May 29, 2002). Although not addressed in this ruling, an alternative basis for concluding that the 10-year rule is satisfied is that the termination of the old partnership, even if unrelated to a foreclosure, does not constitute a placement in service for purpose of that rule. See PLR 200508009 (February 25, 2005); PLR 200502019 (January 14, 2005).

f. As a general matter, a transfer of property results in a new placement in service if, as of the date of transfer, the property is ready and available for its intended purpose. Rev. Rul. 91-38. 1991-2 C.B. 3, 5. However, acquisition of a property that is not fit

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for habitation or other use is not considered a placement in service. PLR 200009032 (December 3, 1999); PLR 9402010 (Oct. 6, 1993).

g. The IRS has ruled that a transfer of property followed by a rescission of the transfer within the same taxable year did not constitute a transfer for federal tax purposes and, thus, did not result in a new "placement in service." See PLR 200309009 (February 28, 2003) (ruling based on transfer/rescission rule of Rev. Rul. 80-58, 1980-1 C.B. 181).

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

i. A transfer of property pursuant to a court-ordered restructuring of a housing program did not constitute a transfer and, therefore, did not result in a new "placement in service" for purposes of the 10-year rule. PLR 9735007 (May 22, 1997).

j. An assignment by a mortgagee of its successful foreclosure bid on a low-income property to an affiliate of the mortgagee who, as a matter of course, holds title to any real estate collateral acquired by mortgagee, was treated as though the affiliate had acquired the project by foreclosure of a security interest held by the affiliate and therefore the acquisition by the affiliate was treated as an acquisition by the "mortgagee" and disregarded for purposes of the 10-year rule pursuant to the exception provided for mortgagees in possession for not more than 12 months. PLR 200003037 (October 26, 1999).

k. 10-year requirement in 1.b. and 1.c above does not apply to a purchase during the Compliance Period; instead the purchaser "steps into the shoes" of the seller and may continue to claim credits based on the seller's Eligible Basis. Code §42(d)(7). PLR 200652015 (December 29, 2006). See V.A.1. below concerning potential credit recapture.

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

C. Special Rules for Calculating Eligible Basis.

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

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

a. Such facilities must be made available on a comparable basis to all tenants without a separate fee. H.R. Rep. No. 841, 99th Cong. 2d Sess. II-89 to II-90 (1986).

b. The IRS has ruled that the cost of a kitchen that is used to prepare meals for which a separate fee is charged is not includable in Eligible Basis. PLR 9338013 (June 23, 1993). Query whether coin-operated laundry machines would be treated the same way.

c. The IRS has ruled that the cost of a community building with meeting rooms, laundry facilities, a kitchen, management offices, and classrooms equipped for child care that is used to provide social services for which a separate fee will not be charged is includable in basis. PLR 9822026 (February 23, 1998). See also PLR 199948025 (September 9, 1999); 12.c., infra.

3. Include land preparation costs only if they are so inextricably associated with the low-income building, common areas, recreational facilities or functionally related and subordinate facilities that the land preparation will be retired, abandoned or replaced contemporaneously with such items. For example, the costs of clearing, grubbing and general grading to prepare a site suitable for any type of structure are inextricably associated with the land and are added to the cost of the land, and as a result are not includable in Eligible Basis, while the costs incurred for fill dirt that is used to set the foundation of a low-income building are treated as inextricably associated with the low-income building and are therefore includable in Eligible Basis. TAMs 200043015-17 (July 14, 2000).

4. The IRS on examination may recharacterize certain fees paid to developers as attributable, in whole or in part, to services other than the acquisition, construction, or rehabilitation of a building and exclude them from Eligible Basis. In settling the case of Williamsburg Gardens, a Limited Partnership, Thomas E. Connelly, Jr., Tax Matters Partner v. Comm'r, the Commissioner and the taxpayer agreed to re-characterize 20% of a "developer fee" which taxpayer had included in Eligible Basis as syndication costs, land costs, and organization costs not includible in Eligible Basis. Tax Court Docket No. 10953-98 (December 10, 1998). The Commissioner permitted a developer fee of 15% of the amount of Eligible Basis to be included in Eligible Basis. See also TAM 200043017 (July 14, 2000).

5. The IRS has ruled that local impact fees (i.e. one-time costs with respect to a piece of property that are assessed when new construction takes place and may relate to such items as roads, water capital, educational facilities,

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law enforcement and fire/rescue facilities) incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under Code §§263(a) and 263A. Rev. Rul. 2002-9, 2002-1 C.B. 614 (February 15, 2002); compare TAM 200043016 (July 14, 2000). The IRS subsequently modified its conclusion in TAM 200043016 with respect to the impact fee issue in light of Rev. Rul. 2002-9. PLR 200216027 (April 19, 2002). Relying on Rev. Rul. 2002-9, the IRS has ruled that infrastructure improvements such as streets and underground utility connections that are constructed by a developer in connection with a low-income building but conveyed to a municipality and, thus, dedicated improvements within the meaning of § 1.263(a)-4(d)(8)(iv), are indirect costs that may be capitalized under § 263A into the basis of the Project's residential rental buildings and includable in eligible basis. PLR 200916007 (Jan. 5, 2009).

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

7. The IRS has held that costs associated with the issuance of tax-exempt bonds (including FHFA fees, state board fees, rating agency fees, trustee fees, underwriter fees, investment fees, legal fees, inspection fees, and costs for photos, prints and renderings) are excluded from Eligible Basis, regardless whether the costs are allocable to construction activities. TAM 200043015 (July 14, 2000). In reaching its conclusion, the IRS first held that bond issuance costs could not be included in a project's Eligible Basis because such costs are amortized as Code §167 intangibles and not subject to depreciation under Code §168 (as required by Code §42(d)(4)). Next, the IRS considered the taxpayer's argument that a portion of the bond issuance costs (those relating to construction activities) were indirectly includable in Eligible Basis because they were capitalized under Code §263A to the produced property and the produced property was depreciable property. The IRS rejected this argument by holding that, regardless of whether the costs were capitalized to depreciable property under Code §263A, the costs were not includable in Eligible Basis because they did not qualify (within the meaning of Code §142 and as required by Code §42(d)(4)) as either residential rental property or costs used for residential rental property nor did they qualify as costs for property used in a common area or provided as comparable amenities to all residential rental units in the building. Id.

8. Tax credit application and allocation fees paid to the housing credit agency are not includible in eligible basis. Rev. Rul. 2004-82, IRB 2004-35.

9. Costs associated with obtaining a construction loan should be capitalized and amortized over the life of the loan, and any amortized deductions incurred during the construction period should be capitalized under Code § 263A and added to the basis of the produced property. The IRS has taken

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the position that the property being produced includes the land, land improvements and the building, and that the taxpayer must reasonably allocate the amortization deductions among all of the produced property. As a result, the taxpayer may include in Eligible Basis only those amortized deductions that are properly allocable to produced property that qualifies as residential rental property. TAMs 200043016-17 (July 14, 2000). The IRS has also allowed taxpayers to use the "substitute cost method" to determine Eligible Basis. PLR 200305015 (January 1, 2003).

10. The IRS has held that nonrecourse notes taken to finance the construction of a building are genuine debt includable in the Eligible Basis of the building despite the fact that such notes may have lengthy terms (30 years) with significant accruals of interest and do not require payments of principal or interest prior to the maturity date. FSA 199948006 (August 31, 1999). Note: The FSA does not address the deductibility (or adequacy) of accrued interest.

11. The IRS has held that the deferred portion of a developer fee represented by a developer fee note is includable in the Eligible Basis of a project, provided there is clear evidence that the note will be repaid at maturity. In reaching its conclusion that the developer fee note was a noncontingent obligation, the IRS considered the following facts: (i) although payments prior to maturity were contingent on cash flow and proceeds of capital transactions, the note was payable at maturity for a fixed amount; (ii) the general partners of the partnership were obligated to contribute to the partnership the amount necessary to repay the developer fee note upon maturity (which was the thirteenth anniversary of the completion date); and (iii) the general partners had the right to refinance the property within one year prior to maturity of the developer fee note in order to repay the note in full. TAM 200044004 (July 14, 2000).

12. Reduce Eligible Basis by the amount of federal grants, see I.B.3.e., supra.

13. 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)(C). Any building placed in service after July 30, 2008 which is designated by a state housing credit agency as requiring the enhanced low-income housing credit for that building to be financially feasible as part of a qualified low-income housing project will be treated, for purposes of the rules governing the enhanced low-income housing credit, as located in a designated difficult development area. Code §42(d)(5)(C). For calendar year 2000 and prior years, a qualified census tract is defined as a census tract in which at least 50% of the households have an income of less than 60% of the area median gross income. Commencing in 2001, the definition is expanded to include any census tract with a poverty rate of 25% or more. Code §42(d)(5)(C)(ii)(1), as

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amended by the 2000 Act. Current HUD designations of qualified census tracts effective for allocations made, and bond-financed buildings placed in service, after December 31, 2007 are listed in 72 Fed. Reg. 53382 (September 18, 2007). Current HUD designations for difficult development areas effective for allocations made and buildings placed in service during the period beginning on January 1, 2006 and ending December 31, 2010 are listed in FR-5235-N-01 (September 8, 2008). HUD has clarified how "multiphase" LIHTC projects are to be treated when DDA or QCT designations change between phases. In the case of a multiphase project, the applicable DDA or QCT status of the site of a multiphased bond-financed project for all phases of the project is that which was applicable when the project received its first allocation of LIHTC, as certified in writing by the LIHTC-allocating agency. The applicable DDA or QCT status of the site of the project for all phases of the project is that which was applicable when the building(s) in the first phase were placed in service or when the bonds were issued as certified in writing by the LIHTC-allocating agency. 72 FR 9961-01 (March 6, 2007)

a. Announcement 91-112, 1991-31 I.R.B. 36, confirms that this 130% rule is available for bond-financed new construction or rehabilitation.

b. Comment. Application of the 130% rule to bond-financed projects increases the amount of credits available because there is no corresponding charge against the state volume cap. See IV.C.3., infra.

c. The definition of Eligible Basis for a project located in a qualified census tract includes a portion of the building (of a character subject to the allowance for depreciation, and not otherwise included in Eligible Basis) used as a community service facility (such as a childcare center or employment training center), provided the increase in Eligible Basis of any building placed in service after July 30, 2008 shall be limited to 25% of the total Eligible Basis not exceeding $15,000,000 plus 10% of the remaining total Eligible Basis of the project. A community service facility means any facility designed to serve primarily individuals with incomes 60% or less of area median income. Code §42(d)(4)(C), as amended by the 2000 Act. This requirement is satisfied if the following conditions are met (Rev. Rul. 2003-77, 2003-29 I.R.B. 75 (June 23, 2003)):

(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

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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.

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, IRB 2004-35.

d. When a project located in a difficult development area received an allocation in Year 1, and seeks an additional allocation in Year 2 when the area in which it is located is not a difficult development area, the maximum amount allocable in Year 2 is equal to the excess of the amount of credits that would be allocable to the project in Year 2 based on 100% of its Eligible Basis over the amount of credits allocated to the project in Year 1. PLR 9712003 (December 11, 1996).

D. Property Purchased During Construction.

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

III. DEFINITION OF "QUALIFIED LOW-INCOME BUILDING"

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

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

1. A "qualified low-income housing project" is a project for "residential rental property" (II.C.1, supra) that satisfies both a tenant-income requirement and a rent-restriction requirement under either of two minimum set aside tests:

a. 20-50 test: 20% or more of residential units are rent-restricted and occupied by individuals with income not more than 50% of area median gross income ("AMGI"); or

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b. 40-60 test: 40% (25% in NYC) or more of residential units are rent-restricted and occupied by individuals whose income is not more than 60% of AMGI.

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

2. Generally, the 20-50 or 40-60 tests must be satisfied by the end of the first year of the Credit Period and for the duration of the Compliance Period.

3. Taxpayer must elect either test irrevocably in the taxable year in which the project is placed in service. Code §42(g)(1). The IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that it acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government. Rev. Rul. 200807010 (February 15, 2008); Rev. Rul. 200737011 (September 14, 2007); Rev. Rul. 200731001 (August 3, 2007).

4. A unit is "rent-restricted" if rents paid by the tenant do not exceed 30% of the "imputed" income limitation. Income is imputed at the applicable 50% or 60% limitation for each individual occupying the unit, assuming that a studio apartment houses one person and that apartments with separate bedrooms house 1.5 persons per bedroom. (See Rev. Proc. 94-9, 1994-1 C.B. 555, regarding the calculation of rent restrictions for projects receiving allocations prior to 1990).

a. For purposes of the "rent-restriction" requirement, imputed income may increase above but cannot decrease below a floor which will be based on AMGI at the date of the credit allocation or, if the taxpayer elects, at the time the building is placed in service. Rev. Proc. 94-57, 1994-2 C.B. 744. No such floor exists for purposes of the tenant income requirements. See 6.e., infra.

b. For this purpose rents include utilities allowances. See Treas. Reg. §1.42-10 for definitions of applicable utility allowances for different types of projects (e.g. FmHA, Section 8). Final regulations published in the Federal Register on July 29, 2008, amend Reg. §§1.42-10 and 1.42-12 by updating the utility allowances regulations to provide new options for estimating tenant utility costs, including use of an energy consumption model estimates calculated by either a properly licensed engineer or a

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qualified professional commissioned by the building owner. Treasury Decision 9420, 07/29/2008. Utility costs paid by a tenant based on actual consumption in a sub-metered rent-restricted unit are treated as paid directly by the tenant, and not by or through the owner of the building. Notice 2009-44, 2009-21 IRB, 05/05/2009.

c. Rents do not include Section 8 assistance or any comparable rental assistance program.

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

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

f. The IRS has ruled that a one-time application fee charged to tenants to reimburse the owner's out-of-pocket costs for obtaining credit checks and references for tenants is not included in rents. PLR 9330013 (April 29, 1993).

g. Rents do not include charges for meals and other services such as laundry, housekeeping and assistance to elderly tenants, even if the services are substantial, provided that the services are optional. Treas. Reg. §1.42-11(a); Rev. Rul. 91-38, Question 12; PLR 8945036 (Aug. 15, 1989); PLR 8944042 (Aug. 8, 1989); and PLR 8920003 (Jan. 17, 1989). Services may not be considered optional unless there is a practical alternative for tenants to obtain them from sources other than the project or the project owner. Treas. Reg. §1.42-11(b)(1). Apparently, meal service may be treated as optional even when the units contain no kitchen facilities, provided there is a practical alternative for tenants to obtain meals other than from a common dining facility. PLR 8945036.

h. Payments for services which are not optional are generally included in rents (PLR 8921035 (Feb. 23, 1989)), even if building owners are required by law to provide the services. Continual or frequently provided nursing, medical or psychiatric services are presumed not to be optional and may cause a building not to be treated as for use by the general public. Treas. Reg. §1.42-11(b)(2); <u>see</u> D.3., <u>infra</u>. However, payment for "support services" designed to enable elderly or disabled tenants to remain

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independent may be excluded from rents provided that the payments are funded by a governmental or charitable program and the funding of services is not separable from the funding of rent. Code §42(g)(2)(b)(iii); Treas. Reg. §1.42-11(b)(3)(ii)(A); PLR 9526009 (March 27, 1995).

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

5. Generally, the same rules that apply for purposes of determining whether a project is a "qualified residential rental project" under Code §142(d) also apply for purposes of defining a "qualified low-income building" under Code §42(g). Code §42(g)(4).

6. Income determinations:

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

(i) Waiver of annual certification may be obtained for buildings 100% occupied by low-income tenants. Rev. Proc. 2004-38, 2004-27 IRB (June 18, 2004).

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(ii) Required supporting documentation generally consists of tenant's tax returns, W-2's 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, IRB 2004-35. If a tenant is receiving housing assistance payments under Section 8 of the United States Housing Act of 1937, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable limit under Code § 42(g). Treas. Reg. § 1.42-5(b)(1)(vii). IRS has relaxed this documentation requirement in order to encourage the owners of low-income housing units to rent on a temporary basis vacant units to certain displaced low-income individuals who reside in major disaster areas. Rev. Proc. 2007-54 (July 2, 2007).

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

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

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

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

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

(iv) If a previously qualified over-income tenant moves to a vacant unit within the same building which unit was, immediately prior to its vacancy, occupied by a qualified low-income tenant, both the vacated unit and the newly occupied unit may qualify as low-income units, although the continued qualification of each is subject to the "available unit rule." Treas. Reg. § 1.42-15(d).

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

(vi) A unit is not available for purposes of the "available unit rule" when the unit is no longer available for rent due to a reservation that is binding under local law. See CCA 200137028 (June 14, 2001).

c. There are safe harbors pursuant to which a unit can qualify as a low-income unit even if a tenant is over-income at the commencement of the Credit Period, provided that the tenant was at or below the applicable income limit at the later of the date the taxpayer acquired the building or the date of initial occupancy. Rev. Proc. 2003-82, 2003-2 C.B. 1097 (November 21, 2003). These safe harbors are helpful when the Credit Period occurs after the later of such dates because of either an election to defer commencement of the Credit Period until the year following placement in service or, in the case of an acquisition of an existing building, the requisite rehabilitation expenditures are not incurred until a year following the year of acquisition. The safe harbors apply only if the unit is rent-restricted and otherwise qualifies as a

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low-income unit (see D.1, infra) from the later of the date of acquisition or initial occupancy until the beginning of the first year of the Credit Period and, in the case of an existing building, if there has been a credit allocation, binding commitment, or an issuance of tax-exempt bonds, by the end of the taxable year in which such later date occurs.

d. For deep rent skewed projects, the unit will not continue to qualify if any available low-income unit is rented to a tenant whose income exceeds 40% of AMGI. See PLR 9848005 (July 2, 1998).

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

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

g. 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.

7. Deep Rent Skewing.

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

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

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

C. Multiple Buildings.

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

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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 200723017 (June 8, 2007); PLR 200723023 (March, 1, 2007)

a. For this purpose a qualified low-income "building" may be an apartment building, a single-family dwelling, a townhouse, a rowhouse, a duplex or a condominium. Notice 88-91, 1988-2 C.B. 414; PLR 2000107022 (February 16, 2001); PLR 9120021 (Feb. 19, 1991); PLR 9101006 (Jan. 4, 1991); PLR 8910015 (Dec. 7, 1988); PLR 8920073 (Feb. 23, 1989).

b. Notwithstanding contrary language in Notice 88-91, a building leased to a cooperative housing corporation may be a qualified low-income building. PLR 9538012 (June 15, 1995); PLR 8941021 (July 13, 1989).

3. Among the provisions of Code §42 which are applied on a project-wide basis and, therefore, may operate differently, depending on whether multiple buildings are treated as a single project or separate projects are (a) the 10% carryover allocation computation under Code §42(h)(4)(E)(ii), (b) the rules for credit allocations for projects with multiple buildings, (c) the satisfaction of the 20-50 or 40-60 tests pursuant to Section 42(g), (d) the "vacant unit" rule (see D.5., infra), and (e) the 25% limitations attributable to community service facilities (see II.C.12.c, supra).

4. Multiple buildings may be treated as part of a single project if they contain similarly constructed units and are owned by the same person, located on the same or contiguous parcels of real estate and financed pursuant to a common plan. Treas. Reg. §1.103-8(b). However, buildings that could not be treated as a single project because of their lack of proximity may be so treated if 100% of the units in each building are rent restricted. Code §42(g)(7). Note: There is no comparable "scattered site" exception under the tax-exempt bond rules so that buildings which are not proximate may constitute multiple projects for those rules and a single project for purposes of the Credit. Comment: There is, as yet, little guidance on the meaning of "similarly constructed units" which could be a concern for a project consisting of a high-rise building and townhouses or of buildings constructed at different times. Units need not be of the same size or have the same number of bedrooms to be "similarly constructed" so long as they are of similar quality and type of construction. See T.D. 7840,

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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 for purposes of the 20-50 and 40-60 tests:

a. Other buildings placed in service by the end of the first year of the first building's Credit Period and designated by the taxpayer may be taken into account for purposes of determining whether the 20-50 test or 40-60 test has been satisfied with respect to both the first building and the other buildings, provided that, in the aggregate, the other buildings and the first building satisfy those tests by the end of the first year of the first building's Credit Period.

b. When determining the Credit Period and Compliance Period for the first building, the building is treated as placed in service on the most recent date that any other building elected for aggregation by the taxpayer was placed in service.

c. The 1990 Act changed the testing date to the end of the first year of the Credit Period from the 12-month period following the date when the building was placed in service. The 1990 Act did not, however, make parallel changes to the provisions for multiple buildings. These provisions still refer to the 12-month period after the first building is placed in service as the time limit for aggregating other buildings with the first building for purposes of satisfying the qualification tests.

d. A building (other than a "first" building) tested on an aggregate basis under a. above, may not be a qualified low-income building unless the remaining building or buildings in the project satisfy those tests without regard to such building.

D. Definition of Low-Income Units.

1. Generally a low-income unit must:

a. be rent-restricted;

b. be occupied by individuals who meet the applicable income limitations (see B.6.b., supra, concerning increases in tenants' income and the "available unit rule");

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

d. be used other than on a transient basis, which will generally be the case if the initial lease term is six months or longer, even if the

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tenant is permitted to occupy the unit on a rent-free basis for one month or less. PLR 9330013 (April 29, 1993). See also PLR 200044020 (August 3, 2000) (providing that units in an acquisition/rehabilitation project which are occupied by tenants with month-to-month tenancy and a documented long-term history of tenancy in the project will satisfy the requirement that low-income units be used on other than a transient basis, provided the tenants had initial leasehold terms of 6 months or longer with the prior owner of the project and that the new owner does not plan to change the use of the units).

2. Exceptions:

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

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

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

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

b. Single-room-occupancy ("SRO") units are not treated as failing to satisfy 1.d. simply because they are rented on a month-to-month basis, so long as they are suitable for occupancy and are actually used for occupancy on a non-transient basis. SRO units in groups with shared kitchen, living room and, in some cases, shared bathroom facilities which satisfied HUD Section 8 quality standards were ruled "suitable for occupancy." PLR 9452030 (September 30, 1994). SRO units in groups with shared kitchen and bathroom facilities with minimum lease terms of 30 days were ruled to be used for occupancy on a non-transient basis. PLR 9814006 (December 18, 1997). SRO units provided to homeless individuals whose residency privileges were conditioned on their participation in, and compliance with, the project owner's social service programs, when there was no lease agreement entered into between the "tenants" and the project owner, were ruled not to be used for occupancy on a non-transient basis. PLR 9811020 (December 2, 1997).

3. To qualify for credits under Code §42, units must also be "for use by the general public," meaning that units must be rented on a non-discriminatory basis in accordance with HUD Rules and Regulations.

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Treas. Reg. §1.42-9. The IRS has ruled that a project which was open to all homeless individuals, but with a preference to homeless individuals with alcohol and/or chemical dependency, is for use by the general public. PLR 9814006 (December 18, 1997). Any unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not for use by the general public. Treas. Reg. §1.42-9(b). See B.4.g.-i., supra, regarding charges for services. A project will not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants with special needs, who are members of a specified group under a Federal program or State program or policy that supports housing for such a specified group, or who are involved in artistic or literary activities. Code §42(g)(9).

4. Student housing does not qualify for the low-income housing credit. However, a unit will not fail to qualify as a low-income unit merely because it is occupied by an individual who is: (I) a student and receiving assistance under title IV of the Social Security Act (42 USC 601 et seq.); (II) enrolled in a job training program receiving assistance under the Job Training Partnership Act (PL 97-300, 10/13/1982) or under other similar federal, state, or local laws; or (III) a student who was previously under the care and placement responsibility of a foster care program under part B or part E of title IV of the Social Security Act. Code § 42(i)(3)(D)(i). A unit will generally be considered to be occupied by low-income individuals if all of the occupants of such units are students who are married and file a joint income tax return or who are single parents and their children and such parents are not dependents of another individual and such children are not dependents of persons other than their parents. Code §42(i)(3)(D). See also, PLR 200339022 (June 20, 2003) (ruling that a unit occupied by a single, 50-year old full-time law student, who satisfied the Code §42(g) income limitations and was not a "dependent" under Code §152, qualifies as a low-income unit).

5. **Vacant Units.**

a. The "vacant unit rule" provides that a low-income unit will not lose its status as a low-income unit for purposes of the set-aside requirement, as well as for determining qualified basis, merely because it becomes vacant, provided reasonable attempts are made to rent the unit or the next available unit of comparable or smaller size to a qualified tenant before another unit in the project is rented to a nonqualifying individual. Treas. Reg. 1.42-5(c)(ix). A unit is not available for purposes of the vacant unit rule when the unit is subject to an agreement that is binding under state law. A "reasonable attempt" to rent a vacant unit requires utilizing "customary methods" of advertising apartment vacancies in the area of the project. Customary methods will vary from location to

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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, IRB 2004-35.

b. Unlike the available unit rule which is applied on a building-by-building basis, the vacant unit rule is applied on a project-wide basis. Id. Thus, the vacant unit rule should apply when a tenant moves from one unit to another within the same "project" even if the units are in separate buildings. Rev. Rul. 2004-82, IRB 2004-35. Query: Absent an election on Form 8609 to treat separate buildings as a single project, each building will be treated as a separate project. Multiple buildings may also be grouped in one or more projects, as described in III.C.4, supra. Does the vacant unit rule apply if a tenant moves between two buildings which are in, or are treated as, two separate projects?

c. See IX.I.4, infra, for special rules regarding the application of the vacant unit rule in the context of temporary occupancy by certain individuals displaced by Hurricanes Katrina and Rita.

E. Extended Use Requirements.

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

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

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

3. The commitment must:

a. be enforceable by 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 project to which the commitment applies without the disposition of the remainder of the project to the same transferee; But see PLR 200703024 (January

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19, 2007) (holding that the foregoing prohibition may be made inapplicable if agreed to by the owner and the allocating agency as part of a plan to provide tenants with right of first refusal in accordance with Code Section 42(i)(7). See VI.B.3, infra.

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

f. provide for a restriction on evictions and rent increases which applies during the extended use period and continues for the three years following a termination of the commitment unless a tenant exercises a right of first refusal to purchase the project. Rev. Rul. 2004-82, IRB 2004-35. Commitments entered into prior to January 1, 2006 that lack particular language to this effect will be treated as conforming provided that (i) the commitment contains "catch-all" language requiring the building owner to comply with the requirements of Code § 42, (ii) the housing credit agency notifies the owner on or prior to December 31, 2005 that the restrictions on evictions and rent increases apply throughout the commitment period, (iii) the building owner includes in its annual certification to the agency a statement that the restrictions on evictions and rent increases were not violated (the agency is required to report a failure to make such a certification on Form 8823), and (iv) if the commitment is amended after December 31, 2005, the amendment includes language clearly providing that the restrictions on evictions and rent increases apply throughout the commitment period. Commitments entered into after December 31, 2005 must provide that the restrictions on evictions and rent increases apply throughout the commitment period and owners must certify annually to the housing credit agency that these restrictions have not been violated (a failure to make such a certification will be reported on Form 8823). Rev. Proc. 2005-37, 2005-28 IRB 79.

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

5. Termination of Extended Use Commitment

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

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

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

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

b. 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.

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

6. Qualified Contracts. Code §§42(h)(6)(F)-(K). In June 2007, the IRS issued Proposed Treas. Reg. §1.42-18 defining the qualified contract formula and many of the terms used therein.

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

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

c. Under the Proposed Regulations, the fair market value of the non low-income portion should reflect the existing and continuing

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

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

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

(ii) the "adjusted investor equity" in the project (Proposed Treas. Reg. §1.42-18(c)(4)),

(iii) other capital contributions not reflected in i. or ii. above, minus

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

e. "Outstanding indebtedness" is defined as the remaining principal balance of any indebtedness secured by, or with respect to, the building that does not exceed the amount of "qualifying building costs." Proposed Treas. Reg. §1.42-18 (c)(3)(i). If such indebtedness bears interest at less than the AFR, the "outstanding indebtedness" is an imputed principal amount calculated by using a discount rate equal to the AFR. Proposed Treas. Reg. §1.42-18(c)(3)(ii). "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. Proposed Treas. Reg. §1.42-18(b)(4).

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. Proposed 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.

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(i) Adjusted investor equity is increased annually by a cost-of-living adjustment of not more than 5% for any calendar year; 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.

Comment: The proposed regulations have elicited comments and criticisms from both practitioners and trade associations. One concern is that the proposed regulations do not sufficiently define the term "bona fide offer" and thus open the way for the potential buyers of a low income housing project to demand onerous terms or conditions in their purchase offer. These commentors point out that the final regulations should contain a list of required as well as prohibited provisions in the purchase offer such as timing requirements, improvements requirements and administrative requirements.

The proposed regulations also allow the state housing agency to adjust the fair market value of the building if, after a reasonable period of time within the one-year offer of sale period, no buyer has made an offer. Proposed Regs. §1.42-18(c)(1). The National Association of Home Builders ("NAHB") has advocated the removal of this provision based on the argument that the agency's ability to place a fair market value cap would distort the proper valuation of the building. Other commentors have pointed out that this provision could lead prospective buyers to wait out the qualified contract process until the state housing agency has decided to lower the price.

IV. ALLOCATION OF CREDIT

A. Allocation Required.

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

B. Timing and Duration of Allocation.

1. General. Although Code §42(h)(1)(B) provides that the allocation must be made "not later than" the year the building is placed in service, the intent

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is that allocations be made in the year of placement in service. Conf. Rep. to P.L. 100-647, §1002(1)(14)(A); Notice 89-1, 1989-1 C.B. 620.

2. Binding commitment exception. An allocation may be made subsequent to the placing of a project in service if, on or before the placed in service date, the housing credit agency had made a binding commitment to allocate a specified dollar amount of credits to the project in a specified later taxable year. Code §42(h)(1)(C); see PLR 8941035 (July 14, 1989). See also I.C.1.b., supra.

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

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

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

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

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

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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, IRB 2004-35.

c. Proposed Regulations and Notice 89-1 provided that a taxpayer had to own a project to have any basis in it. The final Regulations reverse this rule. Thus, deposits or nonrecoverable costs will count, provided they are properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project. Treas. Reg. §1.42-6(b)(2)(i). When a project is to be on leased land, costs that are capitalizable into a leasehold estate ought to qualify so long as the lessee is treated, for federal income tax purposes, as the owner of the buildings on the leased property. Comment: Although neither Code § 42(h)(1)(E) nor Treas. Reg. § 1.42-6(b)(2)(i) require the taxpayer to be treated as the owner of the project in order to have basis in the project and be eligible to obtain a carryover allocation, state agencies may impose such a requirement (i.e. Massachusetts conditions the issuance of a carryover allocation on the receipt of evidence demonstrating that the taxpayer has satisfied the 10% rule and ownership of the project by the taxpayer).

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

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

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

g. Under Code §263A(f), interest is required to be capitalized only during the "production period" which generally corresponds to the

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

h. By the end of the calendar year in which a carryover allocation is made (for allocations made before July 1) or by the date that is 6 months from the date the allocation is made (for allocations made after June 30), 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. Treas. Reg. §1.42-6(c); Rev. Rul. 92-40, 1992-1 C.B. 4.

i. Treas. Reg. §1.42-6(d) sets forth specific information that must be included in a valid carryover allocation. See also Notice 89-1.

j. For purposes of the 10% rule, a partnership is a "taxpayer" so that a partner who acquires an interest in the partnership after satisfaction of the 10% rule but before a project is placed in service may enjoy the benefits of this rule, at least so long as the partnership does not terminate prior to the placed in service date. PLR 9044037 (Aug. 2, 1990). See also Treas. Reg. §1.42-6(e)(2) and Rev. Rul. 91-38, 1991-2 C.B. 3.

k. Projects located in Presidentially-declared major disaster areas are entitled to six additional months to satisfy the 10% requirement and an additional year to satisfy the placed in service requirement, provided that such additional time is approved by the state housing credit agency. Rev. Proc. 95-28, 1995-1 C.B. 704; Rev. Proc. 2007-54, 2007-31 IRB.

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

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

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

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

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

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

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

C. Determination of State Ceilings.

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

a. The greater of $2.30 multiplied by the state population or $2,665,000 (the “population component”) (see, e.g., Notice 2009-21; 2009-13 IRB 724, for 2009 population figures from which this component and the tax-exempt bond volume cap is derived for 2009 allocations (both the per capita multiplier and the $2,665,000 small state level are adjusted annually for inflation and reflects increases for 2008 and 2009 added by HERA);

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

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

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which apply by May 1 of the current year are eligible to receive allocations from the national pool. See Rev. Proc. 2008-57, 2008-41 IRB 855 (October 9,2008) for the list of states receiving such allocations in 2008.

d. the unused credit ceiling for the preceding calendar year (the "unused carryforward component"). 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.

The amounts described above with respect to any state for 2009 shall each be reduced by so much of such amount as is taken into account in determining the amount of any exchange grant to such State under section 1602 of the American Recovery and Reinvestment Tax Act of 2009. Code §42(i)(9)(A).

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 ceiling because those projects are already limited by the bond volume cap rules. Code §146. See IV.H.1., infra.

4. For projects which receive a binding commitment (See I.C.1., supra), Credits are counted against ceiling in year that the 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

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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., infra, regarding monitoring procedures);

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

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

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

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3. Analysis of Financial Feasibility.

a. Must be made three times:

(i) at time of application for credits;

(ii) when allocation is made; and

(iii) when 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 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).

E. Compliance Monitoring.

1. Agencies must specify in their qualified allocation plans a procedure for monitoring a project for noncompliance. Pursuant to Treas. Reg. § 1.42-5, the procedure must include requirements for (i) recordkeeping and retention of records, (ii) certification and review of the project by the agency to ensure, among other things, that the project satisfies the applicable minimum set-aside test, that it is suitable for occupancy, taking into account local health, safety and building codes, and that the owner has received an annual income certification from all low-income tenants, (iii) physical inspection of the project, including a requirement that the agency conduct an on-site inspection of all buildings in the project by the end of the second calendar year following the year the last building in the project is placed in service and at least once every three years thereafter, including, with respect to at least 20% of the project's low-income units, an inspection of the units and a review of the rent records and low-income certifications for the tenants in those units, and (iv) notification of noncompliance.

2. In order to satisfy the minimum standards established by Treas. Reg. § 1.42-5 for compliance monitoring, an agency has the right to require specific documentation from owners of low-income projects and, if an owner fails to provide an agency with the requested documentation such that the agency is prevented from determining whether a project is in

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compliance with Code § 42, the agency can properly treat the project as being out of compliance with Code § 42. CCA 199944019 (August 4, 1999). An electronic storage system may be used to satisfy the minimum standards of Treas. Reg. § 1.42-5. Rev. Rul. 2004-82, IRB 2004-35.

3. Under Code §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 Code §6652(j) shall apply to any failure to submit the report required. Because Code §42(l)(3) specifies a requirement for only one annual report, it is not possible to fine an Agency multiple time for one year. However, if the report is inaccurate or incomplete (e.g., missing required forms that make up the report) or late, the agency has not satisfied its duty under Code §42(l)(3), and it may be fined $100, regardless of the fact that an annual report was submitted. CCA 200913013 (February 20, 2009)

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

F. Set-Aside for Non-profit Organizations.

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

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

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

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b. Organizations seeking exemption under Code §501(c)(3) may have as their charitable purposes relief of the poor or distressed, combating economic deterioration or urban blight, lessening the burdens of government or, occasionally, historic preservation. Treas. Reg. §1.501(c)(3)-1(d)(2); Rev. Rul. 70-585, 1970-2 C.B. 115. Demonstrating an "exclusively" charitable purpose may be problematic for sponsors of mixed-income projects that are not located in blighted areas. Rev. Proc. 96-32, 1996-1 C.B. 717, supersedes Notice 93-1, 1993-1 C.B. 290, and provides a "safe harbor guideline" that an organization will be considered charitable with respect to a mixed-income project if the following requirements are satisfied:

(i) At least 75% of units are occupied by tenants at or below 80% of median income and, inter alia, either the 60-40 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

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must be for sale or rental "exclusively" to persons at or below 80% of median income.

c. Rev. Proc. 96-32 further provides 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, or lessening neighborhood tensions, or relief of the distress of the elderly or physically handicapped.

2. In Housing Pioneers, Inc. v. Commissioner, T.C. Memo 1993-120, aff'd 58 F.3d 401 (9th Cir. 1995), the Tax Court denied exempt status to an organization serving as a co-general partner of a limited partnership formed to own a project qualifying for low-income tax credits. The facts of the case were sufficient to support this result on the grounds that the organization lacked sufficient involvement and control to assure that the project would be operated in furtherance of its charitable purposes with only incidental benefits to limited partners.

a. However, the Tax Court opinion goes even further and suggests that serving as general partner of any partnership that generates tax credits for non-exempt investors precludes tax-exempt status. This suggestion directly contradicts the set-aside provisions of Code §42 which mandate tax-exempt sponsors of tax credit projects as well as the long-standing position of the Tax Court and the IRS that service as a general partner with for-profit limited partners does not preclude tax-exempt status. Plumstead Theater Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd per curiam, 675 F.2d 244 (9th Cir. 1982), and G.C.M. 39005 (December 17, 1982); see also PLR 9438030 (June 28, 1994); PLR 9311034 (December 21, 1992); PLR 9208033 (November 29, 1991); PLR 8938002 (May 31, 1989); and PLR 8342001 (undated).

b. On appeal, the Ninth Circuit Court of Appeals acknowledged the attractiveness of the taxpayer's argument that Code §42 contemplates partnerships between qualified non-profit organizations and for-profit investors. The court also found, however, that the taxpayer had failed to establish that it was a qualified non-profit organization within the meaning of Code §§42(h)(5)(B) and (C). Ultimately, the Court refused to disturb the Tax Court's finding that the taxpayer had a substantial non-exempt purpose and that carrying out that purpose would inure to private benefit. On rehearing, Plumstead Theatre was distinguished on its facts principally because two of the taxpayer's partners were on its board of directors.

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3. Recent rulings suggest that, in order 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. Rev. Rul. 2004-51, 2004-22 IRB; Rev. Rul. 98-15, 1998-1 C.B. 718; PLR 200436022 (September 3, 2004); PLR 9736039 (June 9, 1997). 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.

4. On April 25, 2006, the IRS issued a memorandum signed by Joseph Urban, Acting Director EO Rulings and Agreements, providing criteria for processing applications for exemption under Code §§501(c)(3) or 501(c)(4), when the applicant proposes to serve as a general partner in a low-income housing tax credit partnership. The criteria set forth in the memo are, generally, more reflective of market conditions than the Salins and Fontenrose article described in 5. below. 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.

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

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

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

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

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

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

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

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

5. As part of its training materials, the IRS previously published an article intended to review its position on the participation of tax-exempt organizations in partnerships with for-profit entities. See Salins and Fontenrose, Housing Partnership Agreements, published as part of the IRS's Exempt Organizations-Technical Instruction Program for FY 2003 (2002). This article set forth criteria that were much stricter than those in the April 25, 2006 memorandum described in the preceding paragraph or in previously stated IRS positions. Among the provisions viewed as jeopardizing exempt status were (i) guaranty, indemnification and return of capital provisions which require the tax-exempt organization to put its charitable assets at risk in order to protect the investment of for-profit limited partners and (ii) management provisions allowing for general partner removal or operational approvals by for-profit limited partners

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which indicate that the tax-exempt organization does not have effective control over the activities of the partnership.

6. It is unclear whether tax credits allocated from the non-profit set-aside will be subject to recapture if ownership or "material participation" of the nonprofit organization terminates during the Compliance Period.

7. Note: Participation by a nonprofit organization may have favorable state or local tax consequences. For example, the Massachusetts Department of Revenue held that the purchase of building materials and supplies was exempt from MA sales tax when, during the entire construction period, the project was owned by a limited partnership the partners of which were owned by the same nonprofit corporation and, upon completion, a for-profit entity was admitted to the partnership as an investor limited partner. LR 01-13 (November 15, 2001); see also M.G.L ch. 64H, §6(f). Some states may also provide property tax relief for affordable housing with nonprofit sponsors.

8. See Paul, "Emerging Tax Considerations for Non-Profit Sponsors of Affordable Housing," 12 The Real Estate Tax Digest 181 (1994).

G. Special Rules.

1. Agency may allocate only to buildings within its jurisdiction.

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

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

H. Bond Financed Projects.

1. The 50% Test.

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

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b. In computing the 50% test, the basis of any building is determined by using the building's cost basis under Code § 1012, rather than its adjusted basis under Code §1016, and is determined without regard to any Eligible Basis adjustment allowed for buildings located in high cost areas under Code §42(d)(5)(C). PLR 199917046 (January 29, 1999). Furthermore, "building" is not limited to Code §1250 property, but includes all property (including Code §1245 property and depreciable land improvements) financed with the proceeds of the tax-exempt bonds, as well as any functionally related and subordinate facilities. PLR 200035016 (May 30, 2000).

c. Generally, a taxpayer cannot separately meet the 50% test in Code §42(h)(4)(B) with respect to the acquisition and the rehabilitation of a single building. PLR 200035016 (May 30, 2000). However, a recent IRS letter ruling suggests that a taxpayer may separately meet the 50% test with respect to rehabilitated property which is treated as a "separate new building" under Code §42(e)(1) when the existing building received a previous allocation and none of the rehabilitation expenditures treated as a "separate new building" were previously included in the basis of the existing building. PLR 200335030 (August 29, 2003). This ruling did not address whether the basis in the land on which the rehabilitated property was located should be included in the calculation of the 50% test as required by Code §42(h)(4)(B). Note: In PLR 200335030, the IRS also ruled that the tax-exempt financing did cause the existing building to be "federally subsidized" despite the fact that such financing was attributable solely to the rehabilitated property.

d. Income from the temporary investment of the sale proceeds of tax-exempt bonds that accrues through the date when a project is placed in service may be counted as bond proceeds for purposes of satisfying the 50% test under Code §42(h)(4)(B). Rev. Rul. 2002-21, 2002-17 I.R.B 793. PLR 200022042 (June 5, 2000); PLRs 200109011-014 (November 22, 2000).

e. A critical question in this context is how long tax-exempt bonds must remain outstanding in order to enable a building to be treated as bond-financed. The IRS has ruled that tax-exempt bonds which are redeemed on or after the date that a building is placed in service may nevertheless be treated as financing such building for purposes of Code §42(h)(4). PLR 9853036 (October 1, 1998); PLR 200324025 (February 27, 2003); PLR 200324042 (March 6, 2003); PLR 200334011 (May 7, 2003). 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

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

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

3. In order to generate low-income housing tax credits, tax-exempt bonds must be taken into account under volume cap provisions of Code §146 and principal payments on the financing provided with the tax-exempt bonds must be applied within a reasonable period of time to redeem the bonds. The ceiling on private activity bonds for calendar year 2009 is the greater of $90 multiplied by the State population or $273,270,000. Rev. Proc. 2009-21; 2009-13 IRB 724. In 2010, the volume limits will return to the prescribed levels had the 2008 Housing Act not been enacted. The increase in the bond cap indirectly increases the amount of low-income housing credits available, since projects financed by private activity bonds qualify for credits without an allocation from the state's credit volume cap. Note: The IRS has informally taken the position that, when tax-exempt bonds which are subject to the volume cap are refunded with new bonds which do not require a new volume cap allocation but which continue to be tax-exempt under the refunded bonds' original volume cap allocation, the new tax-exempt bonds are not treated as "taken into account" under the volume cap provisions of Code §146 and thus the new tax-exempt bonds do not generate low-income housing credits. This position, which seems questionable, is only of concern when a refund occurs prior to placement in service. See IV.H.1.e., supra.

4. Scattered site projects are not eligible for financing with tax-exempt bonds unless each scattered site qualifies as a "qualified residential rental project" under the bond rules. See Code §142(d); Treas. Reg. §1.103-8(b)(4)(ii). See also III.c.4 supra.

5. A single building project may qualify as a qualified residential project eligible for tax-exempt bond financing under Code §142(d) even if the low-income and market rate units in such building are owned by different taxpayers, allowing one taxpayer to retain the economic benefits available from the market rate units. PLR 200601021 (January 6, 2006). Apparently, the requirement that multiple buildings have the same owner (see Treas. Reg. § 1.103-8(b)(4)(ii)) was not a concern because, for bond purposes, this was a single building. This ruling paves the way for attracting tax credit investors to 80-20 projects, while preserving the investment in the market-rate units for economic investors.

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6. A building financed with the proceeds of tax-exempt bonds must contain "separate and complete facilities for living, sleeping, eating, cooking and sanitation." Treas. Reg. §1.103-8(b)(8)(i). Units may be served by centrally located equipment, such as heating and air conditioning, but not by shared bathrooms. See PLR 8308051 (November 24, 1982). The tax credit provisions are considerably more liberal in this respect as tax credits are allowable for buildings providing SRO housing used on other than a transient basis, even though such housing may provide eating, cooking and sanitation facilities on a shared basis. General Explanation of the Tax Reform Act of 1986 at 164.

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

I. Correction of Administrative Errors.

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

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

3. To correct an administrative error or omission which has been granted automatic approval by the IRS pursuant to Treas. Reg. § 1.42-13(b)(3)(vi), the agency is required by Treas. Reg. § 1.42-13(b)(3)(vii) to: (i) amend

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

J. LIHTC Exchange (Section 1602) Program authorized for 2009 State allocations.

1. States may elect to receive up to 40% of their 2009 housing credit ceiling as a federal housing grant, priced at $0.85 per dollar of credit, which would be used to award exchange subawards to finance the construction or acquisition and rehabilitation of qualified low-income buildings before January 1, 2011. Section 1602 of the American Recovery and Reinvestment Act ("ARRA") and Code §42(i)(9). States may also elect to receive 100% of their 2008 unused and 2009 returned housing credit as a grant, on similar terms. States interested in accepting all or a portion of the Section 1602 grant amount, must submit an application to the Treasury

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during the period May-June 2009. In addition to applications submitted in the period May-June 2009 applicants will be able to submit subsequent applications through 2010. Any grant funds not used to make subawards before January 1, 2011 must be returned to the Treasury on January 1, 2011.

2. The exchange subawards may be made to projects with or without an existing LIHTC allocation. The exchange subawards made not be made in the form of a loan. HUD/Treasury Webcast, May 6, 2009.

3. Those projects with existing LIHTC allocations are required through a written process to demonstrate good faith efforts as determined by the agency, to obtain investment commitments for such credits before the agency makes exchange subawards.

4. Exchange subawards received by taxpayer owners do not produce income to taxpayer owners. HUD/Treasury Webcast, May 6, 2009.

5. For projects using the grants in conjunction with LIHTC, ARRA provides that the basis of a qualified low-income building shall not be reduced by the amount of any grant of exchange subawards. Code §42(i)(9)(B).

6. Projects receiving these grants would be subject to LIHTC restrictions and compliance requirements. Projects would also be subject to construction and non-construction job creation and retention reporting requirements.

7. State allocating agencies are required to perform asset management functions to ensure compliance and the long-term viability of buildings under Section 42.

8. Projects will also be restricted by recapture provisions to assure all buildings that are funded remain qualified low-income buildings during the compliance period. Any recapture of the grant financing may be enforced by liens on the property made by the IRS.

9. GO Zone and Midwestern Disaster Credits do not qualify for exchange subawards. However, such projects could get a nominal allocation of LIHTC at the time of the exchange subaward and then qualify. [Query what minimum amount of an allocation would qualify as a valid allocation?]

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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 qualified low-income building. Seller no longer needs to post a bond or pledge US Treasury Securities for period required by Secretary. Not withstanding 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. 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). Rev. Proc. 2008-60 provides the procedures for taxpayers to follow when making the election to no longer maintain a surety bond or a TDA to avoid recapture.

b. Prior to the revision of the regulations under Code § 708 in 1997 (see II.B.2.c.(iii), supra), dispositions of partnership interests were generally treated as recapture events (unless a. and b. above were satisfied). Exceptions were provided for: (i) "de minimis" transfers of up to one-third of partner's "greatest total interest" in the project through the partnership at any point in time (Rev. Rul. 90-60, supra); (ii) dispositions of interests in large partnerships (see C., infra); (iii) the transfer of partnership interests from a parent corporation to its wholly-owned subsidiary (PLR 9737006 (June 11, 1997)); and (iv) the transfer of partnership interests to a trust upon the death of a partner (assuming the partnership agreement provided that the death of a partner would not cause the partnership to terminate) (PLR 9801028 (September 30, 1997)). Although not specifically addressed in PLR 9801028, it is likely that this exception to the recapture rules also applies to a transfer of partnership interests to the deceased's estate. Query whether a reduction in a partner's distributive share of credits by virtue of a reallocation of tax losses under the Code §704 rules is a "disposition" for this purpose. See Treas. Reg. §1.47-6; but see PLR 8651050 to the effect that a reallocation of income and gain to a general partner pursuant to Section 704(b) does not change the limited partners' share of "general profits" for the purpose of triggering recapture of rehabilitation credits allowable under Section 47 of the Code.

c. In PLR 199924064 (March 17, 1999), the IRS held that, in the context of transfers between members of an affiliated group, the disposition of interests in several partnerships which resulted in the

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deemed contribution of Code § 42 property to new partnerships under Treas. Reg. § 1.708-1(b)(1)(iv) would not be treated as a disposition of Code § 42 property resulting in recapture of low-income housing tax credits under Code § 42(j). In reaching this conclusion, the IRS stated that little guidance is available to illustrate when, under Code § 42(j), a reduction in qualified basis of a building with respect to a taxpayer has occurred or when there has been a disposition that requires the posting of a bond to avoid recapture. The IRS therefore relied upon the analogous application of provisions concerning the recapture of the investment tax credit ("ITC"), including Treas. Reg. § 1.47-3(f)(1) which provides for an exception to the ITC recapture rules in the case of a mere change in form of conducting a trade or business. The IRS expressed no opinion, however, regarding the application of Treas. Reg. § 1.708-1(b)(1)(iv) to the technical termination of a large partnership (see C, infra). See also PLR 200445015 (November 5, 2004) (transfer of partnership interest to fourth-tier subsidiary in a series of Code § 351 transactions did not result in a recapture event, transferor was deemed to hold the interest constructively after the transfer); PLR 200018022 (January 26, 2000); PLR 2000121016 (February 17, 2000).

d. The sale of bare legal title to a project owned by a partnership to its general partner was not considered a disposition or change in ownership of its interest in the project, and did not trigger recapture. PLR 9903005 (January 22, 1999). See also PLR 200029044 (April 24, 2000); PLR 200206037 (February 8, 2002). PLRs 200232018-20 (August 9, 2002); PLRs 200233013-15 (August 16, 2002).

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

3. Reduction in number of low-income units without disqualification may result in partial recapture, i.e., reduction in Qualified Basis. A reconfiguration of the type of units (i.e., from one and two bedrooms to three bedrooms), where the number of units, percentage of low-income units, and rent charged were not changed, did not result in recapture. PLR 9846008 (November 13, 1998).

4. Failure to repay loan from non-profit organization described in VI.C.2., infra.

5. No recapture upon casualty if project reconstructed within reasonable period. CCA 200134006 (August 24, 2001), states that (i) the meaning of

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casualty loss for tax credit recapture purposes should be consistent with the tax principles for a casualty loss under Code §165, (ii) the state agency must report to the IRS the reduction in qualified basis resulting from a casualty loss, and (iii) there is no support for the taxpayer continuing to claim credits for units which are out of service due to a casualty loss (unless the units are located in a federally declared disaster area). If a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, which is a reasonable period, then there is no recapture and no loss of credits. If the owner had failed to restore the building by the end of the taxable year, no credits would be allowed for the entire taxable year, even if the reasonable period (or reasonable restoration period) to the restore the building extends into the next taxable year. CCA 200913012 (February 20, 2009). Note: The IRS further ruled that reconstruction completed within two years of the casualty was within a reasonable period based on general tax principles under Code §165. If the building's qualified basis is not restored within the reasonable period (or reasonable restoration period), then the building will be subject to recapture under Code §42(j)(1) in the taxable year in which the disaster occurred and the owner cannot claim credits on the building for that taxable year. The owner also will lose all credits claimed during the restoration period. CCA 200913012 (February 20, 2009). In Rev. Proc. 2007-54 the IRS announced that an owner of a building that is beyond the first year of the credit period would not be subject to recapture or loss of credit if the building's qualified basis suffered a reduction because of a disaster that caused the President to issue a major disaster declaration, provided the building's qualified basis is restored within a reasonable period. The IRS has determined that it is appropriate to extend the restoration period provided under Rev. Proc. 2007-54 for qualified low-income buildings located in the GO Zone. Notice 2007-66. Code §42(j)(4)(E) only provides recapture relief for casualty events; it does not provide the allowance of credits during the period of time that the building is being restored due to casualty events not covered under Rev. Proc. 2007-54. CCA 200913012 (February 20, 2009).

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

B. Amount Subject to Recapture.

1. "Accelerated portion of the credit", that is, the excess of the credits claimed over the credits that would be allowable if they were claimed

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ratably over the 15-year Compliance Period. (No recapture of unused credits.)

2. Interest determined under Code §6621 as if accelerated portion had been deficiency in each year for which it is recaptured.

3. No deduction for interest described in 2, even for corporations.

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

C. Large Partnerships.

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

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

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

VI. LIMITATIONS ON CREDIT

A. Regular Section 38 Rules Apply.

1. One-year carryback and twenty-year carryforward for unused Credits. Code § 39.

2. The LIHTC May Offset Alternative Minimum Tax ("AMT") Liability. To the extent attributable to buildings placed in service after Dec. 31, 2007, the §42 LIHTC is included in the list of specified credits in Code §38(c)(4)(B)(ii) as amended. The tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation of Code §38(c)(1) with respect to the low-income housing credit, so that the low-income housing tax credit may offset the AMT liability.

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B. Section 183 Does Not Apply.

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

2. Nevertheless, other principles of tax laws such as "sham," "economic substance" or "ownership" analysis may limit such tax benefits. Treas. Reg. §1.42-4(b).

3. Code §42(i)(7) provides, however, that "no federal income tax benefit" shall be disallowed because a qualified nonprofit organization, government agency, tenants' organization or resident management organization has a "right of 1st refusal" to purchase the property at the end of the Compliance Period. A purchase option may not come within this provision because, unlike a "right of 1st refusal," an option entitles the holder to force a sale of the project. See 136 Cong. Rec. E 2925 (1990). The right of first refusal must be exercisable for a fixed price not less than the sum of

a. the principal amount of all indebtedness encumbering the property other than indebtedness incurred within the 5-year period ending on the date of purchase; and

b. the amount of federal, state and local income taxes attributable to such sale.

C. Application of At Risk Rules.

1. Generally, regular investment tax credit rules apply.

a. Nonrecourse financing treated as amount "at risk" only if

(i) the property is not acquired by the taxpayer from a related person (within the meaning of Code §465(b)(3)(C)); and

(ii) such financing is received from a lender in the business of lending (other than the seller of the property) or a government agency. Code §49(a)(1)(D).

b. At risk limitations do not apply to widely-held C corporations.

c. For partnerships or S corporations, limitations are applied at the partner or shareholder level.

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2. Loans from a qualified nonprofit organization, see IV.F.1., supra, may also be included in amounts at risk whether or not such organization would be a qualified lender provided that

a. the loan is secured by project (unless not permitted by Federal agency holding or insuring a mortgage on the project);

b. the loan represents not more than 60% of project's Eligible Basis, determined at the close of each taxable year; and

c. the loan is repaid on the first to occur of

(i) maturity;

(ii) 90 days after close of Compliance Period, if the loan represents seller financing;

(iii) 90 days after the earlier of the date the building ceases to be a qualified low-income project or the date which is 15 years after the close of a Compliance Period; or

(iv) date of sale of project or refinancing of loan.

3. Interest rate on loans described in 2 may be 1% below AFR.

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

D. Application of Passive Activity Rules.

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

2. Section 502 of the Tax Reform Act of 1986 contains a transition rule making the passive activity rules inapplicable for a limited period of time after 1986 for qualified investors in certain low-income housing projects. Section 502(e)(3) states that no low-income housing credit is available "with respect to any project with respect to which any person has been

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allowed any benefit under [the Section 502 transition rule]." Notwithstanding the language of Section 502(e)(3), in Rev. Rul. 97-4, 1997-1 C.B. 5 (December 30, 1996), the IRS ruled that Section 502(e)(3) was intended only to deny the simultaneous claiming of credits and Section 502 relief and, thus, after the benefits of Section 502 were no longer available for a building, a taxpayer would not be prevented from claiming credits on the building by virtue of having previously claimed Section 502 relief. Although the facts of Rev. Rul. 97-4 involve the purchase of a project with respect to which Section 502 relief had been claimed by a taxpayer who did not claim such relief, the reasoning of the ruling would also seem to encompass the claiming of credits for rehabilitation of a building by the same persons who had the benefit of Section 502, provided that the credit period for the rehabilitation begins when Section 502 benefits are no longer available.

VII. MASSACHUSETTS LOW-INCOME HOUSING TAX CREDIT

A. Timing and Amount of Credit.

1. The Massachusetts Department of Housing and Community Development or its successor agency (the "Department") may authorize annually, for the ten year period beginning January 1, 2001 and ending December 31, 2010, low-income housing tax credits equal to the lesser of 50% of the federal per capita tax credits awarded to the Commonwealth or four (4) million dollars, plus unused Massachusetts low-income housing tax credits, if any, for the preceding calendar years and any Massachusetts low-income housing tax credits returned to the Department by a qualified Massachusetts project. M.G.L. ch. 62, § 6I(b)(1); M.G.L. ch. 63, § 31H(b)(1); 760 CMR 54.03(1). Under legislation approved in 2004, the Department may allow applicants to elect to receive the award in the form of a loan (in an amount not to exceed (as determined by the Department) the expected equity yield from a hypothetical sale of the credits), rather than state tax credits. However, the Department has indicated informally that it has never offered, and does not expect to offer, applicants the option to receive the award in the form of a loan.

2. The Massachusetts low-income housing tax credit will allow a credit for each year of the credit period, which in Massachusetts shall equal five years. A full year of credit may be claimed in the year the project first becomes a qualified project, typically when the project satisfies the 40-60 test or the 20-50 test. The credit shall be subtracted from the amount of state tax otherwise due for each taxable period and shall not be refundable. Any amount of the available Massachusetts low-income housing tax credit which exceeds the tax due for a taxable year in the credit period may be carried forward to any of the five subsequent taxable years. The credit can be claimed by both individuals and corporations. M.G.L. ch. 62, § 6I(c)(3); M.G.L. ch. 63, § 31H(c)(3). Three types of qualified

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Massachusetts projects are eligible for an allocation of Massachusetts low-income housing credits: 1) projects to which the Department has made a prior allocation of federal low-income housing credits, 2) projects to which the Department makes a simultaneous allocation of federal low-income housing credits, and 3) projects with respect to which the federal low-income housing credit is allowable by reason of Code § 42(h)(4) applicable to buildings financed with tax-exempt bonds. 760 CMR 54.04(1).

3. With the exception of unused Massachusetts low-income housing credits which may be carried forward (see A.2., supra) and except for credits claimed under regulations promulgated by the Department consistent with the rule set forth in Code § 42(f)(2) (allowing credits for the first year of the credit period to be reduced if the building is in service less than 12 months of the first year, with the unused portion of the first-year credit allowed in the 11th year), a taxpayer 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 allocated federal low-income housing tax credits in order to be eligible to receive the Massachusetts low-income housing tax credit. M.G.L. ch. 62, § 6I(c)(1); M.G.L. ch. 63, § 31H(c)(1).

2. The Department shall determine eligibility for and allocate the Massachusetts low-income housing tax credit in accordance with the standards and requirements set forth in Section 42 of the Code. M.G.L. ch. 62, § 6I(b)(2); M.G.L. ch. 63, § 31H(b)(2). The total Massachusetts low-income housing tax credit available to a project shall be authorized and allocated by the Department based on the project's need for the credit for economic feasibility. M.G.L. ch. 62, § 6I(c)(2); M.G.L. ch. 63, § 31H(c)(2). Note: Although projects eligible for the Massachusetts low-income housing tax credit must satisfy the 40-60 Test or the 20-50 Test, the amount of the Massachusetts low-income housing tax credit does not depend the amount of eligible basis or qualified basis.

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

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

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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. Curiously, however, the transferee must be entitled to claim a federal low-income housing tax credit with respect to a project in Massachusetts that has received an allocation of state credits. 760 CMR 54.07(1).

6. On March 8, 2006, the Department of Revenue issued LR 06-2 interpreting certain provisions of the Massachusetts historic rehabilitation tax credit that parallel the Massachusetts low-income housing tax credit rules. In particular, the DOR ruled that (i) a partner who is otherwise allocated .01% of a partnership's profits, losses, deductions and gains may nonetheless be allocated 100% of the partnership's historic credits and (ii) a partner that is an exempt organization under Section 501(c)(3) of the Code is, if allocated historic credits, eligible to transfer such credits.

7. Note: Because state taxes are deductible for federal income tax purposes, a state tax credit generally does not provide dollar-for-dollar tax savings. For example, a Massachusetts taxpayer in a 35% federal tax bracket will reduce its combined Federal and Massachusetts tax liability by only 65 cents for every dollar of the Massachusetts credit. However, a state tax credit that has been transferred (as opposed to allocated among those with a direct or indirect ownership interest in the asset generating the credit) is more valuable because it is treated differently. In this case, the IRS has ruled that the use of the 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 (October 29, 2004) (Massachusetts low-income housing and historic rehabilitation credits); PLR 200348002 (November 28, 2003). However, the use of the credit will generate gain to the extent the face value of the credit exceeds the transferee's basis in the credit. CCA 200211042 (February 5, 2002).

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

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amount of federal low-income housing tax credits previously claimed. M.G.L. ch. 62, § 6I(d)(2); M.G.L. ch. 63, § 31H(d)(2).

2. Oddly enough, this means that a reduction in federal qualified basis can trigger recapture of the Massachusetts low-income housing tax credit, even though the amount of federal qualified basis may not have been taken into account in determining the amount of Massachusetts low-income housing tax credits allocated to the project.

3. If the Massachusetts low-income housing credit has been transferred, the transferee is liable for the recapture amount (notwithstanding any agreement between the transferor and transferee). 760 CMR 54.12(1).

VIII. COLLATERAL TAX ISSUES

A. Partnership Allocations.

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

1. Credits Generally. Low-income housing tax credits, unlike credits for historic rehabilitations, are not considered "investment tax credits." See Code §38(b)(1)(5). Consequently, low-income housing tax credits are allocated in the same manner as the allocation of depreciation deductions with respect to the Qualified Basis on which these credits are claimed. See Treas. Reg. §1.704-1(b)(4)(ii); see also, Chief Counsel Advice 200812023 (March 21, 2008). Capital accounts are not reduced by the amount of these credits. By contrast rehabilitation tax credits are generally allocated in proportion to the partners' share of profits and result in a charge to the partners' capital accounts.

2. Minimum Gain. Thus, partnership allocations of depreciation must be respected under Code §704(b) (or Code §704(c)) in order for allocations of low-income credits to work as intended. When depreciation and other deductions drive the capital accounts of the partners negative, a minimum gain analysis is required. Such analysis must show, in effect, that in a taxable disposition of the project for no consideration other than satisfaction of the debt to which it is subject, sufficient gain would be recognized to zero out the negative capital accounts of the partners. In many low-income housing partnerships the equity investment of the partners is sufficiently large that the partners will not have negative capital account balances during the Compliance Period, making a minimum gain analysis unnecessary.

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

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the partnership, including depreciation, are sufficient to create negative capital account balances, the losses and accompanying credits may be subject to reallocation to the partner who made, or whose affiliate made, such loans. Such a reallocation is generally not required when the lending affiliate owns less than 80% of a partner. To prevent potential reallocations, it is not uncommon for a project sponsor to divest itself of more than 20% of the ownership of the general partner when the project sponsor will have loans to, or deferred fees payable from, the partnership.

4. Loans with a Built-In Forgiveness Feature. The IRS may treat a loan of federal funds with a built-in forgiveness feature as a federal grant rather than a loan and thus exclude the amount of such loan from credit basis. See Erickson Post Acquisition Inc., TC Memo 2003-218, non-acq 2006-24 IRB. 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.

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

B. Deferred Development Fees.

1. Bona Fide Debt. Any debt obligation, including an obligation to pay a deferred developer fee, must be respected as bona fide debt in order to be included in the basis of the project for credit and depreciation purposes. See Corbin West Limited Partnership v. Comm'r, T.C. Memo 1999-7 (January 15, 1999). At a minimum, this means that the obligation must have a definite maturity date and the partnership must be able to establish that it is likely to be paid on or before such date. See TAM 200044004 (July 14, 2000), discussed in II.C.110., supra. It is also recommended that the obligation be secured by a mortgage on the project, especially if it is to be taken into account in a minimum gain analysis.

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

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2. Matching Income and Deductions. Generally Code §267 requires a matching of the year in which a fee paid by a partnership to a partner or "related person" is included in the partnership's basis for depreciation purposes and the year in which it is included in the income of the payee. For this purpose, any partner and any owner of more than 5% of a corporate partner is a "related person." Code §267(e)(1)(B) and (3)(B). This matching requirement is not a problem if the payee is a tax-exempt organization and the fee does not represent unrelated business taxable income. See PLRs 9438030 (June 28, 1994) and 8938002 (May 31, 1989), holding that development fees are not unrelated business taxable income. Taxable payees may take the position that Code §267(a)(2) applies only to the matching of income and "deductions" and, accordingly, does not preclude the claiming of credits on fees incurred by a partnership but not included in the income of a related cash basis payee. Such a payee may insist that the fee be unsecured, however, in order not to be deemed in receipt of "property" which represents taxable compensation. See Treas. Reg. §1.83-3(e).

C. Partnership Anti-Abuse Regulations.

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 Code §704(b) Regulations. The transaction in this example is stated not to be inconsistent with the intent of Subchapter K and not subject to recasting by the IRS. Treas. Reg. §1.701-2(d), Example 8. Note: Although not specifically addressed in the example, if the partner who is not allocated credits and depreciation made a capital contribution, satisfaction of the Section 704(b) rules should require a deficit restoration obligation from the other two partners.

2. In Chief Counsel Advices 200704028 and 200704030 released on January 26, 2007, the Chief Counsel advised the Service to recast purported partnerships formed to take advantage of State income tax credits. In these CCAs, a developer and various investors acting through a promoter formed a partnership. Under the terms of the partnership agreement, the

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investors contributed cash in exchange for the allocation of state tax credits earned by developer. The investors also executed option agreements granting the partnership an option to repurchase the investors' interests for their fair market value for a period of one year. Most investors sold their interests to the partnership within a short period of time for a fraction of their bases and subsequently claimed 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. 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 partnership purposes because there was no joint profit motive between the developer and the investors and (ii) the disguised sale rules under Code §707(b) applied to the transfer of the credits to the investors. Accordingly, the Chief Counsel urged the Service to disregard the partnerships and recast the transactions for federal tax purposes as a sale of state credits by the partnership to the investors, fully subject to gain recognition, and to disallow any capital losses on the transaction. The position of the Chief Counsel is actually favorable to investors, who would receive a deduction for state taxes paid under Code § 164 rather than a capital loss. It is, however, adverse to developers who would be required to recognize ordinary income upon the "sale" of the state credits. See CCA 200211042 (February 5, 2002).

D. Imputed Interest.

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

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

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would have caused the project to be unable to service the existing first mortgage loan.

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

3. Comment: When a loan is made in exchange for property, e.g., seller-financing in connection with a purchase of real property, Code § 7872 does not apply and interest is imputed under Code § 1274, which contains no exception for loans from governmental or charitable organizations. Thus, if a below-market note is issued to a charitable or governmental entity as the seller of property, a portion of the stated principal amount of the note will be recharacterized as interest and the cost basis of the property will be reduced accordingly. Similarly, a "significant modification" of a loan (within the meaning of Treas. Reg. § 1.1001-3) from a governmental or charitable organization will result in cancellation of debt income if the modified loan does not bear interest at or above the AFR. CCA 199943037 (October 29, 1999).

E. Property Taxes.

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. 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, Brandon Bay Ltd. Partnership v. Payette County, 2006 WL 695529 (Idaho 2006) (appraisal properly took into account both federal low-income housing credits and restricted rents); Huron Ridge LP v. Township of Ypsilanti, 2005 WL 1798589 (Mich. Tax Tribunal 2005) (Id.); Town Square Ltd. Partnership v. Clay County Board of Equalization, 704 N.W.2d 896 (S.D. 2005) (Id.); Spring Hill, L.P. v. Tennessee State Bd. of Equalization, 2003 WL 23099679 (Tenn.Ct.App. 2003) (Id.); In Re Appeal of Green Pines Ltd., 576 S.E.2d 316 (N.C. 2003) (appraisal properly valued project using market rents because the rent restrictions were voluntarily assumed by the project in order to take advantage of available federal and state tax incentives);

F. Tax-Exempt-Use Property.

Participation by a tax-exempt organization in a project may cause all or a portion of the property to be treated as "tax-exempt-use property" under Code §168(h). If property is treated as "tax-exempt-use property, it will have to be depreciated over a 40-year recovery period rather than over a 27.5 year recovery period. Code §470 generally limits losses with respect to tax-exempt use property, but does not apply to projects to which Code §42 applies. In general, property owned by a

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partnership in which a tax-exempt entity is a partner constitutes tax-exempt-use property, at least in part. The portion of such property treated as tax-exempt-use property is the highest percentage of partnership income or gain (other than Section 704(c) gain) which the tax-exempt entity may receive. For these purposes, a "tax-exempt controlled entity", which is defined as any corporation of which tax-exempt entities own 50% or more of the stock, is treated as a tax-exempt entity, unless it elects under Code §168(h)(6) to have its tax-exempt owner treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the controlled entity. Thus, to avoid tax-exempt use property concerns, a tax-exempt organization should own its interest in a partnership indirectly through a taxable corporate subsidiary which elects under Code §168(h)(6) to have the tax-exempt parent treat as unrelated business taxable income any dividends, interest or gain from the sale of stock with respect to the taxable subsidiary. This will ensure that no portion of the project would be treated as tax-exempt-use property. Note: The election must be made by the due date of the tax return for the first taxable year for which the election is to be effective. Treas. Reg. §301.9100-7T (a)(2)(i). See also PLR 199933043 (May 21, 1999) (noting that the IRS has discretion to grant a reasonable extension of time to make such election provided that the taxpayer demonstrates (1) that they acted reasonably and in good faith and (2) that relief will not prejudice the interest of the government).

G. Reportable Transactions: Disclosure Requirements and Excise Taxes.

1. Disclosure Requirements. Code §6011 and the regulations thereunder impose reporting requirements on certain categories of transactions and may apply to an investment in a low-income housing transaction. The disclosure requirements apply to "reportable transactions" which include, among other things, transactions in which there is "contractual protection", that is a transaction in which a taxpayer or a related party (as defined in Code § 267(b) or 707(b)) is entitled to a full or partial refund (or a reduction) of fees paid to a person who provides a statement (written or oral) about the tax consequences of the transaction (or for whose benefit a statement is made or provided to the taxpayer or related party) if all or part of the intended tax consequences from the transaction are not sustained. Treas. Reg. §6011-4(a). These transactions must be reported by any taxpayer whose income tax or informational return reflects a tax benefit from the transaction and who would be entitled to a full or partial refund of fees. There had been concern that investments in low-income housing tax credit transactions would be subject to these disclosure requirements because of the "contractual protection" often provided by tax credit adjuster and other transaction guaranties. The Service, however, has ruled that transactions in which there is a refundable or contingent fee "related to" low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, IRB 2007-7 (Feb. 12, 2007).

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2. Excise Taxes. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), enacted on May 17, 2006, creates a new Code §4965, which designates certain transactions as prohibited tax shelter transactions and imposes new excise taxes on a tax-exempt organization and its managers if the organization becomes a party to a to a "listed transaction" or a "prohibited tax-shelter transaction." Code §4965(a)(1). Although a "prohibited tax-shelter transaction." includes a transaction with contractual protection under Treas. Reg. §1.6011-4(b)(4), the Service has ruled that transactions in which there is a refundable or contingent fee "related to" low-income housing credits are not taken into account in determining whether a transaction is a transaction with contractual protection. Rev. Proc. 2007-20, IRB 2007-7 (Feb. 12, 2007).

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 credits because there is no exception for transaction in which there is a refundable or contingent fee related to the rehabilitation credit.

H. 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).

I. 2005 Hurricane-Related Relief.

1. Increased Credit Authority

a. *Gulf Opportunity Zone* - the 2006, 2007 and 2008 state credit ceilings of states located within the so-called Gulf Opportunity Zone (which includes portions of Alabama, Mississippi and Louisiana) is increased by the lesser of (i) $18.00 per resident within the Gulf Opportunity Zone or (ii) the credits actually allocated to projects located within the Gulf Opportunity Zone for such year. Code §1400N(c)(1). The areas of Alabama, Mississippi and Louisiana included within the Gulf Opportunity Zone are reflecting in IRS Fact Sheet 2006-1 (January 2006).

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b. *Texas and Florida* – the 2006 state credit ceilings of Florida and Texas are each increased by $3,500,000. Code §1400N(c)(2).

2. Additional Difficult Development Areas – the Gulf Opportunity Zone, the Rita GO Zone and the Wilma GO Zone are treated as difficult development areas with respect to buildings placed in service in 2006, 2007 and 2008 and receiving credit allocations in such years (or bond-financed projects in which the bonds are issued after December 31, 2005). Code §1400N(c)(3). The contours of the Rita and Wilma GO Zones are also reflected in IRS Fact Sheet 2006-1. Pending legislation (H.R. 1562) approved by the House of Representatives on March 29, 2007 would continue to treat GO Zones as difficult development areas through December 31, 2010 and provide that Community Development Block Grants are not taken into account when determining whether buildings located in GO Zones are federally subsidized. Finally, H.R. 1562 would suspend the rule that requires an allocation (other than a carryover allocation) to be made no later than the close of the calendar year in which a building is placed in service for allocations made in 2006, 2007 and 2008 for buildings located in GO Zones, provided such buildings are placed in service no later than January 1, 2011.

3. Special Rule for Applying Income Tests – in the case of buildings placed in service in 2006, 2007 and 2008 in nonmetropolitan areas within the Gulf Opportunity Zone, the income limits of Code §42 are applied by using "national nonmetropolitan median gross income" (determined under the rules applicable to Section 8) rather than area median gross income. Code §1400N(c)(4).

4. Special Occupancy Rules **-** In Notice 2005-69, 2005-40 IRB 622 (effective August 29, 2005), the IRS granted state tax credit agencies the authority to designate "temporary housing periods" (not to extend beyond September 30, 2006) during which, if authorized at the project-level by the agency, displaced individuals who resided in jurisdictions in Alabama, Louisiana and Mississippi designated for individual assistance by FEMA in the wake of Hurricane Katrina will be deemed (notwithstanding actual income) qualified low-income tenants for the purposes of determining a project's first-year qualified basis and satisfaction of the 40-60 and 20-50 Tests. In addition, in years following the first year of the credit period, occupancy by such individuals during a designated temporary housing period will be disregarded in (i) determining the status of a vacant unit and (ii) triggering application of the available unit rule (see III.B.6.b, supra). Building owners need not make attempts to rent to low-income individuals the low-income units occupied by displaced individuals. The rules requiring non-transient occupancy will not apply to any unit providing temporary housing to displaced individuals during a designated temporary housing period, but the rent restrictions applicable to low-income units occupied by displaced individuals will continue to apply and existing tenants may

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not be evicted or have their tenancy terminated as a result of efforts to provide temporary housing to displaced individuals. The Notice also imposes special recordkeeping, certification and listing requirements. Notice 2006-11, 2006-7 IRB 457 (effective September 24, 2005) provides relief on similar terms for displaced individuals who lived in areas of Louisiana and Texas designated for individual assistance by FEMA in the wake of Hurricane Rita.