

March 27, 2014

Via Email

Internal Revenue Service
Attn: Grace Robertson, C2-422
5000 Ellin Road
Lanham, MD 20706
Grace.F.Robertson@irs.gov

Re: Comments on Audit Technique Guide for IRC Section 42

Dear Grace:

Enclosed are comments concerning the Audit Technique Guide for IRC Section 42, Low-Income Housing Credit. These comments were prepared by the Tax Credit-Equity Financing Committee of the American Bar Association Forum on Affordable Housing and Community Development Law (“ABA Forum”). The following people had principal responsibility for preparing portions these comments: Kelly Bissinger, William Callison, Angela Christie, Eugene Crick, Glenn Graff, Kenneth Gross, Daniel Kraus, Jessica Rizer, Mike Saad, Brad Tomtishen, and Susan Wilson. Substantive contributions were made by Alan Cohen Jan Hetland and Michael Haun. Additional comments were made by Craig Emden, Beth Mullen and Edward Ryan. The comments are also supported by the additional organizations and people listed below.

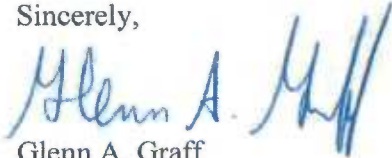
We are submitting two files for your review. The first is a WORD document that contains the entire audit guide with our comments inserted throughout the document. If you go to the table of contents, you will see certain chapter numbers and Appendix C in blue print. These are the chapters or the appendix for which we had comments. If you click on the blue print, it will take you to that chapter or appendix. You will also note that we did not change the page numbering. If our edit caused additional pages, those pages were not numbered. The second file is a PDF and it only has the pages that contain comments.

The Guide has obviously been an extensive undertaking and is comprehensive in its reach. The Committee has been selective in choosing its comments due to time restrictions and other constraints. The absence of comments on any issue should not be construed as agreement by the Committee or its members on the conclusions expressed in the Guide, nor should any comments be deemed to express positions of the individual members of the Committee or their law firms.

Grace Robertson
March 27, 2014
Page 2

We appreciate the opportunity to provide comments on the Draft Audit Techniques Guide. We hope these comments will be helpful. If you need any explanation behind any of the comments, please feel free to contact us.

Sincerely,



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Co-Chairs
Tax Credit-Equity Financing Committee
American Bar Association Forum on Affordable Housing and Community Development Law

Additional Organizations and Persons Signing in Support of this Letter

The Affordable Housing Tax Credit Coalition
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Applegate & Thorne-Thomsen, P.C.
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Ballard Spahr LLP
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Harold R. Berk
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Bocarsly Emden Cowan Esmail & Arndt LLP
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William J. Callison of
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Carle, Mackie, Power & Ross LLP
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Angela M. Christy of
Faegre Baker Daniels LLP
◆
City Real Estate Advisors, Inc.
◆
CohnReznick LLP
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Council for Affordable and Rural Housing
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Dykema
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Enterprise Community Partners, Inc.
◆
Foley & Judell, L.L.P.
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Gallagher Evelius and Jones LLP
◆
General Counsel's Office, Community Builders, Inc.
◆
Gubb and Barshay
◆
Michael Haun of
Paul Hastings LLP
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Additional Organizations and Persons Signing in Support of this Letter (continued)

Janice Hetland of
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Hobson Bernardino + Davis LLP
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Holland & Knight LLPA
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Housing on Merit
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Kantor Taylor Nelson Evatt & Decina PC
◆
Klein Hornig
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Daniel L. Kraus
◆
Kutak Rock LLP
◆
Liles & Rushin, LLC
◆
Nixon Peabody LLP
◆
Novogradac & Company LLP
◆
Nuyen, Tomtishen and Aoun, P.C.
◆
Raymond James Tax Credit Funds, Inc.
◆
Red Stone Equity Partners, LLC
◆
Reno & Cavanaugh, PLLC
◆
Squire Sanders (US) LLP
◆
Stoel Rives LLP
◆
Stryker Slev Law Group
◆
Whyte Hirschboeck Dudek S.C.
◆
Winthrop & Weinstine, P.A.
◆

Edited Pages

- Chapter 2
 - Page 2-4: Multi-Building Projects
- Chapter 5
 - Page 5-5: Extended Use Agreement
- Chapter 6
 - Pages 6-1 through 6-6: Non-Profit Set Aside
- Chapter 7
 - Page 7-1: No Longer Participating in the IRC §42 Program
- Chapter 8
 - Pages 8-15 through 8-25: Developer Fee
 - Page 8-27: Bond Issuance Costs
- Chapter 10
 - Page 10-4: At-risk Rules
- Chapter 11
 - Page 11-6: Grant to Loan
- Chapter 12
 - Page 12-17: Utility Allowance
 - Page 12-30: General Public Use (Fair Housing)
 - Page 12-34: Noncompliance Issues
- Chapter 16
 - Page 16-6: Casualty Loss
- Appendix C: Treatment of Assets/Costs for IRC §42 Purposes

**Multi-Building
Projects**

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

1. are located on the same tract of land (including contiguous parcels), unless all of the dwelling units in all the buildings are rent-restricted low-income units (see IRC §42(g)(7),
2. are owned by the same person for federal tax purposes, and
3. are financed under a common plan of financing, and
4. have similarly constructed housing units.

COMMENT 2-1:

Section 42(g)(7) states that all dwelling units in each of the buildings must be rent-restricted within the meaning of paragraph (2). The Guide's reference to "low-income unit" leads to confusion as that is a defined term that is broader than the rent-restriction language of Section 42(g)(7). Section 42(i)(3) defines a "Low-Income Unit" as a unit that is (1) rent-restricted as defined in 42(g)(2), and (2) occupied by low-income persons. The Guide's statement that all units must be "Low-Income Units" results in the addition of a requirement that all units must be occupied by low-income persons. The clear wording of Section 42(g)(7) requires only that units be rent-restricted and thus the change from "low income unit" rent-restricted is recommended.

In addition, the reference to contiguous land has been added as buildings on contiguous parcels can be part of one project. See Reg. §1.103-8(b)(4)(ii) and Prop. Reg. §1.103-8(b)(4)(ii). Finally, the Code does not require that buildings be of similar construction. While some initial legislative history contained the similar construction requirement, such a requirement is not in the Code. The presence of 1989 amendments to Section 42 adding the scattered site provision provides additional support for the non-inclusion of a similar construction requirement. Having similar construction would become either difficult or impossible or just fortuitous for an owner purchasing and rehabilitating buildings that are not near each other. Furthermore, a project may include traditional apartments, duplexes and individual houses in the same project subject to the requirements of 42(d)(3) (eligible basis reduced where disproportionate standard for units). Furthermore, the term similar construction is vague and ambiguous. Does it mean same type of buildings, same style of buildings, or similar costs per buildings? For these reasons, we recommend its deletion.

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

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

**Minimum
Set-Aside**

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

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

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

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

1. the value of the land and buildings,
2. changes in ownership during the life of the project that may have triggered the credit recapture requirements,
3. debt financing used to finance the low-income project,

**Property
Address**

state law. Also review mortgages and other restrictive covenants recorded against the property; these agreements may include conditions that are inconsistent with IRC §42 requirements.

2. The extended use agreement is a contract between the state agency allocating the IRC §42 credit and the taxpayer owning the IRC §42 project. Make sure the extended use agreement is executed by the owner of the project~~both parties~~.

COMMENT 5-1:

The only requirement should be that the extended use agreement is a legally binding agreement under applicable state law.

While Section 42(h)(6) requires an “agreement between the taxpayer and the housing credit agency”, the signature of the housing credit agency is not required to create an agreement between the two entities. Many legal documents create an agreement without being signed by both parties. A promissory note is obviously a legal agreement to pay money even though not signed by the lender. A condominium declaration is only signed by the property owner, but it clearly creates rights and obligations that run with the property. The extended use agreement, when signed by the property owner, is a similar agreement that creates obligations that run with the property.

Some state agencies have promulgated forms that do not require the credit agency’s signature. This requirement in the audit guide should not place in doubt the validity of the extended use agreements previously executed and recorded in those states.

Because the extended use agreement is to be filed before the end of the first year of the tax credit period, agencies are concerned about the workload created at year-end reviewing and executing extended use agreements. The property owner’s execution of a form developed by the state credit agency creates a binding agreement. Prior to issuing the Form 8609, the state credit agency can verify that the extended use agreement form is properly completed and can require that it be amended if there are any errors. Any amendment would have to be signed by both the property owner and the credit agency, since the property owner could not unilaterally amend a binding agreement.

3. Evaluate whether the extended use agreement meets the IRC §42(h)(6)(B) requirements. Under IRC §42(m)(1)(B) and (C), state agencies can impose additional conditions upon the credit allocation to serve the lowest income tenants for the longest periods in specified locations. For example, the state agency may require a taxpayer to set-aside a percentage of low-income units for occupancy by households with income less than 30% of the area’s median gross income, even though the taxpayer elects the 40-60 minimum set-aside under IRC §42(g)(1). These additional requirements will also be reflected in the

extended use agreement, but are not enforced under IRC §42. Rather, it is the state agency's responsibility to address noncompliance under state law.

4. For extended use agreements executed before January 1, 2006, that include catch-all language requiring compliance with IRC §42 requirements, ask the taxpayer to provide the state agency's notification that the catch-all language prohibits the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period. If the original extended use agreement did not contain catch-all language or specific language on the IRC §42(h)(6)(B)(i) prohibitions, then the agreement should have been amended by December 31, 2005.
5. For extended use agreements executed after December 31, 2005, the agreement should include specific language prohibiting the taxpayer from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) and increasing the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period.
6. If the state agency identified noncompliance, a Form 8823 should have been filed with the IRS. The report should have included an explanation and copy of the notification letter beginning the one-year correction period. Contact the state agency to determine whether the noncompliance issue was timely resolved.

Disallowance of Credit

Disallowance of Current Year Credit

Noncompliance occurs if:

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

Chapter 6
Nonprofit Set-Aside [SEE COMMENT 6-1 BELOW](#)**

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

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

Law

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

- Nonprofit Set-Aside** (A) In general. Not more than 90% of the State housing credit ceiling for any State for any calendar year shall be allocated to projects other than qualified low-income housing projects described in subparagraph (B).
- Qualified Low-Income Housing Projects** (B) Projects involving qualified nonprofit organizations. For purposes of subparagraph (A), a qualified low-income housing project is described in this subparagraph if a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.
- Qualified Nonprofit Organizations** (C) Qualified nonprofit organization. For purposes of IRC §42(h)(5), the term “qualified nonprofit organization” means any organization if—
- (i) such organization is described in paragraph (3) or (4) of IRC §501(c) and is exempt from tax under IRC §501(a),
 - (ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and
 - (iii) one of the exempt purposes of such organization includes the fostering of low-income housing.
- (D) Treatment of certain subsidiaries.
- (i) In general. For purposes of IRC §42(h)(5), a qualified nonprofit organization shall be treated as satisfying the ownership and material participation test of subparagraph (B) if any qualified corporation in which such organization holds stock satisfies such test.
 - (ii) Qualified corporation. For purposes of clause (i), the term "qualified corporation" means any corporation if 100% of the stock of such corporation is held by one or more qualified nonprofit organizations at all times during the period such corporation is in existence.

COMMENT 6-1:

Although we make specific comments to the text of this Chapter below, we believe that the overall approach of the Audit Guide and the CCA dated September 16, 2013 is inconsistent with the statutory language and will create uncertainty that will have a negative effect on projects involving nonprofit organizations.

As the CCA acknowledged, nothing in the text of Section 42 or its legislative history provides the tax treatment for a failure to maintain the involvement of a qualified nonprofit organization in a project throughout the compliance period under Section 42(h)(5). That is because Section 42(h)(5) is a minimum requirement imposed on the state allocating agency in making allocations of housing tax credit, not a specific requirement imposed on a taxpayer to qualify for credits.

We believe the intent of Congress and the specific statutory language of Section 42(h)(5) require the state allocating agency to allocate a minimum of 10% of its housing dollar credit amount to projects that meet the requirements of Section 42(h)(5). The state allocating agency meets that requirement by making allocations that it believes in good faith satisfy Section 42(h)(5) based on its initial determinations at the time of allocation and its obtaining of commitments from the taxpayer that are applicable throughout the compliance period.

Nothing in Section 42 precludes the state allocating agency from proscribing requirements in excess of the minimum required by Section 42(h)(5) or releasing projects from nonprofit setaside requirements so long as the minimum requirements of the Code are met. For example, if the state allocating agency allocated 20% of its credit amount to nonprofit setaside projects, it clearly could release one of those projects representing 2% of its total credit amount from the requirements of Section 42(h)(5).

Unless the credit allocation is invalid because the state allocating agency violated Section 42(h)(5) and credits are therefore disallowed under Section 42(h)(1), there is no basis for finding that a taxpayer who received credits from the nonprofit setaside will lose those credits if the requirements of Section 42(h)(5) are not met throughout the compliance period. Contrast the language of Section 42(h)(5) with the language of the very next paragraph which specifically calls for loss of tax credits if the requirement of that paragraph is not met. Section 42(h)(6) states that “No credit shall be allowed by reason of this section with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year.” There is no similar language in Section 42(h)(5) that applies to loss of credits.

The appropriate remedy for lack of nonprofit ownership and participation is enforcement of the commitment of the taxpayer (usually in the extended use agreement) to continue nonprofit involvement throughout the compliance period (or such longer period as the state allocating agency may require). The CCA recognizes that this is the appropriate remedy after the credit period but before the end of the compliance period. In fact, we would submit that the fact that the remedy proposed by the CCA is inadequate is evidence that it is also inappropriate and not the remedy intended by Congress.

It is the nature of the program created by Section 42 that the state allocating agency makes a single allocation of credit prior to the building being placed in service. Credit authority is authorized year by year and allocations of each year’s authority must generally be made by year end. For a variety of reasons, including the determination of unused housing credit carryover and the determination of “qualified states” entitled to be allocated credits from the national pool, it is

important that the validity of an allocation to a project is not subject to review over the compliance period applicable to that building. The statutory language of Section 42(h)(5) is entirely consistent with a view that the validity of an allocation can be determined at the time it is made.

The nonprofit setaside is a requirement placed upon the state allocating agency and should be deemed satisfied when the agency makes a determination in good faith that a project will satisfy the requirements of Section 42(h)(5)(B) throughout the compliance period based on the commitments required of the taxpayer in the extended low-income housing commitment.

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

Audit Issues

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

Audit Techniques

Step 1: Identify Credit Allocations from Nonprofit Se-Aside Allocations from the nonprofit set-aside are identified on Line 6g of Form 8609, Low-Income Housing Credit Allocation and Certification, starting with the November 2003 revision of the form. If an earlier revision was used, then contact the state agency that made the allocation. Confirmation from the state agency is needed because:

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

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

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

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

First, determine whether the nonprofit is a tax exempt entity in good standing by using the IRS website (www.irs.gov). Enter "78" into the "Search IRS site for" feature; the response will be "Most likely you are looking for "Publication 78, Search for Exempt Organizations." Clicking on the underline portion will provide an alphabetical listing of exempt organizations.

Alternatively, request the determination letter received by the organization from the IRS evidencing its status as a tax-exempt organization. ****SEE COMMENT 6-2 BELOW**

COMMENT 6-2:

Publication 78 will not pick up Section 501(c)(4) organizations. Also, most organizations will have a determination letter as direct evidence of their exempt status.

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Second, determine whether one of the nonprofit’s exempt purposes includes the fostering low-income housing. IRC §501(c)(3) provides, in part, that an organization may be considered exempt if it is organized and operated exclusively for one or more of the following purposes; religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals. Nonprofits participating in the IRC §42 program are usually designated as “charitable.”

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

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

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

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

Rev. Proc. 96-32 only also provides safe harbor guidelines; an organization may still be exempt if the guidelines are not met. If the taxpayer does not satisfy these requirements, the assistance of an Exempt Organization specialist should be requested for further development of this issue. See IRM 4.10.2.6.5 for instructions.

COMMENT 6-3:

Rev. Proc. 96-32 is only a safe harbor and is applicable only to Section 501(c)(3) organizations, while Section 501(c)(4) organizations can be qualified nonprofit organizations.

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

**Step 3:
Ownership Test**

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

**Step 4:
Material
Participation**

A qualified nonprofit organization must materially participate (within the meaning of IRC §469(h)) in both the development and operation of the project throughout the 15-year compliance period. IRC §469(h) defines material participation as activity that is regular, continuous, and substantial. The legislative history suggests the following guidelines in defining material participation in a business activity:

~~1. Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer;~~

COMMENT 6-4:

This is not a true statement of the law. Many significant nonprofits have other activities (such as serving the homeless) that are completely consistent with exemption and material participation. Section 42(h)(5) specifically provides that housing may be only one of the exempt purposes of a qualified nonprofit.

The determination of whether a nonprofit organization materially participates should be determined based on their activities at the project level, not based on their overall activities as an organization.

~~2.1.~~ Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else's decisions or periodic consultation with respect to general management decisions is not sufficient.

~~3.2.~~ Participation must be maintained throughout the year. Periodic consultation is not sufficient.

~~4.3.~~ Regular on-site presence at operations is indicative of material participation.

~~5. Providing services as an independent contractor is not sufficient.~~

COMMENT 6-5:

Development services, supportive services and property management services are nearly almost provided under separate contract. Even if not no separate contract, these services, unless performed without compensation, would be deemed to be services provided by someone who was not a partner in the taxpayer. If such services are disregarded, it would be impossible to materially participate. The reference to services performed as an independent contractor in the legislative history is only in a footnote and addresses the fact that, for example, an attorney performing legal services to a real estate activity is engaged in the activity of performing legal services not a real estate activity.

Accordingly, a nonprofit entity will be considered to materially participate where it is regularly, continuously, and substantially involved in providing services integral to

the development and operations of a project.

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

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

**Step 5:
Exempt Status
and Private
Inurement**

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

The nonprofit and for-profit general partner should not be related parties; i.e., share officers or board of directors. Such relationships may indicate that the primary purpose of the nonprofit organization is to access credit from the nonprofit set-aside. More importantly, such associations may call into question the exempt status of the nonprofit entity. The issue being whether the nonprofit entity acts exclusively in

furtherance of a charitable purpose or to further the interests of private investors. Although there is no all-inclusive list, some indicators that the nonprofit entity is not acting exclusively to further the charitable purpose are identified here.

1. ~~The nonprofit is not the only general partner,~~

COMMENT 6-6:

This is not an accurate statement of the law; the ability of the nonprofit to pursue its exempt purposes is not dependent on whether there is another general partner and can be protected by appropriate allocation of control rights.

2. The nonprofit's minority partnership interest provides for minimal participation in the IRC §42 project's operation,
3. ~~The nonprofit makes guarantees to the limited partners against loss of low income housing credits, and~~

COMMENT 6-7:

This is not an accurate statement of the law. Tax credit guaranties are common and simply reflect a purchase price adjustment of the amount paid by the investor. Where reductions in the amount paid by the investor are made, it is appropriate and proper for the nonprofit to contribute capital to fill the funding gap.

4. Excessive private benefits result from ~~payments to entities other than the nonprofit with respect to~~ real property sales, development fees, or management contracts.

COMMENT 6-8:

We believe this is a clarification; we wish to avoid confusion over whether the auditor must determine if the nonprofit is overpaid.

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

Audit Adjustments

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h)(5)(B) requirements. Failure to comply with IRC §42(h)(5)(B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c)(1). Therefore, the IRC §42(j) credit

recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA dated September 16, 2013.

**Step 1:
Determination
“as of the
Close of the
Taxable Year”**

Determine whether the noncompliance was corrected before the close of the taxable year in which the noncompliance originally occurred. As explained by Chief Counsel in their September 16, 2013, advisory, and consistent with IRC §42(c)(1)(A), compliance should be determined “as of the close of the taxable year.”

**Step 2:
Noncompliance
Corrected
within a
Reasonable
Period**

If a taxpayer is found to be compliant “as of the close of the taxable year” in which the noncompliance first occurred, then no disallowance of credit is required.

If the noncompliance is not corrected “as of the end of the taxable year in which the noncompliance occurred,” then determine whether responsibility for the noncompliance rests solely with the qualified nonprofit organization. For example, if the nonprofit has lost its tax-exempt status or has breached its agreement to meet the ownership and material participation requirements on a continuous basis.

COMMENT 6-9:

We believe clarification is helpful here and that wrongful behavior by the nonprofit, including breach of its agreements, should afford the taxpayer an opportunity to correct any noncompliance.

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

“Reasonable Period” Quantified

Under IRC §42(j)(4)(E), taxpayers are provided relief from the credit recapture provisions in the event of a casualty loss if the loss is restored within “a reasonable period established by the Secretary.” In CCA 200124006, Chief Counsel concurred that a reasonable period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties under IRC §165.

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

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

Related Issues

Federal Financing

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

Developer Fee

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

Tax-Exempt Status (Private Inurement & Taxable Income)

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

1. Private Inurement. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) provides that an exempt entity must be organized and operated exclusively for an exempt purpose specified in IRC §501(c)(3). Because these purposes serve public rather than private interests, an exempt entity must establish that it is not organized for the benefit of private interests. ~~A developer fee paid to a nonprofit entity that may be ascribed, in whole or in part, to the benefit of private persons may call into question whether the entity is being operated “exclusively” for an exempt purpose, which in turn, may jeopardize the tax-exempt status of the entity.~~

COMMENT 6-10:

We do not understand this comment. A developer fee paid to a nonprofit that has housing as an exempt purpose could never adversely affect its exempt status.

2. Unrelated Business Taxable Income. Nonprofit entities may generate income through activities not directly related to their tax-exempt purposes. The developer fee may be subject to taxation under IRC §512 and if the nonprofit entity has an excess of taxable income, the entities tax-exempt status could be jeopardized.

COMMENT 6-11:

Again, we do not understand this comment. In no event could a developer fee be unrelated business income for a LIHTC deal in which a nonprofit with an exempt purpose of providing housing be unrelated business income.

Chapter 7 No Longer Participating in the IRC §42 Program

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

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

Law

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

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

When a state agency notifies the IRS that a building is no longer in compliance nor participating in the IRC §42 program, the state agency may cease compliance monitoring activities. [**SEE COMMENT 7-1 BELOW](#)

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

1. The building is not placed in service within the required time period or fails to meet the minimum set-aside requirements of IRC §42(g)(1) by the close of the first year of the credit period.

COMMENT 7-1:

Page 7-1 of the Audit Guide states that “[w]hen a state agency notifies the IRS that a building is no longer in compliance nor participating in the IRC §42 program, the state agency may cease compliance monitoring activities.” This sentence should be removed from the Audit Guide.

Treas. Reg. §1.42-5(e)(3) states that “If an Agency reports on Form 8823 that a building is entirely out of compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building’s noncompliance.” The regulation does not say that the Agency may completely cease all compliance monitoring activities, but merely says that the Agency does not need to file subsequent Form 8823’s to report noncompliance.

To the contrary, the sentence that follows in Treas. Reg. §1.42-5(e)(3) is “If the noncompliance or failure to certify is corrected within 3 years after the end of the correction period, the Agency is required to file Form 8823 with the Service reporting the correction of the noncompliance or failure to certify.”

An Agency might determine that a building is no longer in compliance, and the taxpayer may disagree with that determination. Or an Agency might speculate that the building will not come into compliance in the future, but the owner might indeed achieve compliance at a later date. In either of those circumstances, the Agency is not required to file subsequent 8823’s to report noncompliance, but to say that they may completely cease compliance monitoring activities, would suggest that they would be no longer obligated to report the correction. There is no statutory or regulatory basis for that notion.

The quoted language from the regulation already included in the Audit Guide clearly presents the controlling law on this topic; that language does not require any sort of embellishment or explanation. The above quoted sentence should be removed from Page 7-1.

ANALYSIS

As set forth in the facts above, Building X, Building Y, and Building Z each contains complete living units within the meaning of Treas. Reg. §1.103-8(b)(8), all of the living units within the respective buildings are available to the general public, and all of the living units are used on a non-transient basis. Since Complex M also provides significant non-housing services to residents of the three buildings (including continual or frequent nursing, medical, or psychiatric services to the residents of Building Z), the analysis must consider the nature and extent of the non-housing services. In the case of Complex M, the analysis must examine whether the buildings of Complex M are hospitals, nursing homes, sanitariums, or rest homes rather than residential rental property. ...The labels are not determinative. The focusis whether the facilities are, in substance, residences or health care facilities. Therefore, the nature and degree of the services provided by the facility controls.

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

HOLDING

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

Development Fees

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

Turnkey Project Fee

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

Fixed Amount Development Fee

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

Completed Project Developer Fee

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

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

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

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

Audit Issues & Techniques

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

1. Character of the services to be provided, and obligations undertaken,
2. Services actually provided, and obligations assumed,
3. Reasonableness of the fee amount, and
4. Method of payment,

COMMENT 8-1:

This comment is intended to clarify that the examiner should also look to the nature of the obligations undertaken.

To address these issues:

1. Review the development agreement or contract. Generally, the contract will outline all the anticipated responsibilities and remedies if the developer fails to perform according to the agreement. It should also disclose the payment terms. Typically, there will be payments at specific times during development and when development is completed. The developer may also have agreed to defer payment of a portion of the fee.

2. If the developer agreed to defer payment, review the development agreement, developer fee note or other document documenting the terms of the deferred payment~~debt~~. The development agreement, ~~Like the original contract~~, the note, or other document will outline the terms (amount, interest, payment schedule, etc.) for payment of the deferred fee.

COMMENT 8-2:

As currently drafted, this assumes that any deferred development fee obligation will be evidenced by a promissory note describing the terms of the deferred development fee obligation. Typically, the terms of a deferred development fee and the obligation to pay such deferred development fee are reflected in the development services agreement or other similar document. The deferred development is not always evidenced by a promissory note and a promissory note is not required as long as the documentation establishes the legal obligation to repay the debt and the terms of such repayment.

3. Review the taxpayer's books and records to identify payment of the fee. If the developer agreed to defer a portion of the fee, determine whether payments have been made and/or interest accrued according to the terms of the agreement.

**Issue 1:
Character of
the Services
to be Provided**

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

Development Costs Includable in Eligible Basis

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

1. Negotiating agreements for architectural, engineering, and consulting services, the construction of the low-income housing (including interiors) or improvements includable in eligible basis, and the furnishing of the associated supplies, materials, machinery or equipment.
2. Applying for and maintaining all government permits and approvals necessary for the construction of the project and securing the certificates of occupancy (or other equivalent documents) when completed.
3. Complying with the requirements imposed by insurance providers during construction.
4. Providing oversight, including inspections during the course of construction and approving eventual payment for the services rendered and assuming the obligation to cause the project to be constructed in accordance with the budget.

COMMENT 8-3:

Often, the developer is responsible for ensuring that the project is constructed in accordance with the budget. Because the developer is typically required to guaranty the payment of any cost-overruns, failure for the project to be constructed on budget can indirectly impact the amount of its development fee or profit from the contract. This obligation should be taken into account in connection with considering the overall reasonableness of a development fee.

5. Implementing the taxpayer's decisions made in connection with the design, development, and construction of the project.

Developmental Costs Not Includable in Eligible Basis

Development of a low-income project will require services that are not associated

with the low-income buildings and, therefore, the costs are not includable in eligible basis. Typical services include (but are not limited to):

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

2. Maintaining contracts, books and records sufficient to establish the value of the completed project. However, costs of maintaining books and records for tracking and administering construction costs, including loan draws may be included in eligible basis.

COMMENT 8-4:

Costs attributable to providing construction oversight, including tracking and approving constructions draws and disbursements are capitalizable under Code Section 263A and thus are basis eligible expenditures. Therefore, clarification is appropriate that costs related to maintaining the contracts and books and records for construction management purposes should be carved out of the general prohibition against basis inclusion.

3. Advising the taxpayer regarding available sources of financing, such as federal, state or local subsidy programs, as well as commercial financing. The developer may also negotiate the terms of the financing with lenders or secure financing. However, services in connection with obtaining construction financing and subsidies are includable in eligible basis.

COMMENT 8-5:

Costs associated with obtaining construction financing are capitalized under Code Section 263A as indirect costs of construction and should be includable in eligible basis.

Partnership Costs

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

Post-Development Costs

Generally, development services end when the construction of the buildings, including construction punchlist items, are completed and are placed in service. However, although buildings are placed in service, project amenities that are includable in eligible basis may be completed and placed in service after the buildings. Developer fees paid for development services attributable to, for example, paving of parking lots and sidewalks, community buildings, pools and landscaping are included in eligible basis to the extent that those are items are properly includable.

COMMENT 8-6:

The edits to the forgoing paragraph are requested because, often, a building is considered placed in service for tax or local law purpose even though there are remaining construction or punchlist items still needing to be completed. For example, a building in a cold locale could be placed in service with tenants moving in during the winter months and still have outstanding landscaping or concrete paving needs that must be performed in warmer weather. In this instance, the development services would continue past placement in service and costs attributable to these services would be basis eligible if incurred prior to the end of the first credit period.

~~However, bB~~ Because of the developer's expertise, the taxpayer may contract with the developer to complete the initial leasing of the rental units. Typical costs include (but are not limited to) hiring on-site managers and trained staff, advertising, and maintaining model units. These costs are not includable in eligible basis. Instead, the costs should be amortized over the life of the lease if long term. If the lease is for a short term, typically at least six months but no more than one year for low-income rental units, then the costs should be amortized over the period necessary for completing the initial leasing of all the rental units.

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

In order to determine whether the development agreement includes any of the foregoing lease-up or property management services, the partnership agreement and any agreements for lease-up services or property management services should be reviewed to determine the roles and compensation of each service provider. Where the taxpayer has not hired a third-party, unrelated management company to perform such services, any management agreement or lease-up services agreement should be reviewed to determine if these services are separately provided and compensated for apart from the development agreement. The partnership agreement should also be reviewed to see if the general partner is responsible for such services. If these services are provided under the development agreement as opposed to any of these other agreements and no compensation other than developer fee is paid for these services, then a portion of the developer fee may be attributable to lease up or property management services and not be includable in eligible basis.

COMMENT 8-7:

The developer may play a number of roles with respect to a particular project. This confluence of roles should not be per se problematic provided that the services with respect to each role and the related payments are separately stated and adequately documented.

**Issue 2:
Services
Actually
Provided**

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

Concurrent Developers

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

1. How were developmental responsibilities divided among the developers? For example, responsibilities may be assigned based on the developers' areas of expertise.

2. Did the developer have the skills and expertise needed to provide developmental services and complete the project?

COMMENT 8-8:

Assuming that the overall fee for services is reasonable in light of the services provided and the manner in which the fee is shared does not create private benefit or other similar concerns with respect to a tax-exempt entity, it should be unnecessary to analyze how the developer fee is shared as between two or more parties. It is appropriate to respect a presumably arm's length negotiation as between two or more developers with respect to how they intend to share a fee. For example, suppose that an experienced developer joint ventures with a non-profit developer or minority owned developer seeking to gain experience developing low-income housing tax credit projects. The investor, state agency and/or lender requires the less experienced developer to joint venture with a more experienced developer to satisfy its experience and financial requirements. The less experienced developer plans to take the day-to-day lead role performing 75% of the work with insight and guidance from the experienced developer. The parties decide to share the developer fee 50/50. It would be unreasonable to recharacterize the parties' arrangement merely because the less experienced developer provides more than 50% of the services because it is difficult to value the more experienced developer's contribution. Assuming a for-profit developer does not unjustly benefit from the tax-exempt organization, it would be appropriate to respect the negotiated relationship between the property.

Consecutive Developers

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

COMMENT 8-9:

SEE COMMENT 8-8 ABOVE

Assuming that the overall fee for services is reasonable in light of the services provided it should be unnecessary to analyze how a fee is shared between two or more parties.

**Issue 3:
Reasonable
Fee**

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

COMMENT 8-10:

The State Agencies provide ceilings on the total amount of development fees a developer may earn with respect to a particular project. The State Agencies make these determinations on the basis of best practices established by the National Council of State Housing Agencies. The best practices are established based on input from a spectrum of low-income housing tax credit interested parties. Deference to the ceilings established by the State Agencies should be respected absent unusual facts and circumstances.

**Issue 4:
Method of
Payment**

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

COMMENT 8-11:

Additional time beyond the development period is necessary to take into account any payment lags attributable to the normal billing, accounting and substantiation process along with any post-placement-in-service construction or punch list items. See Comment #6 above.

Performance of Additional Services

1. Because the developer may be (or is related to) the general partner, consider whether the payment is contingent upon providing services usually associated with the duties of a general partner. If the developer and general partner are related, the development services agreement should be reviewed to confirm that it does not include responsibilities typically attributable to a general partner of a partnership.

SEE COMMENT 8-7 ABOVE

2. Because the developer may be (or is related to) the entity operating the low-income project, consider whether payment of the developer fee is contingent on successfully operating the project, or maintaining the project in compliance with IRC §42.

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

Intent to Pay Deferred Developer Fee

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

[SEE COMMENT 8-2 ABOVE](#)

1. ~~the projections or other transaction documents the note bears no interest rate or no payment is required for extended periods of time, suggesting that the agreement is not an arm's length transaction do not show that the development fee is expected to be paid over a reasonable period of time, presumed to be the compliance period,~~

[SEE COMMENT 8-14 BELOW](#)

2. payment is contingent on events unlikely to occur,
3. payment is subordinate to payment of other debt, and it is unclear that payment would ever be financially possible,

4. Except as otherwise permitted pursuant to Code Section 42(i)(7), the developer holds a right of first refusal to purchase the property for a price equal to the outstanding debt, or

COMMENT 8-12:

Assuming the developer is a resident management corporation of the building, qualified nonprofit organization, government agency or a tenant organization then pursuant to Code Section 42(i)(7), no federal income tax benefit, including the benefit of tax credits and depreciation attributable to the inclusion of a deferred development fee in basis, may be denied to a taxpayer merely by reason that the developer has a right of first refusal to purchase the property at a purchase price equal to the outstanding debt plus exit taxes, if any. Attempting to reduce eligible basis by disallowing a deferred developer fee because of the presence of a Congressionally sanctioned right of first refusal is denying a taxpayer a tax benefit and contravenes Section 42(i)(7).

- ~~5. the general partner, who is or is related to the developer, is required to make a capital contribution sufficient to pay the deferred fee if the fee is not paid before a specified date.~~

COMMENT 8-13:

According to the opening paragraph of this section “Intent to Pay Deferred Developer Fee” the presence of the above factors, including #5, “may suggest that the taxpayer does not intend to pay the deferred fee.” The presence of a fixed maturity date on which the deferred developer fee must be paid along with an obligation on the part of an owner of the taxpayer to come up with the funds to meet the taxpayer’s obligations on the maturity date suggests the contrary – that if all else fails, the taxpayer intends to pay the deferred fee on or before its maturity date, even if it means reaching into its own pockets.

Citing an obligation to make a capital contribution to repay the deferred fee as evidence that the taxpayer does not intend to pay the deferred fees is in direct conflict with Technical Advice Memorandum 200044004. In this TAM, the general partner of the taxpayer was obligated to make additional capital contributions at the maturity of the development fee obligation in an amount sufficient to enable the taxpayer to repay the deferred developer fee. The IRS viewed this fact as a positive indicator that the

deferred developer fee was not contingent – “while payments are contingent prior to maturity – it is payable at maturity for a fixed amount that is not contingent.” The obligation of one or more partners to contribute equity to a partnership in order to pay the partnership’s debts should be evidence of an intent to pay the debt.

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

[SEE COMMENT 8-2 ABOVE](#)

Analysis of Debt

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

Recourse or Nonrecourse Debt

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

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

Genuine Indebtedness

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

1. The intent of the parties;
2. the identity between creditors and shareholders;
3. the extent of participation in management by the holder of the instrument;
4. the ability of the debtor to obtain funds from outside sources;
5. thinness of capital structure in relation to debt;
6. the risk involved;

7. the formal indicia of the arrangement;
8. the relative position of the obligees as to other creditors regarding the payment of interest and principal;
9. the voting power of the holder of the instrument;
10. the provision of a fixed rate of interest;
11. a contingency on the obligation to repay;
12. the source of the interest payments;
13. the presence or absence of a fixed maturity date;
14. a provision for redemption by the corporation;
15. a provision for redemption at the option of the holder; and
16. the timing of the advance with reference to when the taxpayer was organized.

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

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

1. whether there is an unconditional promise on the part of the taxpayer to pay a fixed sum on demand or at a fixed maturity date that is in the reasonable foreseeable future,
2. whether the lender has the right to enforce the payment of principal and interest,
3. whether the lender’s rights are subordinate to rights of general creditors,
4. whether the instruments give the lender the right to participate in the management of the issuer (in this case, the IRC §42 project),
5. whether the taxpayer is thinly capitalized,

6. whether the lender (stockholders or partners) are related to the taxpayer,
7. the label placed upon the instrument by the parties, and
8. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

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

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

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

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

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

The Court relied upon *Story v. Commissioner*, supra, in *Haygood v. Commissioner*, 42 TC 936 (1964), in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated

that it will “continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor...where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received...” Action on Decision, 1976 A.O.D. LEXIS 364.

COMMENT 8-14:

A lack of stated interest rate should not be considered indicative of a deferred developer arrangement not being an arm’s length transaction or that the taxpayer has no intention of paying the deferred fee.

1. It is not unusual in the context of a low-income housing transaction for debt instruments to have below market interest rates.

It is not unusual, particularly in the context of low-income housing tax credit transactions, for debt instruments to bear nominal or no interest rates. Rather, it is quite common as lower interest rates directly translate to lower affordable rents to low-income tenants. Below market interest rates were expressly sanctioned by Congress under Section 3002(b) of the Housing and Economic Recovery Act of 2008 which modified Code Section 42(i)(2)(A) by eliminating the concept of “below market federal loans” which has the effect of permitting low or no interest loans to be included in eligible basis.

Many of the below market loans described in the preceding paragraph are with third parties (e.g., federal, state or local governmental entities) that are unrelated to the developer or taxpayer. Lenders may be willing to take lower interest rate compensation for their risk where the result is community benefit such as additional housing or lower rents for low-income families. Presumably if these types of loans are permissible as to unrelated third parties, applying the same standards to a related party relationship, it would not be appropriate to determine that an arrangement is per se not arm’s length merely because the parties are related.

2. IRS and judicial guidance does not support a conclusion that nominal or no interest is in and of itself determinative of true debt status

Generally, the IRS rulings and case law in the area of true debt analysis generally look to numerous factors to reach an overall facts and circumstances determination that it is appropriate to recharacterize a purported debt instrument as other than true debt. The guidance cited in the true debt discussion of this guide below follows this approach.

For example, in the **Fin Hay** case cited below, “the provision of a fixed rate of interest” was just one of 16 factors considered by the court in making a facts and circumstances determination that the debt instrument involved in this case was more property

characterized as equity. Similarly, in Notice 94-47, the IRS listed eight factors to be considered in determining whether an instrument should be characterized as debt or equity. The purpose of Notice 94-47 was to provide guidance to describing how the IRS views “instruments designed to be treated as debt for tax purposes but as equity for regulatory, rating, or financial accounting purposes.” Among the eight factors the IRS deemed important in this context, charging interest was not included.

The Goldstein case cited below involved an interest-free debt instrument. Among the factors listed in the Goldstein, the Tax Court listed interest as a relevant factor for determining whether an instrument is debt. Despite the fact that the debt instrument was interest free, the Tax Court held that the loans were property characterized as debt for tax purposes.

It is inconsistent with the longstanding guidance in the true debt area to recharacterize a debt instrument solely on the basis that it bears no or nominal interest.

3. The Internal Revenue Code acknowledges the existence of no or below-market interest rates loans.

The Code devotes several sections to debt instruments that bear no or below-market interest rates, including Sections 467, 483, 1271-1275 and 7872. These sections reflect an acknowledgement by Congress that an obligation can be respected as a debt instrument despite the fact that no or below-market interest rates are charged. Instead of recharacterizing such debt instruments as equity, Congress has determined that in some, but not all circumstances, interest should be imputed to certain debt instruments.

Deferred fees for services is not one of these areas where the IRS has “imputed” interest to below market or no market deferred obligations. None of those sections of the Code currently require that interest be charged or imputed on a payment for services that is deferred and made after the time that the services are rendered. However, Section 467, which generally deals with stepped or deferred payments of rent, specifically authorizes the IRS to promulgate regulations to apply similar provisions to deferred payments for services.

The Code does not provide a precedence for recharacterizing a debt instrument on the basis that it does not charge interest. Instead, if the IRS believes that the deferred payment of development fee represents, in part, an interest charge compensating for the delay in payment, the IRS should impute interest to a portion of the deferred developer fee as opposed to excluding the entire fee from basis under the theory that the deferred fee does not represent true debt. However, before taking this approach the IRS should promulgate regulations under its statutory authority supporting this approach.

Related Party Transactions

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

COMMENT 8-15:

The developer is sometimes a contractor or an unrelated third party developer.

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

Intrinsic Economic Nature

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

SEE COMMENT 8-2 ABOVE

1. Independent Creditor Test

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

time of default. Despite these unusually generous terms, the debt is interest-free.

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

COMMENT 8-16:

In the context of a low-income housing tax credit transactions where there are multiple layers of debt from conventional bank lenders, the United States Department of Housing and Urban Development ("HUD"), and/or federal, state and local lenders, it is unlikely that senior lenders would permit deferred developer fees to be in a senior priority position to such lender's mortgage or payable until after senior lender debt and expenses related to its security have been paid. For example, when obtaining financing from HUD, some HUD programs only permit governmental soft mortgages junior to its collateral. Further, regardless of whether there are governmental or non-governmental subordinate mortgages, HUD programs limit payments on such loans to "surplus cash". Thus, depending the particular facts and circumstances of a transaction as well as the negotiations between the developer and the partnership, the debt may be recourse or nonrecourse and may or may not be secured.

2. Debt-Equity Ratios

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

robust, that alone, especially in light of the highly favorable terms of the debt, would not necessarily tip the balance in favor of treating a deferred developer fee as described above as genuine debt.

3. Potential Sources of Repayments

A related factor when considering the substance of the transaction is the taxpayer's ability to repay the advance and the reasonable expectation of the repayment. *Laidlaw*, 75 TCM (CCH) at 2624. Normally, there are four such possible sources: (1) liquidation of business assets, (2) profits, (3) cash flow, and (4) refinancing with another lender. "The burden is on the taxpayer to establish this, of course, and such a conclusion must be based on concrete facts and sound assumptions about the [taxpayer's] future." *Fischer v. United States*, 441 F.Supp 32, 39 (1977).

Consider the taxpayer described in TAM 200044004, which was a partnership formed to construct, develop, and operate a low-income housing tax credit property. The taxpayer's managing partner was related to other parties, including the developer. The other general partner was a nonprofit corporation. At completion of the construction, the taxpayer did not have sufficient funds to pay the entire development fee so it issued a note for the balance owing. The note was payable at maturity, 13 years from completion of the project. The note was

unsecured and source-of-payment restrictions were in effect during the term of the note. Payment was subordinate to other debts. The note bore interest which was compounded annually and added to the unpaid principal during the term of the note. The taxpayer was obligated to pay off the note in full at maturity and the general partners were obligated to make additional capital contributions necessary to pay off the note at maturity. Financial statements also indicated that payments had been made on the note.

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

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

**Court Case:
Substantiation
of Services
Performed**

In *Carp & Zuckerman v. Commissioner*, the Tax Court concluded that the taxpayers failed to prove that they performed the development services specified in the agreement. The Court explained that the taxpayer bears the burden of proving that the developer fee constituted a qualified expenditure and that it was inappropriate to apply the rule found in *Cohan v. Commissioner* did not apply. See Appendix I.

COMMENT 8-17:

Please provide additional discussion regarding the relevant factors of the [Carp & Zuckerman](#) case that should be applied in connection with an auditor’s review of whether the taxpayer has performed services specified in the development services agreement. Likewise, please provide additional specificity in terms of what evidence the taxpayer should have to prove the services were performed and that the developer fee constituted a qualified expenditure.

Summary

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

COMMENT 8-18:

As described in [COMMENT 8-14](#) and [COMMENT 8-16](#) above, the appropriate standard is whether there is a reasonable expectation that the debt will be repaid. Just as governmental lenders often choose to accept low interest rates (or not interest at all) and other generous terms in order to accommodate the low rents and restricted cash flow of low-income housing projects, such a choice by a developer with respect to receiving its development fee should not impact the treatment of deferred developer fee as long as repayment is reasonably expected.

Partnership Costs

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

Cost of Securing Financing

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

Common costs include:

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

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

Cost of Issuing Tax-Exempt Bonds

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

[SEE COMMENT 8-19 BELOW](#)**

Bond costs includes:

1. fees assessed by the state agency,
2. state board fees,
3. rating agency fees,
4. trustee fees,
5. underwriter fees,
6. investment fees,
7. legal counsel fees,
8. bank inspector fees, and
9. costs for photos, prints, and renderings.

TAM 200043015 provides the rationale for excluding all bond issuance costs from eligible basis. As explained in the TAM, Congress determined that bond issuance costs are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the bond offering. Characterizing a certain portion of bond issuance costs under IRC §263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Further, permitting an IRC §263A characterization of bond issuance costs to control for purposes of IRC §42 would result in the disparate treatment of the term “residential

COMMENT 8-19:

The proposed IRS Audit Technique Guide provides at page 8-27 that bond issuance costs are not eligible to be included in low-income housing tax credit basis. Specifically, the draft Guide provides:

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

Bond costs includes:

1. fees assessed by the state agency,
2. state board fees,
3. rating agency fees,
4. trustee fees,
5. underwriter fees,
6. investment fees,
7. legal counsel fees,
8. bank inspector fees, and
9. costs for photos, prints, and renderings.

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

Under Code section 263A, and the Treasury Regulations issued thereunder, an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer are required to be capitalized to the property produced. Indirect costs that should be capitalized under Code section 263A to produced property are those that are properly allocable to the property. These are costs that directly benefit or are incurred by reason of the production of property. The capitalization provisions of Code section 263A are generally applicable to all real or tangible personal property produced by taxpayers. Property is “produced” by a taxpayer if it is constructed, built, installed, manufactured, developed, or improved by the taxpayer. The direct costs of such property and “such property's proper share of those indirect costs (including taxes), part or all of which are allocable to such property,” must be capitalized. Thus, in addition to normal “hard” costs, the reach of the statute extends beyond construction period interest and taxes to cover indirect or “soft” construction period costs such as overhead.

Under Rev. Rul. 75-172 (1975-1 CB 145), the nonrefundable fee a corporation paid, under a loan agreement for construction and permanent mortgage financing and on or before initial receipt of funds, as compensation for the cost of specific legal, architectural, and engineering services incurred by the lender is a cost to be deducted ratably over the duration of the loan. Under Rev. Rul. 81-160 (1981-1 CB 312), this amortization requirement was extended to commitment fees or

standby charges incurred pursuant to a bond sale agreement under which funds for construction are made available in stated amounts over a specified period. In CCA 201136022 (Sept. 9, 2011), the Service held that a loan commitment fee is similar to the assets described in Regulations section 1.263A-11(d)(1). That Regulation section states that the adjusted bases of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property is included in accumulated production expenditures (which are required to be included in the depreciable basis of such property). The Regulations section goes on to state that examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly-line structures, cranes, bulldozers, and buildings. CCA 201136022 continues:

“Here, Taxpayer incurred Commitment Fee for the purpose of ensuring access to funds to produce the unit of designated property. This created an asset for Taxpayer. This asset is used in a reasonably proximate manner to the production of the unit of designated property. Therefore, the adjusted basis of this asset, i.e. the amount of Commitment Fee, must be included in Taxpayer’s accumulated production expenditures under § 1.263A-11.”

As noted in the draft of the Guide, the IRS’s position on the exclusion of tax-exempt bond issuance costs from low-income housing tax credit basis is based on are not LIHTC basis eligible is based on the reasoning contained in TAM 200043015 (the “TAM”). As noted in the TAM, Code section 142(a) describes an exempt facility bond as any bond issued as part of an issue of bonds if 95% or more of the net proceeds of the issue are to be used to provide listed types of projects or facilities. Within the list, in Code section 142(a)(7), are qualified residential rental projects. The TAM’s conclusion that the bond issuance costs are not includable in LIHTC basis is based on the fact that the legislative history to Code section 142 provides that bond issuance costs cannot be paid from the 95% portion of the issue, and that such costs cannot therefore be considered residential rental property. However, we believe that the analysis contained in the TAM is incorrect for two reasons. First, following the rationale of the TAM would result in construction loan fees generated by a non-tax-exempt funded loan being treated differently (i.e. included in LIHTC basis) than such fees being generated by a tax-exempt funded loan (i.e. not included in LIHTC basis). We do not believe that anything contained in Code section 42 or Code section 263A supports such different treatment. Second, we do not believe that an exclusion from the 95% test contained in Code section 142(a) causes such bond issuance fees to not be included in the basis of the property, as required under Code section 263A. Instead, we believe that the legislative history to Code section 142(a) merely limits certain categories of costs from being included in the tests for determining whether a bond should be treated as being tax exempt.

In addition, under the tax-exempt bond rules, while bond issuance costs can’t be paid out of the 95% portion of the issue, they can be paid from other sources besides the remaining 5% of the issuance, such as investor equity. If such costs are paid out of investor equity, they would not be subject to the Code section 142(a) limitations, and would therefore be LIHTC basis eligible. It does not make sense to provide that if the bond issuance costs are paid out of investor equity they are LIHTC basis eligible, but if they are paid out of 5% of the bond proceeds they are not eligible.

In addition, the Service’s position that bond issuance costs are not included in LIHTC basis because they are “bad” costs under the tax-exempt bond rules goes too far.

The legislative history of Section 42 does provide that “residential rental property for purposes of

the low-income housing credit has the same meaning as residential rental property within Code section 103.” However, the very next sentence provides “Thus, residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project.” Pg II-89 of the Conf. Rpt. to the 1986 Tax Act. It is much more plausible to infer that Congress intended to refer to Treas. Reg. § 1.103-8(b), which defines “residential rental property” for purposes of Sections 103 and 142 and refers to physical characteristics of such property, rather than the 95% test, which encompasses tax policy considerations that are paramount in the bond area, but have little application in the context of Section 42.

For example, Treas. Reg. § 1.150-2 provides that amounts will not be considered used for the governmental purpose of the issue if they reimburse expenditures unless those expenditures meet certain requirements, including generally, for example, that the expenditures were not made more than 60 days prior to the adoption of official intent indicating an intention to finance the project with bonds. Assume, for example, that a taxpayer began constructing an apartment building with its own funds in 2014, took no action with respect to bonds, and was 25% done with the project on December 31, 2014. On March 1, 2015, official intent was adopted with respect to the issuance of bonds, bonds were issued and were used to complete the project. Bond proceeds were used to pay for 60% of the total cost of the land and buildings in the project, all of which was incurred in 2015. None of the 2014 costs were reimbursed with bond proceeds because the requirements of Treas. Reg. § 1.150-2 were not satisfied and any reimbursement of such costs would have been “bad costs” that were not considered part of the governmental purpose of the bonds.

Is it the Service’s position that the 2014 costs for bricks and mortar that are included in the depreciable basis of the apartment buildings are not residential rental property and not part of eligible basis? Would the Service extend that conclusion by analogy if, rather than a bond transaction, the taxpayer did not file an application requesting an allocation of tax credits until 2015?

Similarly, under Treas. Reg. Section 1.148-6(d)(7), “[a]ny payment of gross proceeds of the issue to a related party of the payor is not an expenditure of those gross proceeds”. As a result, the Treasury Regulations prohibit these costs being paid out of the proceeds of the bond issue. These “bad” costs include developer fees payable to a related party. Does the Service take the position that the “bad” cost rules preclude any developer fees paid to a related party (which would mean almost all developer fees paid in an LIHTC deal) from being included in eligible basis for purposes of Section 42?

In the tax-exempt bond area, Congress is concerned with issues of overissuance and arbitrage. Key questions relate to when and if bond proceeds are spent or alternatively, whether they can be invested in a way to earn arbitrage. Congress limited the financing of bond issuance costs because it “believed that it is important for issuers of tax-exempt bonds to pay the costs associated with their borrowing. . . . Congress believed that these restrictions will result in a more efficient use of tax-exempt financing, as borrowers more closely monitor the costs of their borrowing and eliminate unnecessary bond volume that often was issued ‘at no cost’ to the borrower under prior law.” Page 1155 of the General Explanation of the Tax Reform Act of 1986.

Considerations of overissuance and arbitrage are not applicable to Section 42 and there is no reason to believe that Congress intended to graft them onto Section 42. Congress instead intended that residential rental property for Section 42 purposes, like for bond purposes, include

those facilities described in Treas. Reg. § 1.103-8(b). The depreciable basis in those facilities included in eligible basis should be determined under the relevant provisions of the Code, including the principles of Section 263A, regardless of whether that basis is indirectly related to bond issuance costs.

Finally, under the tax-exempt bond rules, up to 2% of bond proceeds can be used to pay bond issuance costs. This contradicts the Audit Guide and TAM 200043015's position that all bond issuance costs are ineligible to be paid from bond proceeds and, thus, should be ineligible for tax credits. Congress has specifically stated that up to 2% of bond proceeds are eligible to pay bond issuance costs. Thus, at a bare minimum, bond issuance costs up to 2% of bond proceeds should be includible in eligible basis.

2. amounts borrowed with respect to the activity for which the taxpayer has a personal liability or has pledged property as security (recourse financing).

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

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

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

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

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

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

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

COMMENT 10-1:

The at-risk rules only apply to individuals and closely held corporations and do not apply to the typical tax credit investor.

**Audit
Techniques**

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

1. All documents, agreements, and debt instruments should be reviewed for debt associated with the financing of assets included in eligible basis. Regardless of

**Audit
Techniques**

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

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

1. Ask the taxpayer for the loan agreement and any other related loan documents. Consider whether the terms are particularly favorable; i.e., a low interest rate or no interest rate, no repayment required until the loan is due, or a loan period longer than the 15-year compliance period. Consider whether the lender realistically expects to receive payments. Also determine whether the loan is secured by the property, which establishes that the lender can receive the property in lieu of payment.
2. Interview the lender and determine the source of the funds used to make the loan. Also review documentation of the source of the funds. The documentation may identify the funds as a grant, loan, or other long-term payable. In addition, the documentation may identify the housing (by name, location, characteristics) for which the funds are to be used. This may indicate that the funds were originally intended by the federal source to be used for the low-income project and, if initially provided as a grant, and suggests that the funds should retain their original character as a federal grant. ****SEE 11-1 COMMENT BELOW**
3. Review the financial feasibility analysis completed by the state agency. The federal tax issue is resolved if the state agency reduced the eligible basis by the amount of the purported loan when determining how much credit to allocate to the building. Under IRC §42(m)(2), the state agency cannot allocate more credit to a project than is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. When the project is finished, the state agency evaluates the sources and uses of funds, and the total financing planned for the project. The owner must disclose the full extent of all federal, state and local grants and subsidies.
4. Determine whether the future value of the property securing the purported loan will equal or exceed the face value of the loan and accrued interest at the time the loan is due. Obtain an engineer's evaluation if the value of the property is in doubt.

COMMENT 11-1:

Page 11-6 of the Audit Guide states that “This may indicate that the funds were originally intended by the federal source to be used for the low-income project and, if initially provided as a grant, and suggests that the funds should retain their original character as a federal grant.”

This statement is directly contrary to common practice in the industry and previous guidance from the Service. Federal grants are often provided to state agencies, municipalities, tax-exempt organizations or other qualified recipients, which then use the proceeds to make loans to owners of low-income housing projects. It is a rare occasion in which grants are made without reference to a specific project. We believe that the treatment of a loan made from the proceeds of a federal grant is well recognized in the industry and by the Service. The transaction between the grant recipient and the owner must first be characterized as either a loan or a grant. If characterized as a loan, no reduction in eligible basis is required. If characterized as a grant, then further inquiry is required to determine whether the direct or indirect source of the grant is federal funds.

For example, in Private Letter Ruling 8813024 (December 30, 1987), a city received a federal grant and then made a loan to the taxpayer who was building a low-income housing project qualifying for tax credits under Section 42. The Service held that:

“Evidently, the two-step character of a federal grant (to a local governmental unit) followed by a grant or loan (from that unit to a building owner) must be recognized and respected for purposes of both Section 42(d)(5) and Section 42(i)(2) of the Code. First, it seems clear from Section 42(d)(5)(B) that although federal funds are involved, a grantor (of a federal grant to which this subsection applies) is not necessarily the federal government nor is the grant funds necessarily all federal funds, since the eligible basis of the building must be reduced only by the portion of the grant that is funded with federal funds. Second, it seems clear that a first step grantee is not necessarily a second step grantor of the federal funds based on the language in the Conference Report that is used in giving an example of a federal subsidy: “. . . a reduced interest rate loan attributable in part to a federal grant.” A grantee of federal funds, in certain cases, apparently, is free to make a grant or extend a loan to a building owner using only those federal funds, or those funds plus funds from no federal sources; and Section 42(i) indicates that if it is a loan, it may or may not be at the market interest rate.

“We have concluded that we should look only to the proposed financial arrangement between City T and Partnership to determine whether funds will be granted or loaned, and that we should make that determination without regard to the source of the funds or the terms under which they were received by City T. After making that determination the source of the funds becomes relevant for purposes of sections 42(d)(5) and 42(i)(2) of the Code.”

See also, TAM 200523023 (May 4, 2004), in which HOME (federal funds) and AHP grants were made to a nonprofit organization with respect to a specific property and were loaned by that nonprofit to the taxpayer. The loans bore no interest, had a term of 31 years and required no debt service payments prior to maturity. The nonprofit lender was the general partner of the taxpayer and held a right of first refusal described in Section 42(i)(7) of the Code. The Service held that no reduction in eligible basis was required under Section 42(d)(5)(A).

We are aware of no case or ruling in which the Service has taken a position contrary to PLR 8813024 or TAM 200523023.

Treas. Reg. 1.42-11 provides exceptions to the general rule for (1) supportive services provided under IRC §42(g)(2)(B)(iii) discussed below, and (2) on a project basis, for the cost of mandatory meals in any federally-assisted project for the elderly and handicapped (in existence on or before January 9, 1989) that is authorized by 24 CFR 278 to provide a mandatory meals program.

Supportive Services

Under IRC §42(g)(2)(B)(iii), gross rent does not include any fee for a supportive service which is paid to the taxpayer (on the basis of the low-income status of the tenant of the unit) by any governmental program of assistance (or by an organization described in IRC §501(c)(3) and exempt from tax under IRC §501(a)) if such program (or organization) provides assistance for rent and the amount of assistance provided for rent is not separable from the amount of assistance provided for supportive services.

"Supportive service" means any service provided under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. In the case of a single-room occupancy unit or a building described in IRC §42(i)(3)(B)(iii) related to transitional housing for the homeless, or IRC §42(i)(3)(B)(iv) related to single-room occupancy, such term includes any service provided to assist tenants in locating and retaining permanent housing. See Treas. Reg. §1.42-11(b)(3)(ii)(A).

Common Areas If the cost of common areas is included in eligible basis (see Chapter 8), then, as explained in the legislative history for the original enactment of IRC §42, no fee can be used for the use of the facility.

“...the allocable cost of tenant facilities, such as swimming pools, other recreational facilities and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project.”

Alternatively, if the taxpayer excludes the allowable cost relating to the facility from eligible basis, IRC §42 does not control the taxpayer’s use of the facility related to the excluded costs.

Determining Whether Units are Rent-Restricted

Under IRC §42(g)(2)(A), a unit qualifies as a low-income unit when the gross rent does not exceed 30% of the imputed income limitation applicable to such unit, which is an annual amount. Therefore, taxpayers must satisfy the rent-restrictions requirements on a tax year basis, as of the end of the tax year.

IRC §42(g)(2)(B) defines gross rent to exclude certain payments and includes consideration of any utility allowances and fees on a monthly basis. Therefore, taxpayer’s must also satisfy the rent-restrictions each month of the tax year.

****SEE COMMENT 12-1 BELOW**

As a result, a unit can fail to satisfy the rent restriction requirements if the rent exceeds the limit on a tax year basis or on a monthly basis; i.e., any one or more months during the tax year. A unit also fails to satisfy the rent restriction requirement if an owner charges impermissible fees.

COMMENT 12-1:

Section 42(g)(2)(B) gives no indication that gross rent is determined on a monthly basis. Section 42(g)(2)(A) provides that gross rent is determined for imputed income limitations on an annual basis as stated on page 12-17. Treas. Reg. Section 1.42-10 regarding utility allowances are concerned with establishing the allowance and when a change in the allowance is effective, but this regulation does not state an annual or month period for computing the utility allowance. Prop Reg. Sec. 1.42-10(e)(2) provides for monthly fee for the owner's actual cost of administering a sub-meter arrangement. Again, no language in Section 42 or the regulations thereunder support that any component of gross rent is determined on anything but an annual basis. In fact, utility companies bill customers on a monthly basis but billing practices do not set the time for determining gross rent.

As to the Section 8 rules, the monthly income calculations (utilized to calculate the income-based rent amounts for Section 8 Housing, and adopted by Section 42) are derived from the tenants' annual income and annual adjusted income. See 24 CFR Sec. 5.603, 5.609, 6.611, 5.628. The tenants' monthly income is merely the annual income calculations divided by twelve. There is nothing to suggest that the tenants' income calculations are to be determined on anything but an annual basis.

The IRS conclusion on page 12-17 is faulty, and it takes quite a leap in reasoning to get to the position that rent is determined monthly. We disagree with the IRS position.

demonstrate that at the time the unit was rented, the taxpayer had made reasonable attempts to first rent the low-income units.

**Audit
Techniques:
100% Low-
Income
Buildings**

Like the Available Unit Rule, the Vacant Unit Rule has no immediate application for 100% low-income buildings because available units are only rented to qualifying households.

As a result, for purposes of applying the Vacant Unit Rule, the IRS will treat all households documented as initially income-qualified households as income-qualified as long as the taxpayer demonstrates due diligence when completing the initial income certification. Further, the taxpayer does not violate the Vacant Unit Rule when a unit is unintentionally rented to a nonqualified household.

The Vacant Unit Rule is violated when a taxpayer fails to make reasonable attempts to rent vacant units to qualified households, and either:

1. the taxpayer attempted, but failed to rent a unit to an income-qualified household, and cannot demonstrate due diligence when making the determination of income eligibility, or
2. The taxpayer deliberately rents a unit as a market-rate unit; i.e., the rent is not restricted.

Unless a taxpayer can document which units were vacant low-income units when the taxpayer deliberately violated the Vacant Unit Rule, the building's qualified basis is deemed to be zero; i.e., the building is not part of a qualified low-income project at all times during the 15-year compliance period under IRC §42(c)(2).

No credit is allowable until such time as the taxpayer can establish compliance with the Vacant Unit Rule; i.e., the applicable fraction is deemed to be zero. Note: The taxpayer must first demonstrate that the Available Unit Rule was not applicable, or if applicable, was applied correctly. (See discussion of this rule above.)

General Public Use [SEE COMMENT 12-2 BELOW](#) & Transient Use**

Law

The General Public Use Requirement is not included in the Code, but is described in the legislative history for the initial enactment of IRC §42. It reads:

Residential rental units must be for use by the general public and all of the units in a project must be used on a non-transient basis. Residential rental units are not used by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing, sanitarium, life care facility, retirement home providing significant services other than housing dormitory, or trailer park may be a qualified low-income project. Factory-made housing which is permanently fixed to real property may be a qualified low-income building..."

COMMENT 12-2 RE: GENERAL PUBLIC USE

The Audit Guide makes a mistake in its discussion of the General Public Use requirement. It is not correct that Reg. §1.42-9(a) makes low-income projects subject to the Fair Housing Act, thereby making it unlawful to discriminate due to age, etc. The Fair Housing Act stands on its own to the extent it makes discrimination unlawful in low-income housing projects and in other housing generally, and the Audit Guide should not refer to "unlawfulness" in the context of Code §42. Instead, Section 42 includes a general public use requirement, and the question of general public use is determined, in part, by reference to the Fair Housing Act. The Audit Guide should make this clear by stating:

The term 'for use by the general public' shall be determined in a manner consistent with the Department of Housing and Urban Development ('HUD') housing policy governing non-discrimination as evidenced by HUD rules and regulations. See HUD Handbook 4350.3 (or its successor). Accordingly, owners of residential rental units that give preferences to certain classes of tenants (e.g., the homeless, disabled and/or handicapped, and in certain projects for elderly tenants) will not violate the general public use requirement if such preferences would not violate any HUD policy governing non-discrimination expressed in the HUD Handbook. However, if the owner acts with respect to residential rental units in a manner that violates HUD housing policy (e.g., impermissible discrimination based on race, nationality, gender, age, etc.) then these units will be ineligible for the credit. In addition to the HUD nondiscrimination rules, if a residential rental unit is provided solely for members of a social organization or by an employer for its employees, then the general public use requirement is not met with respect to the unit.

3. IRC §42 project is located on Indian land and it is anticipated that only income-qualified members of the designated Indian tribes will occupy the low-income units.

Noncompliance Issues

****SEE COMMENT 12-3 BELOW**

Noncompliance occurs if:

- Under Treas. Reg. §1.42-9(b), a residential unit is provided only for members of a social organization or provided by an employer for its employees.
- Under Treas. Reg. §1.42-9(b), any residential rental unit that is part of a hospital, nursing home, sanitarium, life care facility, retirement home providing significant services other than housing, dormitory, trailer park, or intermediate care facility for the mentally and physically disabled is not for use by the general public.
- The taxpayer is renting low-income units to members of a specified group allowable under IRC §42(g)(9)(B), but cannot document ~~association with or participation in~~ that the targeted group are members of a group under a federal program or state program or federal/state policy that supports housing for such a specified group as required under IRC §42(g)(9)(B).

~~Noncompliance also occurs when the following fact patterns are identified. This list is not intended to be all inclusive. Other scenarios requiring evaluation of the taxpayer's compliance with the General Public Use Requirement may be identified during an audit.~~

The following fact patterns may indicate situations where satisfaction of the general public use requirement may require additional review. This list is not intended to be all inclusive.

- The taxpayer sets aside a portion of the low-income units for the exclusive use of income-qualified households referred by a third party. For example, a taxpayer may enter into an agreement with a third party to set-aside 25 of its 100 low-income units for the exclusive use of income-qualified households referred by the third party and the third party guarantees rent payments for the 25 units.
- A taxpayer restricts low-income units to student households, even if the student households meet one of the exceptions under IRC §42(i)(3)(D) for households comprised entirely of full-time students. The student households are not a qualified group under IRC §42(g)(9) and the General Public Use Requirement has precedence over the exceptions under IRC §42(i)(3)(D).
- The tenants' special needs require physical adaptations or services such that the taxpayer is effectively providing nursing, medical, or psychiatric services, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See Treas. Reg. §1.42-11(b)(2). For example, tenants diagnosed with dementia are isolated in an area where the taxpayer has installed combination locks on doors so that the tenants, who cannot remember the combination or operate the lock, cannot wander off the premises.

COMMENT 12-3 RE: NONCOMPLIANCE ISSUES

The discussion of “Noncompliance Issues” is inaccurate for the following reasons:

- a. The statement regarding “documented association with or participation in” programs under 42(g)(9)(B) should only reiterate the language of the section, which does not require “participation” in a program.
- b. We are not aware of any authority that all of the scenarios are impermissible in every situation. Rather than stating that “noncompliance also occurs when the following fact patterns are identified,” we recommend that the Audit Guide indicate only that the following fact patterns may give a basis for questioning whether the GPU requirement is met.
- c. For example, there is nothing definitively wrong with third party referrals whether or not units are exclusively set aside. For example, housing authorities and nonprofit entities might have a contractual sublease.
- d. Although the student situation identified might be problematic, the question is whether this violates Fair Housing rules. There should not be a proclamation in the Audit Guide.

Audit Techniques

Potential violations of the General Public Use Requirement may be identified using the following audit techniques.

**Tax Credits
Not Applied
Against the
Recapture
Amount**

Under IRC §42(j)(4)(D), the credit recapture amount (accelerated credit + interest) cannot be offset by any other tax credit; i.e., the credit recapture amount is not treated as a federal income tax against which any federal tax credit can be applied.

Generally, this rule is applied when calculating the recapture amount for taxpayers who actually reduced their tax liability by claiming the credit, usually partners in a partnerships owning a IRC §42 project. See Chapter 19. The rule also has application at the partnership level to prevent taxpayers from offsetting a recapture amount by reducing the credit allowable for the taxable year.

Example 3: Offsetting the Recapture Amount at the Partnership Level

A taxpayer owns a 100% low-income building with a \$120,000 allocation of credit. The taxpayer claimed the full credit each year, for year 1 through 8 of the credit period. At the end of the 9th year, there was a reduction in the qualified basis such that the allowable credit for the year was \$95,000 and the resulting recapture amount was \$54,000.

The taxpayer cannot reduce the allowable credit by the recapture amount (\$95,000 - \$54,000) and claim IRC §42 credit in the amount of \$41,000 for the 9th year.

The taxpayer must separately report the \$95,000 credit allowable for the 9th year and \$54,000 recapture amount.

**Casualty
Losses
**SEE
COMMENT
16-1 BELOW**

Under IRC §42(j)(4)(E), the recapture provisions do not apply if the reduction in qualified basis results from a casualty loss if the lost qualified basis is restored by reconstruction or replacement within a reasonable time established by the Secretary.

As explained in Chapter 12, a casualty loss for purposes of IRC §42 is the same as defined under IRC §165; i.e., the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Property damage is not considered a casualty loss if the damage occurred during normal use, the owner willfully caused the damage or was willfully negligent, or was progressive deterioration such as damage caused by termites.

In CCA 200134006, Chief Counsel clarified that a period of up to two years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties.

If the taxpayer fails to restore or replace the lost qualified basis within a reasonable period, then the recapture provisions are applied for the tax year in which the casualty event occurred. In CCA 200913012, Chief Counsel explained that if the statute of limitations is closed, whether for the casualty event or credits claimed during the restoration period under Rev. Proc. 95-28 or Rev. Proc 2007-54, then the taxpayer's first open taxable year in the compliance period should be treated as the year of the taxpayer's reduction in qualified basis. In other words if a taxpayer represents on its returns that it was entitled to IRC §42 credits in a closed taxable year, then the taxpayer is estopped under the duty of consistency to deny that it had qualified basis at the end of that taxable year.

COMMENT 16-1 RE: CASUALTY LOSSES

While IRC §42(j)(4)(E) only discusses recapture of tax credits following a casualty event, it does not preclude the owner continuing to claim credits. As long as the owner restores the property within a reasonable period, credits should be allowed during the restoration period.

CCA 200134006 provides relief in the form of ability to take tax credits during the replacement period if the project is located in a presidentially declared disaster area. The reasoning for allowing credits for these properties and not for projects out side of disaster areas is stated as “Such an event is quite distinct from the general loss situation confronting property owners.” However, it is not that distinct. In both situations, some sort of involuntary event has resulted in damage to the property. In both cases, the owner is motivated to restore the property in a reasonable time. While there are more widespread needs in a presidentially declared disaster area that may lengthen the reasonable time to restore, there are also more resources deployed to those areas that can help accommodate the restoration in a reasonable period of time. In fact, a project that continues to occupy unaffected units or buildings while restoring the damaged ones presents its own challenges. If the IRS felt it was appropriate to allow credits to continue following a casualty in a disaster area, the same should be allowed in a casualty situation that is outside a disaster area.

Once placed in service, credits should continue to be allowed as long as the owner continues to operate it as qualified housing. A temporary removal from service after a casualty occurs should not prevent the owner from claiming credits. This is supported by the depreciation rules. Reg. 1.167(a)-10(b) states that depreciation “shall end when the asset is retired from service.” Reg. 1.167(a)-8(a) defines a retirement as “the permanent withdrawal of depreciable property from use in the trade or business or in the production of income.” IRS Publication 946 provides that taxpayers should continue to claim a deduction for depreciation on property used in their business or for the production of income even if it is temporarily idle. There are numerous cases that support the concept that depreciation would be allowable during periods when the property is unusable, as long as the intent is to return it to service.

CCA 200913012 draws a negative inference from the fact that Congress provided specific relief from recapture in Section 42(j)(4)(E) but did not specifically provide that credits continue with respect to a building or unit that suffers a casualty loss. We think that the negative inference is unwarranted.

First, it is not clear that Congress expected credits would stop with respect to a damaged unit. To the extent the unit had to be vacated, if the taxpayer was making reasonable efforts to rent the unit (including presumably efforts to restore the damaged unit) and did not rent a comparable or smaller unit to a non-qualifying tenant, credit would likely continue under the vacant unit rule. The only provision of Section 42 that would potentially stop the running of credits on a damaged unit is Section 42(i)(3)(B)(i), which requires that a low income unit be suitable for occupancy. That provision, appears to refer to local health and safety codes that may or may not be applicable.

Second, if damage to a unit constitutes noncompliance under Section 42(i)(3)(B)(i) or otherwise, such noncompliance is wholly outside of the control of the taxpayer. The legislative history of Section 42 provides that noncompliance should be corrected within a reasonable time period. For example, “[o]wners and operators of low-income housing projects on which a credit has been claimed must correct any noncompliance with the set-aside requirement or with a

reduction in qualified basis within a reasonable period after the noncompliance is discovered or should have been discovered.” Page II-97 of the Conf. Rpt. to the Tax Reform Act of 1986. The Service has recognized, in at least two cases, that taxpayers should not lose credits for noncompliance outside of their control when the noncompliance is corrected within a reasonable period – tenant fraud and noncompliance with nonprofit setaside requirements (see Chapter 6 of this draft Audit Guide). Thus, the taxpayer should have a reasonable time to restore the property and make it suitable for occupancy without losing credits.

A casualty loss is an involuntary removal from service. If the owner chooses not to restore it, then it should be considered a retirement and a loss of credit and recapture should result. However, if the property is restored and returned to service in a reasonable amount of time, defined as up to 24 months, then the owner should not be penalized by the loss of credits during that time. Allowing the credits would make align the credit rules with the depreciation rules and is consistent with Congressional intent to allow a reasonable period to correct noncompliance, especially when such noncompliance is totally outside of the control of the taxpayer.

Market Studies

Market Studies used to evaluate the type of building to build. For example, one-bedroom units targeted for seniors vs. 3 bed-room units targeted for families.

Impact Fees and Dedicated Improvements

Impact Fees: Impact fees are one-time charges imposed by a state or local government against new development or expansion of existing development to finance specific off-site capital improvements for general public use that are needed because of the new or expanded development. Taxpayers are required to pay impact fees to compensate the government entity for the financial impact of the taxpayer's development. The fees, for example, could be used to build a new school or expand a sewage system.

Rev. Rul. 2002-9 provides guidance for including impact fees for determining the eligible basis. Impact fees are indirect costs under IRC § 263A because they directly benefit, and are incurred by reason of, a taxpayer's production activity. Impact fees are assessed because of a taxpayer's plans to construct a new residential building. In accordance with Treas. Reg. 1.263A-1(f), the taxpayer must allocate the impact fees to the property produced. Because impact fees are calculated based upon the characteristics of the building and the impact fees are generally refundable if the building is not constructed as planned, the fees are 100% allocable to the building.

Dedicated Improvements: Similar to the treatment of impact fees, costs to construct dedicated infrastructure improvements are indirect costs for purposes of IRC §263A and within the meaning of Treas. Reg. §1.263A-1(e)(3)(i) and are capitalizable to the property produced because the costs directly benefit, or are incurred by reason of, the construction of the project. Infrastructure, for example, includes streets, curbs, sidewalks, and storm water drainage required by the local government and constructed according to the local government's specifications. To qualify, the improvements must be dedicated to the state or local government for public use after completion. Upon acceptance of the dedication, the state or local government will own and maintain the infrastructure assets. Treas. Reg. §1.263(a) 4(d)(8)(iv). See PLR 200916007 for example.

Personal Property:

- Fixtures
- Furniture
- Appliances

Personal property (e.g., fixtures, furniture and appliances) may be included in eligible basis. Treas. Reg. §1.103-8(b)(4)(iii).

Assets/Costs Associated with Land

Expenses related to acquiring the land are excluded from eligible basis. These costs are capitalized under IRC §§ 1016 and 263.

Land Acquisition

- Developer Activities
- Finders Fees
- Brokerage Fees
- Legal Fees
- Professional Fees
- Assumed Liabilities

Generally, land acquisition involves the purchase of unimproved land for the construction of IRC §42 projects.

Activities normally performed by a developer and associated with the acquisition of land, which should be capitalized to the land, include (but are not limited to):

1. Analysis of the Qualified Allocation Plan (QAP) for targeted areas within a state,
2. Identification of potential land sites,
3. Analysis of population demographics for potential sites.
4. Analysis of a site's economy and forecast future growth potential.
5. Determining a site's zoning status and possible rezoning actions.

Land Acquisition
• Assumed Liabilities

Unpaid real estate taxes and similarly assumed costs are added to the land's basis. See *P. W. Havener*, 23 T.C.M. 539, Dec. 26,735(M), T.C. Memo. 1964-91.

Demolition & Tenant Relocation

IRC §280B states that in the case of the demolition of any structure, no deduction shall be allowed to the owner or lessee of such structure for any amount expended for such demolition, or any loss sustained on account of such demolition. The costs should be added to the capital account for the land on which the demolished structure was located. Therefore, these costs are excluded from eligible basis.

The costs of relocating tenants out of an acquired building that will be demolished are associated with the demolition and are capitalized to the land.

Land Preparation Costs:
• Clearing
• Grubbing
• Cutting
• Filling
• Rough Grading

Rev. Rul. 80-93 addresses whether a taxpayer is allowed to take a depreciation deduction for costs incurred for the clearing, grubbing, cutting, filling and rough and finish grading necessary to bring the land to a suitable grade for constructing certain depreciable assets. These costs will not be repeated when the depreciable asset is replaced. This revenue ruling holds that the land preparation costs are unaffected by replacement of the depreciable assets and will not be replaced contemporaneously. Therefore, they are nonrecurring general land improvement costs that are inextricably associated with the land and are to be added to the taxpayer's cost basis in the land. These land preparation costs are not depreciable and, therefore, are excluded from eligible basis.

Land Preparation Costs:
• Grading

The grading of land involves moving soil for the purpose of changing the ground surface. It produces a more level surface and generally provides an improvement that adds value to the land. Rev. Rul. 65-265, clarified by Rev. Rul. 68-193, holds that such expenditures are inextricably associated with the land and, therefore, fall within the rule that land is a nondepreciable asset. Costs attributable to the general grading of the land (not done to provide a proper setting for a building or a paved roadway) become a part of the cost basis of the land and, therefore, are not subject to a depreciation allowance. See *Algernon Blair, Inc. v. Commissioner*, 29 T.C. 1205 (1958), acq., 1958-2 C.B. 4. As such, the costs are not includable in eligible basis under IRC §42(d)(1).

Land Surveys
• Boundary
• Mortgage

Land and environmental surveys are generally conducted over the entire property of the development, not just where the buildings and improvements will be specifically placed. Some surveys, such as boundary or mortgage surveys help to define the property. Costs incurred for these types of survey are inextricably associated with the land, are not depreciable, and are excluded from eligible basis. See TAM 200043017.

COMMENT C-1:

Surveys are often required by construction lenders. In such cases, the cost of the survey should be amortized over the term of the loan. The portion of the loan term that occurs during the construction period should be capitalized into the building as an indirect cost of construction.

Environmental Surveys

- **Percolation Tests**
- **Contamination Studies**
- **Soil Borings**
- **Geotechnical Inspections**

Environment surveys such as percolation tests and contamination studies are used to determine if the land is suitable for the construction of the contemplated improvements. Other similar surveys include soil borings, geotechnical investigations, suitability studies, wetland reviews, mapping of wetland, and inspections of wetland, wetland characterization, and groundwater investigations. If this type of survey will not necessarily need to be redone contemporaneously when the depreciable improvement is replaced, the costs incurred for the survey are inextricably associated with the land and are not depreciable and are excluded from eligible basis.

- **Wetland Studies**
- **Groundwater Investigations**

A survey is considered to be redone contemporaneously with the replacement of the depreciable improvement if the physical replacement of the depreciable improvement (included in eligible basis) mandates a reperformance of the survey. Although an ordinance may require reperformance of the survey, such requirement is irrelevant as to whether the physical replacement of a depreciable improvement necessarily mandates a reperformance of the survey.

If necessary, the cost should be allocated between nondepreciable property (for example, land) and depreciable property (for example, buildings) using any reasonable method. For example, if staking costs are incurred to demarcate sidewalks (depreciable) and landscaping not immediately adjacent to buildings (nondepreciable), the staking costs should be allocated between the sidewalks and the landscaping.

See TAM 200043017

COMMENT C-2:

If a law or ordinance requires surveys or other services to be incurred if the building were to be replaced, then that cost should be capitalized.

Costs Associated with Land Improvements

- **Water Retention Ponds**

Generally, land preparation and improvement costs are excluded from eligible basis. For a land cost to be included in eligible basis, it must be so closely associated with a particular depreciable asset includable in eligible basis that the land improvement will be retired, abandoned, or replaced contemporaneously with that depreciable asset; i.e., the cost will be reincurred if the building is replaced or rebuilt. Whether a specific land cost will be retired, abandoned, or replaced contemporaneously with the depreciable asset, is a question of fact. *Eastwood Mall, Inc. v. U.S.*, 95-1 USTC 50,236 (N.D. Ohio 1995), aff'd without published opinion, 59 F.3d 170 (6th Cir. 1995).

Costs incurred by a taxpayer to haul dirt and fill to an area to raise the level of the land surrounding a creek to make the area useful as an industrial site is an improvement to the land itself and must be capitalized. *Coors v. Commissioner*, 60 T.C. 368, (1973).

The costs incurred in construction of steel cellular revetments and a stable slope berm outward from a lake shoreline, as part of a project to enclose and fill in an area of the lake to provide additional land for industrial facilities, and the cost of filling in the enclosed area are nondepreciable land acquisition costs and, therefore, are excluded from eligible basis. Rev. Rul. 77-270, 1977-2 C.B. 79.

Landscaping:

- **Clearing**
- **General Grading**
- **Top soil**
- **Seeding**
- **Finish Grading**
- **Planting of perennial shrubbery and trees**

Landscaping immediately adjacent to the low-income buildings is depreciable property because the replacement of the buildings will destroy the landscaping. These costs are considered inextricably associated with the buildings and the costs are included in eligible basis. Otherwise, landscaping is general land improvement that will be unaffected by the replacement of the low-income buildings and, therefore, will not be replaced contemporaneously. These costs are excluded from eligible basis. See Rev. Rul. 74-265.

Engineering and Architectural Services

Engineering and architectural services may include (but are not limited to) the preparation of erosion control plan, grading plan, utility plans, general details, easement descriptions, sewer and sanitary plans, and traffic engineering. Such services associated with nondepreciable land are excluded from in eligible basis.

The services associated with a tangible depreciable asset includable in eligible basis, such as detailed construction drawings, are includable in eligible basis.

While it is a case-by-case factual determination, engineering and architectural services should be characterized consistently with the subject of the service. Services that may be associated with both nondepreciable property (e.g., land) and depreciable property should be allocated among the nondepreciable property and the depreciable property using a reasonable method.

COMMENT C-3:

Engineering costs associated with depreciable costs should be depreciable. For example, water and sewer hook-ups are depreciable, so engineering costs incurred in connection with water and sewer hook-up should also be depreciable.

Financing Costs

Fee, Cash Flow Guarantee

A “cash flow guarantee fee” paid by a partnership to secure agreement that its general partner would make loans to the partnership to fund any operating deficits is excluded from eligible basis. See Appendix G, Corbin West Limited Partnership v. Commissioner.

Fee, Tax Credit Guarantee

A “tax credit guarantee fee” paid to ensure that the project is operated in compliance with IRC §42 and guarantee that the taxpayer is entitled to claim the IRC §42 credit is excluded from eligible basis. See Appendix G, Corbin West Limited Partnership v. Commissioner.

Tax-Exempt Bonds:

• **Issuance Costs**

Notwithstanding the general rule of IRC §263A, bond issuance costs are excluded from eligible basis under the specific requirements of IRC §42(d)(1). The legislative history of IRC §142 provides that bond issuance costs cannot be paid from the 95% portion of the issue. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686, 729 (1986), 1986-3 (Vol. 4) C.B. 868, 729. Since bond issuance costs are not costs included in the 95% used for qualified residential rental projects, the bond issuance costs are not residential rental property or costs used to provide residential rental property within the meaning of IRC §§142 or 42.

Characterizing a certain portion of bond issuance costs as includable in eligible basis under IRC §263A is directly contrary to this specific congressional determination. Permitting an IRC §263A characterization of the bond issuance costs for purposes of IRC §42 would result in the disparate treatment of the term residential rental property between IRC §§42 and 142. This result is contrary to the statutory and legislative history construct governing IRC §42 that requires that residential rental property have the same meaning for purposes of both sections.

Accordingly, notwithstanding the general rule under IRC §263A, no portion of bond issuance costs are included in eligible basis. See TAM 200043015.

COMMENT C-4:

See the discussion concerning Page 8-27 where bond issuance costs are discussed.

Loans:

- Origination Fees
- Legal Fees
- Closing Costs
- Title Searches
- Recordation Fees

Costs incurred in obtaining a loan are capitalized and amortized over the life of the loan. See *Enoch v. Commissioner*, 57 T.C. 781, 794-5 (1972), acq. on this issue, 1974-2 C.B. 2. See also Rev. Rul. 70-360, 1970-2 C.B. 103, Rev. Rul. 75-172, 1975-1 C.B. 145, and Rev. Rul. 81-160, 1981-1 C.B. 312. The cost of securing financing includes costs such as origination fees, legal fees, closing costs, title searches and recordation fees.

Construction Loans: The costs and fees incurred in obtaining a construction loan are not capitalized to depreciable property, but are treated as an amortizable IRC §167 intangible. Amortization deductions relating to the construction loan may be capitalized under IRC §263A to the produced property and the produced property is subject to IRC §168 if the amortization deductions directly benefit, or were incurred by reason of, the production of the property.

COMMENT C-5:

SEE COMMENT ABOVE regarding survey costs includable in depreciable basis.

**Loans:
Reserves
and Escrows
Required by
Lender**

Permanent Financing: The cost of securing permanent financing is excluded from eligible basis, but capitalization of the amortization during the construction period may be possible under IRC §263A if the loan is associated with the building. However, permanent financing is not usually in place during the construction period. Bridge loans are treated the same way.

Funds held in escrow accounts or required by a lender to be held in reserve are not depreciated and are excluded from eligible basis.

**Construction
Contingency
Amounts**

Amounts in a construction contingency account created for unexpected construction overruns are excluded from eligible basis because no cost was incurred.

**Loans:
Interest Paid
or Incurred**

Interest incurred during the “production” period related to production expenditures loans associated with the low-income buildings is includable in eligible basis under IRC §263A(f). Generally, the production period begins when physical activity on the site begins and ends when the produced property is placed in service. Physical production excludes planning and architectural design, soil testing, or securing permits. Treas. Reg. §1.263A-12(f).

Interest attributable to completed units (after the construction period) is expensed as an ordinary and necessary business expense.

Costs Excluded from Eligible Basis

**IRC §42 Credit:
Application &
Allocation Fees**

A state agency may charge a fee for submitting and processing the application for an allocation of IRC §42 credit, and if successful, may impose an allocation fee. These fees are excluded from eligible basis because the fees are not capitalizable into the adjusted basis of the building. See IRC §§263 and 263A. However, depending on the facts and circumstances, all or a portion of these fees may be required to be capitalized as amounts paid to create an intangible asset. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections. Rev. Rul. 2004-82.

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**IRC §42 Credit:
Cost
Certifications**

Under IRC §42(m)(2), the credit allocated by a state agency is not to exceed amount necessary to assure project feasibility and viability as a qualified low-income housing project throughout the credit period. To make sure only the credit necessary is allocated, the state agencies perform evaluations of the sources and uses of funds at three critical points of the development process: (1) when the taxpayer applies for the credit, (2) when the credit allocation is made, and (3) when the building is placed in service. The cost of preparing the cost certifications is excluded from eligible basis. Like credit applicable and allocation fees, the cost of preparing cost certifications is associated with the creation of an intangible asset. See Treas. Reg. §1.263(a)-4. Any portion of these fees not required to be capitalized under Treas. Reg. §1.263(a)-4 may be deductible as an ordinary and necessary expense under IRC §§162 or 212, provided the taxpayer satisfies the requirements of those sections.

COMMENT C-6:

Cost certifications are prepared at the completion of projects and documents what development costs were incurred by the owner. It is used for a variety of purposes other than to secure 8609's. The certification is related to the development of the project and should be included in basis.

**Compliance
Monitoring**

State agencies may charge taxpayers a fee to offset the cost of compliance monitoring under Treas. Reg. §1.42-5. The fees are an ordinary and necessary business expense under IRC §162 in the year the fee is incurred or paid. The cost is not depreciable and, therefore, is excluded from eligible basis.

**Management
Fee**

“Rental management” is the continuing day-to-day management of the property, including all dealings with the tenants, leasing and renewal of current leases, procurement of new tenants for any vacancies, etc. Rental management fees are usually a set amount plus a percentage for any lease renewals and incentives for new tenants obtained to fill vacancies. Amounts paid for the original leasing of the units and continued management of the project should be expensed on a yearly basis and matched against current rental income. These fees are excluded from eligible basis.

**Partnership
Organizational
Costs**

Partnership may be amortized over a period of time not less than 60 months under IRC §709(b). These costs are not included in adjusted basis for depreciation purposes and are, therefore, excluded from eligible basis.

Treas. Reg. §1.709-2(a) defines “organizational expenses” as expenses that are: (1) incident to the creation of the partnership; (2) chargeable to capital account; and (3) of a character that, if expended incident to the creation of a partnership having an ascertainable life, would (but for IRC §709(a)) be amortized over that life. An expenditure that fails to meet one or more of the three tests does not qualify as an organizational expense for purposes of IRC §709(b) and Treas. Reg. §1.709-2(a).

Examples of organizational expenses include legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the

partnership; and filing fees. Examples of expenses that are not organizational expenses include costs to acquire assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

See TAM 200043017.

