ID: CCA_2010020312111806

Office:

UILC: 42.00-00

Number: **201046014**
Release Date: 11/19/2010

From:
Sent: Wednesday, February 03, 2010 12:11:20 PM
To:
Cc:
Subject: Section 42 over-income advice

Taxpayer:
TIN:
Tax Form:
Tax Years:
Earlier Tax Years:
Year 1:
Year 2:
Year 3:
Agency:
Location

This responds to your request for views regarding the position taken by Exam in its June 5, 2009, Memorandum to Associate Area Counsel, Examination, Location (Exam).

We address two points. First, whether Taxpayer used the correct (or incorrect) income limits in initially determining the income of the tenants under § 42. Second, Exam's proposal to disallow § 42 credit for Tax Years because the Taxpayer failed to certify that the project was in compliance with §§ 42 and 1.42-5.

Facts:

Taxpayer's project, which is located on a Native American Reservation, received a memo from the Department of Housing and Urban Development (HUD) (including opinions of counsel) providing that the income limits for the project could be adjusted to a level higher than the HUD section 8 Area Median Gross Income limits for the surrounding area. The Agency accepted the higher income limits for the project and issued Forms 8609. Following the initial compliance monitoring review of the project, the Agency determined that the actual, unadjusted HUD section 8 income limits were the correct income limits for the project and subsequently issued Forms 8823 indicating that project was out of compliance, that the minimum set-aside for the project had been violated, and as a result, the project was ineligible for § 42 credit for any year. Agency later issued additional Forms 8823, checking line J, indicating that it considered the project non-compliant and removing the project from the housing credit program. Exam disallowed the § 42 credit for Earlier Tax Years on the basis that the income limits charged to tenants exceeded the § 42 income limits applicable to the area because they exceeded the HUD section 8 income limits for the area.

For the Earlier Tax Years, Appeals sided with Taxpayer, stating that the adjusted, higher income limits for the project were correct. Exam now seeks to disallow § 42 credit for Tax Years because the Taxpayer has not certified to the Service that the project was in compliance with §§ 42 and 1.42-5 for these years.

Issue #1.

We agree with Exam that Taxpayer used the incorrect income limitations for the project, that is, the published 50% or 60% income limitations for the HUD section 8 program should have been applied to the project, not the adjusted, higher income limits for the project that appears to have been acceptable for HUD programs. Section 142(d)(2)(B)(i), through § 42(g)(4), controls income limits for § 42(g)(1) purposes. We read that section as Exam does that it is the Secretary of Treasury (not the Secretary of HUD) that makes the determination of what income limitations control for § 42 purposes in a manner consistent with determinations of lower income limits under HUD section 8. In previous published guidance (cited in Exam's memos), we reference the HUD section 8 published figures for the 50% income limit (modified by the Rev. Rul. 89-24 to include the 60% figure). However, these Service published rulings are not determinative of the issue at hand, in fact, it was not until after this published guidance was issued that we were aware that HUD could deviate from their own published HUD section 8 published figures for projects on Native American reservations. At best, one can only draw an inference from our rulings that it is limited to the 50% published figures (or 60% figures pursuant to Rev. Rul. 89-24).

Ultimately, the issue comes down to how one interprets the first sentence of § 142(d)(2)(B)(i), particularly the words "in a manner consistent with." We interpret this language, literally, to mean that the published HUD section 8 limits are used. To support this view, we note the second sentence in this paragraph providing that "Determinations under the preceding sentence shall include adjustments for family size." HUD section 8 published limits already make adjustment for family size. If the language "in a manner consistent with" includes ***all*** adjustments to the HUD section 8 figures as determined by HUD, including the higher adjustment to for Taxpayer's project, it would seem to make this second sentence (adjustments for family size) superfluous. Further, from a practical standpoint, if the owner of a project did not bring a HUD permitted (but unpublished) adjustment to an awarding agencies attention, the equity gap calculation for that project may not be properly determined, possibly resulting in an over allocation of credit. [Although that is not the case here]. Nonetheless, the first sentence of § 142(d)(2)(B)(i) is worded ambiguously enough to permit a reading that "in a manner consistent with" can include the HUD section 8 published figures, as further adjusted by HUD. This is borne out by the fact that Taxpayer received opinions of counsel (recognized as having § 42 expertise) prior to the awarding of credit stating that the adjusted, higher income limits for the project complied with the § 42 income limits. The opinions of counsel were initially accepted by the Agency.

Further, our branch discussed this issue with an Appeals Officer by phone before a decision was made for the Earlier Tax Years and gave our view that the Taxpayer had used the wrong figures and that the HUD published figures, without variation, were the correct ones to use. Notwithstanding, the Appeals Officer concluded otherwise based on the officers "plain reading of the statute" and "lack of published guidance" to the contrary.

Hazards of Litigation.

[redacted]

[redacted]

2. Exam alternative argument regarding certifications:

As an alternative argument, Exam seeks to disallow credits for Tax Years because the Taxpayer has not "certified" to the Service that the project is in compliance with §§ 42 and 1.42-5.

Our view is that the alternative argument being offered, ultimately, arises because of the purported initial violation (i.e., that the project was initially over income because of the adjusted, higher income limits permitted by HUD).

If there was no violation initially, then the failure to certify that the project was back in compliance seems misplaced given that the project (assuming no other violation) was not initially out of compliance.

Further, it is the Agency, not the Taxpayer, that certifies (via issuance of the Form 8823) to the Service that the project is back in compliance. How can the Service hold the Taxpayer responsible for the failure of the Agency to notify the Service that the Taxpayer is back in compliance? Also, Exam is taking the position that there is a duty by the Taxpayer to contact the Agency to request reinstatement into the program once the Taxpayer has been removed from the program by the Agency (over the Taxpayer's objection -- an objection that was later upheld by the Service). We find no such duty imposed on the Taxpayer in the regulations or the Code.

Section 1.42-5 was written to satisfy the § 42(m)(1)(B)(iii) requirement that a monitoring procedure be in place by the Agency in order to have an effective compliance monitoring plan, which is necessary to validate the credit allocated by the Agency. It was not intended (nor is it anywhere stated in § 1.42-5) that the section be used by the Service to deny credit to a taxpayer who does not comply with the certification or other requirements specified in the regulation. However, the Taxpayer's failure to provide certification may mean that Taxpayer is not following the requirements under § 42 (e.g., over-income tenants).

The opening paragraph in § 1.42-5(a) which provides "These regulations only address compliance monitoring procedures required of Agencies." The regulations are a template for what an Agency must provide in its qualified allocation plan (QAP) for the QAP to be valid. A violation by a taxpayer of its duties under a QAP does not result in the QAP becoming invalid. The penalty to a taxpayer for noncompliance under § 1.42-5 must be found somewhere else. For example, failure to certify certain annual information to the Secretary is required by § 42(l)(1) and (2). The Taxpayer complied with the 1st year certification requirement in Year 1, so § 42(l)(1) is not at issue. While there is no cross reference to § 42(l) in §1.42-5, an argument can be made that the certification requirements in §1.42-5 are enforceable via the authority provided in § 42(l)(2). If so, the penalty for failure to satisfy the § 42(l)(2) certification is prescribed under § 6652(j). Nevertheless, without an annual owner certification, an Agency can assume that the project is out of compliance with the requirements under § 42 and should report the noncompliance on a Form 8823 to the Service.

Exam's memo provides a sequence of statements (highlighted in bold, below) to support disallowance of the credit. Our views follow immediately thereafter.

1. **First, the Agency determined that the project no longer in compliance nor participating in the program and notified the Service using Form 8823 in Year 3**.

[The Service subsequently conceded that the project was not out of compliance for Earlier Tax Years and accepted the appeals settlement. The Agency's action was proper under the circumstances, but the regulations never address what a taxpayer's responsibilities are when the Agency unilaterally (in fact, over the taxpayer's objection) removes the taxpayer from the program over a violation that is subject to review.]

2. **Second, the annual certification for Year 2 was the last annual certification provided to the Agency. The Taxpayer ceased filing the annual certification and, as a result, the Agency did not conduct any reviews of the annual certifications for Year 3 or any subsequent year**.

[If the Taxpayer did not supply a certification to the Agency for Year 2, then the penalty, arguably, is under § 6652(j) via § 42(l)(2). It is not correct to say that "as a result" the Agency did not conduct any reviews of the annual certifications thereafter. The background material to this case indicates that the Agency did not conduct any reviews of the annual certifications because it considered the Taxpayer out of the program from a purported violation of the minimum set-aside requirement. Ultimately it is up to Exam to determine whether the project violated § 42].

3**. Third, the Agency did not review any tenant records or conduct any physical inspections after project removed from program in Year 3**.

[An Agency's failure to review tenant records or conduct a physical inspection is not an imputed violation to the Taxpayer.]

4. **Fourth, the Agency has not reinstated property in the 42 program. An Agency can reinstate in program, but must notify the Service in writing. A reinstatement does not reverse a previous finding that the project was not participating in the program. In this case, the project was removed from the program in Year 3.**

[Assuming there was legitimate underlying violation that was corrected, a notification to the Service in writing (i.e., filing a corrective Form 8823) is only required to be filed indicating a correction within 3-years after the end of the correction period. The correction period is (at the latest) 6 months after the taxpayer is notified of the noncompliance. The facts do not indicate whether, or ***if***, the Taxpayer was notified by the Agency of this particular failure (i.e., to provide the certifications), which is required by § 1.42-5. We assume it was not notified because the Agency thought the Taxpayer was out of the program. Also, and more importantly, removal of a Taxpayer from the program by the Agency is not prima facie evidence that the project is out of compliance. In this case, the Service conceded that the project was in compliance for the Earlier Tax Years. An underlying violation (e.g., over-income tenants) must occur for the project to be out of compliance in the open years. That issue is still unresolved for the Tax Years and would take revisiting the original issue (i.e., whether correct income limits were used).

Further, assuming that there was a legitimate violation that was corrected, failure by the Agency to notify the Service that a project has been reinstated should not prejudice the Taxpayer, which is what Exam's result would do.

Exam concludes with the statement that "upon reinstatement, the project would be eligible for credit under § 42(c)(2) on the date of reinstatement" and that "no credit is allowable for the period during which the Taxpayer is not participating in the program."

[If a building is otherwise a qualified low-income housing project under § 42(c)(2) and the Agency takes it out of the program and it is later determined that it should not have been taken out of the program, there is no authority for saying a taxpayer cannot claim credit during the period the Agency said it was out of the program.]

The examiner concludes that recapture applies.

[Recapture applies if, at the end of one year, there is a decrease in qualified basis from a prior year, but this presupposes an actual violation. This gets back to the income issue. The Service conceded this issue in the Earlier Tax Years. Absent a different violation that results in a decrease in qualified basis, there is no decrease in qualified basis that would result in recapture. Thus, to get recapture, the Service has the difficult task of arguing that the Taxpayer violated the income issue in the open years, notwithstanding the Service conceded this issue on the same facts in the closed years].