

MEMORANDUM

TO: Maryland Affordable Housing Coalition
FROM: Gallagher Evelius & Jones LLP
RE: Low-Income Housing Tax Highlights of 2007
DATE: January 3, 2008

Below we briefly describe several notable changes affecting the low-income tax credit industry in 2007. If you would like additional information about these changes, or any other issues relating to low-income tax credits, please feel free to contact Dave Raderman, Nita Schultz, Ken Gross, Rebecca Weaver, Martha Hylton, Jessica Lang, Ben Rubin, Matt Oakey, Natalie Sherman, Gina Zentz or Vonda Orders.

I. Federal Highlights

IRS Issues Form 8823 Guide

In January of 2007, the IRS published an updated version of its Guide for Completing Form 8823: Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. The guide provides standards for the noncompliance categories listed on Form 8823, and contains specific examples to illustrate compliance versus noncompliance and methods for bringing noncompliant projects back into compliance. Categories include, among others, income limitation violations, changes in eligible basis, gross rent violations, changes in applicable percentage, violations of annual certification provisions and violations of the available unit rule and vacant unit rule. A copy of the guide may be obtained at:
http://www.novoco.com/low_income_housing/lihtc/8823_guide.php

IRS Provides Low-Income Housing Exception to "Reportable Transactions"

The IRS in Rev. Proc. 2007-20 determined that low-income housing tax credit transactions do not fall under the "contractual protection" category of reportable transactions, which are subject to the reporting requirements and penalties for taxpayers engaging in and material advisors to such transactions under the American Jobs Creation Act (2004) ("AJCA"). Prior to the issuance of Rev. Proc. 2007-20, most in the tax credit industry believed that the IRS would not consider

low-income housing tax credit transactions to be reportable transactions, even though there was no clear guidance from the IRS on the issue. However, there was a concern that the IRS could determine that low-income housing tax credit transactions were transactions with contractual protections, and therefore a reportable transaction under the AJCA. Treasury Regulation § 1.6011-4(b) defines a transaction with contractual protection as a transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained or for which fees are contingent upon the taxpayer's realization of tax benefits from the transaction. However, the IRS in Rev. Proc. 2007-20 stated that "transactions in which the refundable or contingent fee is related to the low-income housing credit under § 42(a) "are not taken into account in determining whether a transaction is a transaction with contractual protection under Treasury Regulation § 1.6011-4(b)(4)."

IRS May Challenge State Tax Credit Investor's Status as a Partner

A Memorandum from the IRS Office of Chief Counsel dated January 11, 2007 (AM 2007-002) (the "Memo"), suggests that the IRS may, in certain situations, deem a state tax credit investor to be a purchaser of the state tax credits rather than a partner of the tax credit partnership. A partnership which owns a low-income housing project and qualifies for federal low-income housing tax credits may also qualify for state tax credits, including state historic or state low-income credits. Often, in addition to the admission of the federal low-income credit investor, the tax credit partnership will admit a separate investor partner to receive an allocation of 100% of the state tax credits in exchange for capital contribution payments. In the Memo, the IRS analyzed a scenario in which 100% of the state credits were allocated to an investor, while the investor did not receive material distributions of cash flow or allocations of income, gain, loss or deduction. The investors sold their interests back to the general partners after a brief period of time. The IRS applied the substance over form doctrine and explained that the investors lacked a joint profit motive and had full knowledge that the only benefits of entering the partnerships were the distributions of state tax credits and the federal income tax losses to be claimed at the sale of the investors' interests. Therefore, the IRS concluded that the transfers of the state credits to the investors for cash investments should be recharacterized, in accordance with their substance, as sales and purchases of the credits. In order to avoid such treatment by the IRS, parties to federal low-income housing tax credit transactions with state investors should take steps to ensure that the state credit investor will be respected as a partner. Such steps may include providing the investor with distributions of cash flow and/or capital proceeds, requiring that the investor's partnership interest not be sold until a significant period of time has elapsed after all of the state credits have been used by the investor, and providing the investors with decision-making rights relating to major partnership actions such as the purchase of additional real estate, the acquisition of new loans or the admission of new partners.

Indian Housing Block Grant Payments Are Not Federal Grants

In Revenue Ruling 2008-6, the IRS determined that rental assistance payments made to a building owner on behalf or in respect of a tenant under the Indian Housing Block Grant Program (IHBGP) are not considered federal grants made with respect to a building or its operation under § 42(d)(5).¹ § 42(d)(5) provides that if a federal grant is made with respect to a tax credit building or the operation thereof, then the building's eligible basis shall be reduced by the amount of such federal grant. The IHBGP is authorized by the Native American Housing Assistance and Self-Determination Act of 1996.

New Methods for Estimating Utility Allowance Proposed

On June 19, 2007, the IRS issued proposed regulations which provide new options for calculating utility allowances. Under § 42(g), the calculation of a tenant's gross rent must include a utility allowance if the low-income tenant directly pays utility costs. The utility allowance is calculated based upon procedures set forth in Treasury Regulation § 1.42-10, and takes into account whether the project or its tenants receive federal rental assistance or federal subsidies, among other factors. The proposed changes address complaints that the existing regulations yield inaccurate utility allowance figures and that owners are sometimes unable to obtain local utility estimates. Among other things, the proposed regulations would (i) permit estimates obtained from a utility company to include combined rates from multiple utility companies, (ii) permit project owners to obtain utility estimates for each unit in the project from the applicable state tax credit agency, which estimates would take into account local utility rate data, property type, climate variables, taxes and fees on utility charges, and property building materials and mechanical systems and (iii) permit project owners to calculate utility allowances based upon the HUD Utility Schedule Model, found at <http://www.huduser.org/datasets/lihtc.html>. A hearing on the proposed regulations was held on October 9, 2007, but final regulations have not been promulgated.

Qualified Contract's Minimum Purchase Price Clarified in Proposed Regulations

On June 19, 2007, the IRS issued proposed regulations which describe the purchase price in a qualified contract under § 42(h)(6)(F). Generally, the extended use period during which a low-income housing project owner must comply with low-income rent restrictions continues for at least fifteen years after the end of the fifteen year compliance period. § 42(h)(6)(I) allows a project owner to submit a written request, any time after the fourteenth year of the compliance period, to the housing credit agency to find a person to acquire the owner's interest in the low-income portion of the building. Under § 42(h)(6)(E)(i)(II), the extended use period for a building terminates if the housing credit agency is unable to present, within one year of receipt of such request, a qualified contract for the acquisition of the low-income portion and non low-income portion of the building by any person who will continue to operate the low-income portion of the building as a qualified low-income building. A qualified contract must have a fair market value purchase price with respect to the non low-income portion of the building. The

¹ All Section references are to the Internal Revenue Code of 1986, as amended and revised, unless otherwise noted.

proposed regulations state that fair market value in this case should take into account the restrictions contained in the extended use agreement and should include the fair market value of the land underlying the entire building. Fair market value would also include the value of personal property that conveys with the building. The general formula for the low-income portion of the building remains as stipulated in § 42(h)(6)(F), which is the applicable fraction multiplied by the result of the following formula: the sum of the outstanding indebtedness, the adjusted investor equity and other capital contributions, reduced by the amount of cash distributions from the project. The proposed regulations expand upon the formula with the following provisions, among others: (i) outstanding indebtedness is the remaining principal balance of debt up to the eligible basis, including developer fee notes, (ii) imputed principal amounts of the indebtedness must be used if the loan has an interest rate below the AFR, (iii) the adjusted investor equity is multiplied by a cost of living adjustment and (iv) cash distributions include distributions made to related parties of the owner, and include reserve funds available for distribution at the time of sale. A hearing on the proposed regulations was held on October 15, 2007, and final regulations have not yet been promulgated.

IRS Guidance on 50% Bonus Depreciation for GO Zone

In Notice 2007-36 (Mar. 29, 2007), the IRS clarified some of the issues relating to additional 50% bonus depreciation for property located in the "GO Zone" described in § 1400N(d). To qualify for 50% bonus depreciation, property generally must be placed in service on or before December 31, 2007 (or December 31, 2008 in the case of nonresidential real property and residential rental property), but this deadline is extended until the end of 2010 for "specified Gulf Opportunity Zone extension property" ("Go Zone Extension Property"). GO Zone Extension Property must be located in a county or parish that was identified by the Secretary as being an area in which the hurricanes in 2005 damaged more than 60% of the area's occupied housing units. Notice 2007-36 lists these counties and parishes, which include Orleans Parish. The Notice also states that land improvements that are not located in a building are not considered GO Zone Extension Property (and therefore must be placed in service by December 31, 2007 in order to be eligible for 50% bonus depreciation under § 1400N).

II. Maryland Highlights

2008 Maryland Qualified Allocation Plan

A revised draft of the 2008 Maryland Qualified Allocation Plan (QAP) was released for public comment on December 20, 2007 (*See Multifamily Programs Notice 07-11*). The public comment period for this draft has been extended to January 11, 2008. A revised draft will be issued on January 21, 2008. The final 2008 Maryland Qualified Allocation Plan is expected to be published in April 2008.

The 2007 Qualified Allocation Plan and the Multifamily Rental Financing Guide dated October 19, 2006 will govern the Spring 2008 Competitive Funding Round.

2008 Multifamily Rental Financing Program Guide

A revised draft of the 2008 Multifamily Rental Financing Program Guide was released for public comment on December 20, 2007 (See Multifamily Programs Notice 07-11). The public comment period has been extended to January 11, 2007. The draft includes many proposed changes, including a revised Exhibit C (Development Quality Criteria). The final 2008 Multifamily Rental Financing Guide will be published in April 2008 with the 2008 Maryland Qualified Allocation Plan. The revised draft of the 2008 Multifamily Rental Financing Guide may be found at

<http://www.mdhousing.org/website/programs/rhf/notices/DRAFT2008Guide121707Unmarked.pdf>.

2007 Special Session Legislation – Recordation and Transfer Taxes

Beginning July 1, 2008, recordation and transfer taxes will be payable upon the transfer of a “controlling interest” in a “real property entity.” The effect of this legislation is that transfer and recordation taxes will be imposed on the transfer of ownership interests in an entity in the same manner and amount as if the property had been conveyed by deed or other instrument recorded among the land records. “Controlling interest” is defined as an interest of more than 80% of (i) the total value of all classes of stock in a corporation, (ii) the beneficial interest in a trust, or (iii) the total interest in capital and profits in an entity. A “real property entity” is defined any entity (including limited liability companies, limited partnerships, corporations and trusts) that directly or beneficially owns real property in Maryland, if that property (i) constitutes at least 80% of the value of the entity's assets, and (ii) has an aggregate value of at least \$1,000,000.

THIS MEMORANDUM IS INTENDED FOR INFORMATION PURPOSES ONLY AND IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR MATTER ADDRESSED IN THIS MEMORANDUM.