Chapter 3
Guidelines for Determining Noncompliance

Overview

State agencies are responsible for determining whether owners are compliant with the requirements of IRC §42 and its regulations. Professional judgment should be used to identify significant noncompliance issues, establish the scope and depth of the project/building review, and apply the law and regulations to the facts and circumstances of the case in a fair and impartial manner. This chapter includes guidelines to assist the state agencies meet these responsibilities.

Current Noncompliance Issues

Initial Physical Inspection and Tenant File Review

Treas. Reg. §1.42-5(c)(2)(ii)(A) requires state agencies to conduct on-site inspections of all buildings in the project, and for at least 20 percent of the low-income units, inspect the units and review the certifications, the documentation supporting the certifications, and the rent records for the tenants in those units, by the end of the second calendar year following the year the last building is placed in service.

Under Treas. Reg. §1.42-14(d)(2)(ii), an allocation of credit may not be returned any later than 180 days following the close of the first tax year of the credit period. Therefore, it is highly recommended that the first review of the LIHC project be conducted within that timeframe. Under specific circumstances, previously allocated credits can be reclaimed and returned to the state's credit ceiling if necessary.[1] Timely review of the initial lease-up provides owners an opportunity to correct problems early in the compliance period.

Subsequent Physical Inspections and Tenant File Reviews

Treas. Reg. §1.42-5(c)(2)(ii)(B) requires that, at least once every 3 years, state agencies conduct on-site inspections of all buildings in the project and, for at least 20 percent of the project's low-income units, inspect the units and review the certifications, documentation supporting the certifications, and the rent records for all the tenants living in the units.

Example 1: Current Tenant Income (Re)Certification and Documentation

> An LIHC building was placed in service and the first tax year of the credit period was 2000. The state agency inspected the property and reviewed tenant certification in May 2001; no noncompliance issues were identified. The next inspection and review were conducted in April 2004; the tenant files were reviewed using the most recent recertification, or initial income certifications for tenants moving into the building within the last year.

Reporting Current Noncompliance

Under Treas. Reg. §1.42-5(a), state agencies are required to report any noncompliance of which the agency becomes aware. Agencies should report all noncompliance, without regard to whether the identified outstanding noncompliance is subsequently corrected.

The inspection standard for on-site inspections of buildings and LIHC units generally requires state agencies to determine whether the building and units are suitable for

[1] See chapter 21.

occupancy based on local health, safety, and building codes or whether the buildings and units satisfy the uniform physical condition standards established by HUD. [2]

The state agency is required to review the low-income certifications, the documentation supporting the certifications (and recertifications[3]), and the rent records for the tenants in the units selected for the physical inspection. [4] Therefore, the state agency should be reviewing the initial income certification if the tenant moved in within the last year or the most recent income recertification.

In addition, state agencies must report any change in the applicable fraction (such as converting LIHC units to market rate units) or eligible basis (such as converting common area to commercial space) that results in a decrease in the qualified basis as noncompliance.

Noncompliance issues identified and corrected by the owner prior to notification of an upcoming compliance review or inspection by the state agency need not be reported; i.e., the owner is in compliance at the time of the state agency's inspection and/or tenant file review. Small Business/Self-Employed (SB/SE) considers the date of the notification letter a "bright line" date comparable to the rules for requesting a PLR or the disclosure on From 1040X that an amended tax return is being filed after being audited by the IRS or subsequent to notification that it will be audited. See Form 1040X, line B.

Sampling Requirements

The review (or sampling) of 20 percent of the LIHC units in a project and the associated tenant files is required under the Treasury regulations. The purpose is to estimate the compliance level of all the tenant income (re)certifications by providing a "snap shot" view of the owner's activities and compliance level at a specific moment in time. Sampling reduces the labor costs, and enables state agencies to meet time constraints when dealing with large LIHC properties.

Selecting a Sample

A random selection of tenant files or LIHC units is required. The method of choosing the sample of files or units to be inspected must not give the owner advance notice of which units and tenants records are to be inspected and reviewed[5]. There is no advantage to selecting different units over the 15-year compliance monitoring cycle.

If the sample includes a currently vacant unit, then the last (re)certification for the last tenant should be reviewed. The "snap shot" is indicative of current compliance.

Interpreting the Results

The IRS uses the results of the state agencies' reviews as an indicator of the owner's level of compliance with IRC §42 requirements. If audited, the IRS can also use the results to make adjustments to the LIHC on a unit-by-unit basis as identified on Form 8823. However, the IRS cannot project the results to the entire population of LIHC units[6].

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[2] See Treas. Reg. 1.42-5(d)(2).
[3] Treas. Reg. 1.42-5(c)(1)(iii) refers to an "annual income certification" which for clarity purposes is often referred to as a "recertification."
[4] See Treas. Reg. 1.42-5(c)(2)(ii)(A) and (B).
[5] Treas. Reg. 1.42-5(c)(2)(iii).
[6] The IRS has specific requirements for using sampling techniques as part of an income tax audit. A state agency is not required to use these more stringent techniques for random selection and sample size when conducting a compliance review.

Example 1: Applying Tenant File Review Results

A state agency conducts a tenant file review and physical inspection of a 100% LIHC single building project with 100 units. The LIHC associated with each unit is $3,000. Twenty units are inspected and the associated tenant files are reviewed. Various noncompliance issues were identified for fifteen, or 75 percent, of the twenty sampled units.

The IRS can make an LIHC adjustment of $45,000 (15 units x $3,000) for the year of the review, with a recapture of $15,000 plus interest for each of the prior years of the credit period. Although the sample results indicate significant noncompliance, the results cannot be projected to the entire population; i.e., the IRS cannot conclude that 75 of the 100 units are out of compliance and, therefore, disallow the entire LIHC because the taxpayer did not meet the minimum set-aside.

Expanding the Sample Size

In the event that extensive noncompliance is identified, state agencies should consider expanding the number of units inspected/files reviewed beyond the 20 percent sample required under Treas. Reg. 1.42-5(c)(2)(ii). Circumstances warranting consideration of expanding the sample of LIHC units reviewed include (but are not limited to):

1. Poor internal controls (significant risk of error)
2. Multiple problems
3. Significant number of nonqualified units
4. Significant number of households are not income-qualified
5. Credible information from a reliable source

Determining the Scope of the State Agency's Inspection/Review

Large, Unusual and Questionable Items (Materiality)

Large, unusual, or questionable items (LUQ's) may be material in determining whether noncompliance exists, and thus affect the scope of the state agency's inspection/review. Some factors to consider when determining the materiality of items include:

1. Comparative nature of the issue – two of one hundred of a building's rental units out of compliance for a month is not as important as a project failing the 40/60 minimum set-aside.

2. Absolute nature of the issue – violations of the physical conditions standards should be investigated thoroughly whether one or one hundred units are impacted.

3. Inherent nature of the issue – a permanent decrease in the eligible basis of the property is more significant than two units that are not available for rent for two months.

4. Evidence of intent to mislead – this may include missing, misleading or incomplete documentation.

5. Extenuating circumstances – the issue cited is very temporary or in the process of being fixed at the time of inspection.

Determining the Depth of the State Agency's Inspection/Review

Issue Development

Depth is the extent to which an issue of potential noncompliance is developed. It demonstrates the degree of intensity and thoroughness applied to make a determination of noncompliance. State agencies must use judgment to determine the depth required to satisfactorily develop an issue of noncompliance. The following factors should be considered:

1. The type and reliability of evidence available or expected,
2. Complexity of the issue, and
3. Techniques used.

It is important to obtain sufficient evidence for evaluating the owner's compliance with IRC §42 requirements. Determining the proper amount of evidence to accumulate is a judgmental decision. Factors to consider include the risk that the owner may have made errors that are individually or collectively material and the risk that tests (such as sampling) will fail to uncover material errors.

Consideration of Taxpayer Due Diligence

For most taxpayers, voluntary compliance consists of preparing an accurate tax return, filing it timely, and paying any taxes due. Compliant behavior can be demonstrated when a LIHC property owner exercises ordinary business care and prudence in fulfilling its obligations. Due diligence can be demonstrated in many ways, including (but not limited to) establishing strong internal controls (policies and procedures) to identify, measure, and safeguard business operations and avoid material misstatements of LIHC property compliance or financial information. Internal controls include:

1. Separation of duties,

2. Adequate supervision of employees,

3. Management oversight and review (internal audits),

4. Third party verifications of tenant income,

5. Independent audits, and

6. Timely recordkeeping.

Evidence

State agencies gather information to determine the owner/taxpayer's compliance with IRC §42. This determination must be made on the basis of all available facts, including facts supporting the owner's position. Evidence is something that tends to prove a fact or point in question.

Owners have the right to expect that the information they provide will be safeguarded and used only in accordance with the law. To promote and maintain owners' confidence in the privacy, confidentiality, and security protections provided by the state and IRS, the following principles should be followed.

1. No information will be collected or used (with respect to owners/taxpayers) that is not necessary and relevant for tax administration and other legally mandated or authorized purposes.

2. Information will be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates.

3. Information about taxpayers collected from third parties will be verified, to the extent practicable, with the taxpayers before a determination of compliance is made using the information.

Types of Evidence

The Internal Revenue Code requires all taxpayers to keep adequate records to support the items on their tax returns. However, not all evidence need be "books and records." The following discussion is an overview of different types of acceptable evidence of taxpayer compliance.

Documentary Evidence

Physical documentation is generally regarded as providing proof or evidence. Writings made contemporaneously with the happening of an event generally reflect the actual facts and indicate what was in the minds of the parties to the event. If possible, original documentary evidence should be reviewed.

The records to be retained by the LIHC property owner are described in Treas. Reg. §1.42-5(b). The records must be retained for at least 6 yeas after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

Owners may use electronic storage systems instead of hardcopy (paper) books and records to retain the required records.[7] However, the electronic storage system must satisfy the requirements of Rev. Proc. 97-22. In addition, the owner must satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the state agency. For example, the housing agency may require the owner to maintain hardcopy books and records.

While documentary evidence has great value, it should not be relied upon to the exclusion of other facts. Facts can also be established by oral testimony. There will be times when greater weight should be given to oral testimony than to conflicting documentary evidence. The owner should not be considered noncompliant simply because documentary evidence is incomplete to establish precise compliance when there is some evidence to support compliance.

The "Cohan Rule," as it is known, originated in the decision of Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). In Cohan, the court made an exception to the rule requiring taxpayers to substantiate their business expenses. George M. Cohan, the famous entertainer, was disallowed a deduction for travel and business expenses because he was unable to substantiate any of the expenses. The judge wrote that "absolute certainty in such

[7] Rev. Rul. 2004-82, I.R.B. 2004-35, Q&A #11.

matters is usually impossible and is not necessary, the Board should make as close an approximation as it can." In general, the Tax Court has interpreted this ruling to mean that in certain situations "best estimates" are acceptable in order to approximate expenses. The Cohan Rule is a discretionary standard and can be used to support a reasonable estimate of compliance requirements.

State agencies may allow owners to reconstruct records when the situation warrants, consider incomplete or imperfect documentation, and accept credible oral testimony to determine the owner/taxpayer's overall compliance with the requirements of IRC §42.

Example 1: Incomplete Documentation

> A couple's current income recertification was timely signed by the wife, but the husband's signature is missing because he is on active military duty and stationed out of the country. The husband's income is included in the recertification and the reporting instructions for his overseas assignment are included in the file. The state agency may consider the unit in compliance, even though the husband's signature is missing.

Example 2: Reconstructing Evidence

> The tenant's income recertification was timely completed and signed. The summary records are in the file, but the income verification from the employer is missing. The state agency may allow the property manager to perfect the documentation.

<u>Oral Testimony</u>

There are times, due to taxpayer-specific circumstances, when records may not exist or are incomplete. In such cases, oral testimony may be the only evidence available. Therefore, oral statements made by the owner to the state agency represent direct evidence that must be considered. Although self-serving, *uncontradicted* statements that are *not improbable* or *unreasonable* should not be disregarded.

Example 1: Plausible Oral Testimony

> During a compliance review, an issue involving the income certification for a household was noted. However, the tenant had moved out and could not be located. The manager remembers discussing the item with the tenant, but there is no third party that can corroborate the manager's statement. If the manager's statement is plausible, the oral testimony can be considered sufficient.

The degree of reliability placed on an owner's oral testimony should be based on the credibility of the owner and surrounding circumstantial evidence supporting the owner's testimony. The following concepts are helpful when evaluating oral testimony.

a. Oral evidence should not be used in lieu of available documentary evidence

b. If the issue involves specific recordkeeping required by law, then oral testimony alone cannot be substituted for necessary written documentation

c. Oral testimony need not be accepted without further inquiry. If in doubt, or there are inconsistencies, attempts should be made to verify the facts from another source.

Third Party Evidence

Third party evidence is evidence obtained from someone other than the taxpayer. Credible third party evidence is used when the owner is unable to provide the information or it is necessary to verify information provided by the owner. Information about owners collected from third parties will be verified, to the extent practicable, with the owner before determinations are made using the information provided by third parties.

Evaluating Evidence

The state agencies should exercise sound judgment to make reasonable determinations and ensure that there is a basis for each item considered. This may involve considering the extent to which detailed documentation is required, examining all existing documentation, and determining the weight that should be given to oral testimony. *All* the information needed to definitively resolve an issue will seldom be available; state agencies will need to determine when there is sufficient information, or substantially enough, to make a proper determination of compliance with IRC §42.

State agencies are expected to arrive at definite conclusions based on a balanced and impartial evaluation of all available evidence. The state agencies should employ independent and objective judgment in reaching conclusions and should decide all things on their merit; free from bias and conflicts of interest. Fairness may be demonstrated by:

1. Making decisions impartially and objectively based on consistent application of procedures and tax law;
2. Treating individuals equitably;
3. Being open-minded and willing to seek out and consider all relevant information, including opposing perspectives;
4. Voluntarily correcting mistakes and refusing to take advantage of mistakes or ignorance on the part of the owner; and
5. Employing open, equitable, and impartial processes for gathering and evaluating information necessary for making decisions.

Factors to consider when evaluating evidence include the following:

1. Number and type of noncompliance issues,
2. Elements missing from the documentation,
3. Reasons why documentation is incomplete,
4. Availability of other information to substantiate compliance, and
5. Materiality of unsubstantiated documentation.

In the event that an owner provides clarification or evidence that the potential violation *does not exist*, it is not necessary to report the incident to the IRS; i.e., the owner has clarified that they are in compliance.

Workpapers

Content and Purpose

Workpapers are the state agencies' written records that provide the principal support for their project audits and the filing of Forms 8823. They should include all the information needed to conduct the inspection/review, and document contacts with the owner, the procedures applied, tests performed, information obtained, and the conclusions reached. Workpapers serve the following purposes[8]:

1. A record of the evidence gathered, procedures completed, tests performed, and analyses conducted;

2. Provide support for technical conclusions;

3. Basis for internal reviews by state agency management; and

4. Support for IRS audits of the owner's tax returns.

State agency workpapers may be used by IRS examiners to support conclusions regarding the accuracy of the owner's tax return. These papers and other documents in files may be reviewed to help establish the scope and depth of an IRS audit, establish a pattern of noncompliance, or provide evidence to support adjustments to the tax return. In some cases, the workpapers may be the only evidence.

While there are no requirements for the form or style of workpapers or documentation, workpapers should include certain "identifying" information to support IRS examinations. Workpapers should include:

1. Identity of the owner of the building being reviewed,

2. Name (or initials) of person preparing the workpapers, and

3. Date the workpapers were prepared.

Required Recordkeeping and Retention Provisions – State Agencies

For monitoring compliance with low-income housing credit requirements, Treas. Reg. §1.42-5(a)(2)(i)(A) provides that a procedure for monitoring for noncompliance must include the recordkeeping and record retention provisions of Treas. Reg. §1.42-5(b).

Under Treas. Reg. §1.42-5(e)(3)(ii), a state agency must retain the original records of noncompliance or failure to certify for 6 years beyond the state agency's filing of the respective Form 8823. In all other cases, the state agency must retain the certifications and records for 3 years from the end of the calendar year in which the state agency received the certifications and records.

[8] Internal Revenue Manual 4.10.9(3).

Availability of Workpapers to Owners

IRS agents can informally provide taxpayers with access to the workpapers associated with their own audit *that would otherwise be made available under the Freedom of Information Act.* If consistent with the state's disclosure rules, similar access to the workpapers for the compliance monitoring review can be helpful to owners; e.g., clarifying facts or preparing relevant evidence to resolve issues.