Now & Next
Community Development Finance Alert

March 8, 2024

Tax Court rules on including construction period finance costs in LIHTC basis

By Forrest David Milder

The court ruled that properly computed construction-period finance costs, including bond issuance costs, can be included in LIHTC basis and are eligible for tax credits.

What's the impact?

- Finance costs must be allocated between affordable housing and other uses, then over the term of the particular instrument, and finally to the construction period of the project.
- The case took 21 years to get to a Tax Court decision.
- The IRS sought to have recapture for closed years, but the court didn't consider this request since it found for the taxpayer.

The **23rd Chelsea Associates** case,[1] recently decided by the Tax Court, involved a syndicated Section 42 partnership that qualified for low-income housing tax credits based on tax-exempt bonds issued by the NY Housing Finance Agency. The case stands for the proposition that an

[1] *23rd Chelsea Associates, LLC et al. v Commissioner*, 162 TC No. 3, filed February 20, 2024.

This newsletter is intended as an information source for the clients and friends of Nixon Peabody LLP. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct. Copyright © 2024 Nixon Peabody LLP. All rights reserved.

appropriate share of finance costs attributable to the construction period of the affordable housing part of a project can be included in tax credit basis. These include bond fees imposed by the state agency, origination and letter of credit fees (provided as security for the bonds) imposed by the bank that provided a letter of credit, and underwriters' fees and expenses and bank and state agency servicing fees. All things considered, this is not a surprising result; it is more surprising that the taxpayer and the IRS fought for so long over a relatively small amount.

IRS's arguments regarding Section 42

The IRS made two arguments:

- First, the costs of financing were associated with intangibles (the bonds and certain loans), and therefore not included in Section 42 basis.
- Second, because the tax-exempt bond rules consider "bond issuance costs" to be "bad costs" under the bond rules, they also shouldn't be eligible costs for Section 42 purposes.

Note that the taxpayer contended that many of the costs that the IRS called "bond issuance costs" were mischaracterized, and shouldn't be subject to the IRS's second theory anyway. Regardless, the tax court rejected both arguments as being inconsistent with the rules for capitalizing construction period expenditures under 263A, concluding that "for purposes of determining eligible basis in section 42, bond issuance costs are allocable to residential rental property, provided that they were incurred by reason of construction or production."

Taxpayer's computations of includible fees

The taxpayer produced a memorandum for the court explaining how the proper portion of each fee or expense should be computed:

- First, because 1.7% of the project was commercial, this was backed out of eligible basis.
- Second, most other expenses were allocated across the life of the particular item, and then only the portion attributable to the construction period was included in basis.

For example, only a brief portion of the 31.5-year bonds was allocable to the construction period. So, only a small portion of many costs associated with the bonds were included in basis.

On the other hand, the letter of credit securing the bonds was attributable almost entirely to the construction period, and therefore, nearly the entire amount of costs associated with the letter of credit were included in basis. The result of these computations was about $1.2 million of expenditures in dispute.

The Tax Court dispute by the numbers

What did this $1.2 million actually mean to the computation of tax credits? The project cost a little less than $72 million. This was then increased by 30% to about $93 million on account of the project being in a qualified census tract. Still, this was not the cost of the low-income portion of the project, because the project consisted of both market rate and low-income units. Using the "square footage fraction" of 18.32% yielded a qualified basis for Section 42 purposes of $17 million. Multiplied by the applicable credit rate of 3.48% produced an annual LIHTC of about $594,000. Now compare this to the amount in dispute. The IRS was contending that $1.2 million of financing costs should not go into tax credit basis. Multiplying that amount by the same 130%, 18.32%, and 3.48%, we get a shade less than $10,000 of credits in dispute for each year. (The IRS had originally disputed a second amount, also about $1.2 million, but it abandoned that claim early in the Tax Court process). Given the amount involved, there was a bit of the "immovable object" encountering the "unstoppable force" in this dispute.

21 years later, what years of the credit period can be subject to recapture?

The property was placed in service in 2002, and the first year of the credit period was 2003, i.e., 21 years ago! The dispute arose out of an audit of the 2009 year, and the IRS claimed that if it was right, it would seek a recapture adjustment for ***all*** of the years of the credit period, even though many of those years were now closed as a matter of the statute of limitations. Because the court sided with the taxpayer on the fundamental tax computations, it never got to the question of whether the IRS was limited to only the open tax years.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Forrest David Milder
617.345.1055
fmilder@nixonpeabody.com