



Audit Report



OIG-19-039

Domestic Assistance

Recovery Act of Georgia Department of Community Affairs
Payment Under 1602 Program

July 18, 2019

Office of
Inspector General

Department of the Treasury

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Abbreviations

1602 Program	Payment to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits for 2009
audit techniques guide	<i>Audit Techniques Guide for IRC §42, Low-Income Housing Credit</i>
CPA	Certified Public Accountant
DCA	Georgia Department of Community Affairs
FY	fiscal year
IRC	Internal Revenue Code
IRS	Internal Revenue Service
JAMES	Joint Audit Management Enterprise System
OFAS	Office of the Fiscal Assistant Secretary
OIG	Office of Inspector General
OMB	Office of Management and Budget
QAP	Qualified Allocation Plan
QCT	Qualified Census Tract
Recovery Act	American Recovery and Reinvestment Act of 2009
TCE	Tax Credit Exchange
Terrace	The Terrace at Edinburgh
Treasury	Department of the Treasury
Treas. Reg.	Treasury Regulation
West Haven	West Haven Senior Apartments

*The Department of the Treasury
Office of Inspector General*

July 18, 2019

David A. Lebryk
Fiscal Assistant Secretary

As part of our ongoing oversight of the Department of the Treasury's (Treasury) Payments to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits for 2009 (1602 Program),¹ authorized by Section 1602 of the American Recovery and Reinvestment Act of 2009 (Recovery Act),² we conducted audits of awards made to selected State housing credit agencies. The objective of these audits was to assess whether the agencies awarded funds under Treasury's 1602 Program complied with the program's overall requirements and the "Grantee Terms and Conditions" (together referred to as 1602 Program requirements). In this report, we provided our assessment of Georgia Department of Community Affairs (DCA) compliance with the 1602 Program requirements. DCA was statistically selected from a universe of 55 States and territories eligible to receive 1602 Program funds. To determine 1602 Program eligibility, our audit scope comprised \$195,559,945 of 1602 Program funds awarded to DCA in July and December of 2009. Of this amount \$195,011,467³ was subawarded to 45 eligible low-income housing projects from which we statistically selected 12 low-income housing projects (comprising \$40,358,461) to further assess subaward compliance with 1602 Program requirements. Appendix 1 provides a more detailed description of our audit objective, scope, and methodology.

¹ Treasury's Office of the Fiscal Assistant Secretary administers this program.

² Public Law 111-5, 123 Stat. 362-364 (February 17, 2009). Under section 1602 of the Recovery Act, Treasury shall make a grant to the housing credit agency of each State in an amount equal to such State's "Low-Income Housing Grant Election Amount." The "Low-Income Housing Grant Election Amount" is further discussed in footnote 8 of this report.

³ DCA did not subaward \$548,478 of 1602 Program funds and returned such amount to the General Fund by Treasury's December 31, 2011 deadline, as required by the 1602 Program requirements.

Results in Brief

We found that DCA did not fully comply with Treasury's 1602 Program requirements at the time of our review. Although DCA substantially met the eligibility and compliance requirements set forth in both Section 42 of the Internal Revenue Code (IRC)⁴ and Section 1602 of the Recovery Act for receiving its 1602 Program award, it did not meet all requirements for subawarding those funds to low-income housing projects. Specifically, DCA used 1602 Program funds to reimburse 14 subawardees a total of \$170,500 for legal fees, which were unallowable under the 1602 Program requirements. In addition, excess payments totaling \$208,447 were made as a result of two subawardees including ineligible costs per Section 42 of the IRC in the eligible bases of their low income housing projects. Ineligible costs were associated with property appraisals, market studies, boundary and topographical surveys, real estate attorney fees, accounting fees, and title and recording fees that were ineligible under Section 42 of the IRC. Of the \$208,447 in excess 1602 Program payments, DCA agreed to having made excess payments totaling \$97,474 and returned funds to Treasury in payments of \$13,112 in July 2015, \$77,792 in August 2015, and \$6,570 in April 2016.

Overall, we question a total of \$281,473 in 1602 Program payments as follows:

- \$170,500 of unallowable legal fees;
- \$55,817 of ineligible costs included in the cost basis of West Haven Senior Apartments (West Haven); and
- \$55,156 of ineligible costs included in the cost basis of The Terrace at Edinburgh (Terrace).

See appendix 2 for the definition of a questioned cost included as part of the schedule of questioned costs.

We also concluded that DCA established compliance and asset management processes to ensure that 1602 Program-funded low-income housing projects comply with Section 42 of the IRC and

⁴ 26 U.S.C. §42 "Low-Income Housing Credit."

remain compliant during the 15-year compliance period.⁵ At the time of our review, there were no matters impacting compliance and the long-term viability of 1602 Program-funded projects. DCA also complied with 1602 Program reporting requirements in submitting quarterly project performance reports and annual certification reports to Treasury. That said, we also want to emphasize the need for continued diligence on the part of Treasury and DCA to ensure compliance with the 1602 Program requirements over the remaining 15-year compliance period.

While we found no matters regarding DCA's performance of compliance and asset management functions, we did note a matter of concern regarding the DCA's collection of \$5,866,798 in asset management fees from all 45 subawardees to cover the future costs of performing asset management functions throughout the projects' 15-year compliance period, which is expected to end in 2026. Collecting such fees in advance is not prohibited by 1602 Program requirements. However, it is a matter of concern that the total cost of performing asset management over the 15-year performance period may be significantly less than the \$5,866,798 collected by DCA given that actual costs were unknown at the time fees were collected. Since DCA's asset management is ongoing, we do not question the \$5,866,798 of asset management fees collected. Nonetheless, this a matter requiring closer attention on the part of OFAS in monitoring DCA's compliance with 1602 Program requirements.

In all, we recommend that the Fiscal Assistant Secretary ensures that DCA reimburses Treasury the following: (1) \$170,500 of excess 1602 Program payments made to 14 subawardees for unallowable legal fees; (2) \$55,817 of excess 1602 Program payments made to West Haven as a result of including ineligible costs in the project's cost basis; and (3) \$55,156 of excess 1602 Program payments made to Terrace as a result of including ineligible costs in the project's cost basis. We also recommend that Treasury management require DCA to provide support, going forward, for its actual costs to perform asset management

⁵ Section 42 of the IRC defines compliance period as the 15 taxable years beginning with the calendar year in which the project is placed in service or the succeeding taxable year, based on the election of the project owner.

functions over the remaining 15-year compliance period to ensure that fees collected from subawardees do not exceed actual costs.

As part of our reporting process, we provided DCA management an opportunity to comment on a draft of this report. In a written response, DCA management acknowledged the overall audit conclusion but did not agree with all the facts of our findings. Based on our evaluation of the response, the results of our audit have not changed. We have summarized the response and our evaluation in the "Finding" section of this report. DCA management's response, in its entirety, is included as appendix 4 of this report.

After incorporating DCA's response, we provided a draft of this report to Treasury management for comment. In a written response, Treasury management generally agreed with our recommendations and noted that it will work with both DCA and [Treasury] tax counsel on the matters of federal tax law. Regarding our first recommendation on legal fees, management responded that it will work with DCA to obtain sufficient support demonstrating that \$170,500 in reimbursements for erroneously charged legal fees were used for other project costs, and will take appropriate action regarding any amounts not supported. In response to our second and third recommendations regarding excess 1602 Program payments to West Haven and the Terrace, management stated that federal tax law governs the determination regarding what costs are required to be capitalized in the basis of property, and such determinations are highly dependent on particular facts and circumstances. Having stated this, management responded that it will work with both [Treasury] tax counsel and DCA to determine whether or not certain costs were properly included in the basis of "Section 1602" property. If it is concluded that the costs questioned were not properly included in the basis, it will require DCA, in accordance with the "Section 1602" recapture guidance, to make reasonable efforts to obtain reimbursement from the project owner(s). With respect to our fourth recommendation on asset management fees, management responded that it will seek support from DCA for its actual costs and compare those costs to fees collected from subawardees. While Treasury management's stated actions meet the intent of our recommendations, management will need to provide due dates for

implementing its specific corrective actions in the Joint Audit Management Enterprise (JAMES), Treasury's audit recommendation tracking system. Treasury management's response, in its entirety, is included as appendix 5 of this report.

Background

The low-income housing tax credit program codified in Section 42 of the IRC was authorized by the Tax Reform Act of 1986.⁶ The tax credit is an incentive for individuals and corporations to invest in the construction or rehabilitation of low income housing. For projects meeting the program requirements, the tax credit provides the investor a dollar-for-dollar reduction in personal or corporate federal income tax liability for a 10-year period.

The Recovery Act intended to provide relief to the conditions caused by the economic crisis at the time. Part of that relief, provided in Section 1602 of the Recovery Act, consisted of grants awarded to States⁷ for low-income housing projects in lieu of low-income housing credit allocations. The purpose of Section 1602 was to fill the gap left by the reduced demand for low-income housing tax credits that would enable low-income housing projects to continue or begin in cases where developers could not obtain private investment, as well as, increase the availability of affordable housing. The Secretary of the Treasury is responsible for carrying out the requirements of Section 1602.

Eligibility Under the 1602 Program

Under the Recovery Act, State housing credit agencies were allowed to exchange a portion of their low-income housing credits for Section 1602 funds. The maximum funds available to a State could not exceed its "Low-income Housing Grant Election

⁶ Public Law 99-514, Stat. 2189 (October 22, 1986)

⁷ According to Treasury's "Grantee Terms and Conditions (appendix 2) "... 2. Grantee Eligibility a. The grantee is the housing credit agency for one of the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, American Samoa, Guam, or the Northern Mariana Islands which files Form 8610, Annual Low-Income Housing Credit Agencies Report with the Internal Revenue Service."

Amount”⁸ as determined under Section 1602. In turn, State housing credit agencies would disburse funds to eligible subawardees to help finance either the construction or the acquisition and rehabilitation of qualified low-income housing projects. Section 1602 also provided that subawarded projects be subject to the same eligibility and compliance requirements as the low-income housing credits found in Section 42 of the IRC. In addition to following the IRC Section 42 eligibility and compliance requirements, Section 1602 required that state housing credit agencies:

- (1) establish a process to ensure that applicants who were allocated low-income housing credits demonstrate “good faith efforts” to obtain investment commitments for credits elsewhere;
- (2) perform asset management functions to ensure subawardee compliance with Section 42 of the IRC and the long-term viability of projects;⁹ and
- (3) recapture funds in the event of subawardees’ noncompliance payable to Treasury.

As part of its overall administration of Treasury’s 1602 Program, the Office of the Fiscal Assistant Secretary (OFAS) developed the “Grantee Terms and Conditions” of award to identify the eligibility and compliance requirements set forth in both Section 42 of the IRC and Section 1602 of the Recovery Act. State housing credit agencies and subawards funded by them are subject to these terms and conditions for the 15-year compliance period. Among the terms and conditions, State housing credit agencies are required to provide financial status and project performance reports quarterly and other applicable reports to ensure their compliance with the terms and conditions of their 1602 Program awards. In its post

⁸ “Low-Income Housing Grant Election Amount” may not exceed 85 percent of the sum of (1) 10 times (a) the unused State housing credit ceiling (if any) for calendar year 2008 and (b) the amount of State housing credit ceiling returned in 2009, plus (2) 10 times 40 percent of (c) the greater of \$2.30 multiplied by the State population or \$2,665,000 and (d) unused housing credit carryover allocated to the State in the 2009 National Pool.

⁹ Low-income housing projects must be financially feasible and remain viable throughout the 15-year compliance period required by Section 42 of the IRC.

subaward reporting guidance, OFAS required that State housing credit agencies certify annually that (1) the amount of Section 1602 funds subawarded to a project was equal to or less than 85 percent of the project's eligible basis; and (2) funded projects remain "qualified" throughout the 15-year compliance period. Appendix 3 provides the detail contained in OFAS' "Grantee Terms and Conditions."

Since awards under the 1602 Program are not conventional grants, but an exchange of low-income housing credits falling under the requirements of Section 42 of the IRC, they are not within the scope of the *Single Audit Act of 1984*¹⁰ nor a part of the audit universe explicitly set by the Office of Management and Budget. Therefore, unless the State auditor specifically audits these awards, the awards to the respective States and their subawardees will not receive any audit coverage.

Georgia Department of Community Affairs



Powell Place Apartments
(OIG Photograph, October 2012)

DCA was created in 1977 to serve as an advocate for local governments. Using State and Federal resources, DCA implements safe and affordable housing by helping qualified low- and moderate-income Georgians buy homes, rent housing, and prevent foreclosure and homelessness. DCA is

responsible for administering Georgia's low-income housing tax credit program and allocates credits based on the selection criteria set forth in its "Qualified Allocation Plan" (QAP).¹¹

¹⁰ Public Law 98-502 (October 19, 1984), amended by Public Law 104-156, *Single Audit Act Amendments of 1996* (July 5, 1996).

¹¹ The QAP establishes the criteria used by the housing credit agency to determine the State's housing priorities that are appropriate to the local conditions and, along with other requirements, gives preference to allocating credit dollar amounts among selected projects.

From 2009 through 2011, DCA disbursed \$195,011,467 under the 1602 Program, which funded 45 projects, many of which were stalled due to the downturn in the low-income housing tax credit equity market. The funded projects yielded 2,881 housing units which were set aside as low-income for qualifying residents throughout Georgia. Projects were certified for occupancy and placed in-service between June 2010 and July 2012.

Finding

Georgia Department of Community Affairs Did Not Fully Comply with 1602 Program Requirements

We found that DCA did not fully comply with Treasury's 1602 Program requirements. Although DCA substantially met the eligibility and compliance requirements set forth in both Section 42 of the IRC and Section 1602 of the Recovery Act for receiving its 1602 Program award, it did not meet all requirements for subawarding those funds to low-income housing projects. Specifically, DCA reimbursed 14 subawardees a total of \$170,500 for legal fees that were unallowable under the 1602 Program requirements. In addition, excess payments totaling \$208,447 were made as a result of two subawardees including ineligible costs per Section 42 of the IRC in the eligible bases of their low income housing projects. When presented our summary of overpayments, DCA management agreed that overpayments were made, but contend that overpayments totaled only \$97,474, which was returned to Treasury.

Although deficiencies were identified in the subaward phase as described below, we found that DCA established a process for monitoring the long-term viability of projects and their compliance with 1602 Program requirements. At the time of our review, DCA found no matters impacting the long-term viability of low-income housing projects. DCA also met all Treasury quarterly and annual reporting requirements.

Awarding

DCA was awarded \$195,559,945 of 1602 Program funds, which we verified was equal to DCA's "Low-Income Housing Grant Election Amount" requested in its application packages. As

required by the 1602 Program requirements, DCA subawarded funds to 45 low-income housing projects which (1) qualified under Section 42 of the IRC; (2) demonstrated “good faith efforts” to obtain investments elsewhere; and (3) did not exceed the amounts necessary to make the projects financially feasible and viable throughout the 15-year compliance period.

Subawarding

The 45 qualified low-income housing projects that received subawards were stalled due to the downturn in the low-income housing tax credit equity market. In identifying the 45 projects, DCA applied the selection criteria set forth in its QAP as required by Section 42 of the IRC. DCA subawarded 1602 Program funds to these 45 projects in lieu of making low-income housing tax credit allocations. DCA disbursed \$195,011,467 to the 45 subawardees and de-obligated and returned \$548,478 to the General Fund by Treasury’s December 31, 2011, deadline as required by the 1602 Program requirements.

Although DCA selected qualified low-income housing projects in accordance with Section 42 of the IRC, not all subawards were disbursed in accordance with the 1602 Program requirements. As part of our testing of DCA’s compliance with 1602 Program subaward requirements, we also tested a non-statistical sample comprising, at a minimum, 50 percent of the disbursements made for each project totaling \$33,474,576. We found no instances of noncompliance with 1602 Program subaward requirements specific to (1) the disbursement of funds to subawardees within 3 days of DCA drawing funds from its Treasury account, and (2) the expenditure and accounting for funds in accordance with the State’s policies and procedures, and disbursements. While we found that DCA maintained program, financial, and accounting records, they did not sufficiently demonstrate that funds were used in accordance with 1602 Program requirements.

Specifically, DCA used 1602 Program funds to reimburse subawardees a total of \$170,500 for legal fees, which were considered administrative costs, and therefore, unallowable under the 1602 Program requirements. In addition, we found that two low-income housing projects had included \$188,640 of ineligible

costs in the determination of their eligible cost bases, which resulted in excess payments totaling \$208,447 (after 130 percent Qualified Census Tract¹² boost and 85 percent of eligible basis¹³). The following provides details of administrative costs and other ineligible costs per Section 42 of the IRC.

Administrative Costs

According to the 1602 Program requirements, “The grantee shall use all grant amounts to make subawards, or for transfer to other agencies to make subawards. The subawards shall be in the form of cash assistance and are not required to be repaid unless there is a recapture event with respect to the qualified low-income building. The grantee shall not use grant election amounts for any other purpose, including administrative costs.”

During its October 2010 compliance review, OFAS noted that DCA charged two subawardees for legal fees to process their 1602 Program awards. OFAS informed DCA that legal fees were “considered administrative fees and are not permitted to be charged for the 1602 Program.” However, DCA appealed OFAS’ determination, and during the appeal process, continued to charge subawardees for legal fees. In all, DCA collected legal fees totaling \$328,500 from 27 of its 45 subawardees,¹⁴ the entirety of which was refunded to them in April 2011 using DCA funds. In addition to receiving DCA’s refund of legal fees, 14 of the 27 subawardees had already requested and received 1602 Program reimbursements totaling \$170,500. The remaining 13 subawardees did not request reimbursements of legal fees from 1602 Program funds. Accordingly, we question \$170,500 of 1602 Program payments made to reimburse the 14 subawardees for unallowable legal fees.

¹² Low-income housing projects in a Qualified Census Tract (QCT) or Difficult to Develop Areas received 130 percent boost for the purposes of determining maximum possible Section 1602 subaward amount.

¹³ Per Treasury’s Frequently Asked Questions and Answers, “The amount of the subaward cannot exceed 85 percent of the amount of a building’s eligible basis as determined at the end of the first year of the credit period (as defined in Section 42(f)(1) of the Internal Revenue Code) and, also for this purpose, eligible basis includes any increase for buildings located in high cost areas under Section 42(d)(5)(B).”

¹⁴ DCA did not collect legal fees from 18 of the 45 subawardees.

DCA Management Response

In a written response to a draft of this report, DCA management acknowledged the audit properly found that DCA reimbursed 14 subawardees a total of \$170,500 for legal fees that were deemed not eligible under the 1602 Program requirements. Management stated it did not verify that \$12,500¹⁵ reimbursed to each individual subawardee was replaced with other eligible costs until receipt of the required cost certification. At that time, DCA verified that the legal fee reimbursement was replaced with other eligible costs and verified in the cost certification. According to DCA management, the repayment of funds to the subawardee created a "moment in time" overpayment of "Section 1602" funds under DCA's stringent internal procedures for oversight of "Section 1602" as noted in the audit report. This "moment in time" imbalance was corrected when the subawardee replaced the legal fee expense with other eligible incurred costs during project construction. DCA management also noted that it was unlikely that the "Section 1602" funds were paid prior to incurring these other eligible costs based on its policies, procedures, and practices, as discussed in more detail in its response.

Management asserted that DCA met Treasury's regulations and guidance for administering Section 1602, which did not require subawardees to trace how "Section 1602" funds are used in the project. Certified eligible basis costs did not include DCA's legal fees, so the related amounts would not have resulted in an excess payment of "Section 1602" funds as sufficient eligible basis costs would have remained without the legal fees. See appendix 4 for DCA's management response in its entirety.

In considering DCA's response, we acknowledge that some subawardees had other eligible costs included in their final CPA cost certifications. However, the CPA cost certification did not support that the 1602 Program overpayments for legal fees were directly applied to offset other project costs. That is, there were other sources of funding available that could have been used for these other project costs such as private capital, deferred developer's fees, and State low-income housing subsidies.

¹⁵ Three 1602 Program funded projects were reimbursed \$11,000 and the remaining 11 projects were reimbursed \$12,500 for a total of \$170,500 of legal fees paid.

Furthermore, DCA's *ARRA Draw Procedures* required subawardees to submit a draw request with documentation to support reimbursement of a project's costs and could also request which source of available funding to use. Therefore, the CPA cost certification by itself would not support that the legal fee overpayments of \$170,500 were replaced by other eligible costs as they may have already been reimbursed through other funding sources. As such, there is a risk that subawardees were reimbursed for the same project costs twice. Additionally, there was no evidence that subawardees replaced their legal fee costs with other eligible incurred costs during project construction correcting the "moment in time" imbalance as referred to in DCA's response.

During our site visit in October 2012, we reviewed DCA's policies and procedures, and its practice to trace 1602 Program funds and review 100 percent of subawardees' draw requests as noted in its management response. It was during our review of DCA's internal control that we identified the \$170,500 of 1602 Program overpayments for the unallowable legal fees. At that time, DCA's Director of the Office of Housing Finance stated that DCA was not aware of the 1602 Program overpayments. Furthermore, subawards were made based on a project's estimated costs. While a project's actual costs were later certified in the final CPA cost certification, documentation was lacking to support that subawardees in fact replaced the 1602 Program overpayments with other eligible costs. The 1602 Program required that DCA "maintain program, financial, and accounting records sufficient to demonstrate that grant funds were used in accordance with the Section 1602 program." As such, the other eligible costs that DCA management stated were used to replace the \$170,500 of questioned 1602 Program payments were not supported.

Ineligible Costs

Section 42 of the IRC requires that the amount of funding provided to a low-income housing project be based on the sum of each low-income housing building's eligible basis, including common areas. Treasury further explains in its *Frequently Asked Questions and Answers* that, for each low income housing building within the project, the maximum amount of a "subaward cannot exceed 85 percent of the amount of a building's eligible basis," including a

130 percent boost to basis for any building located in a Qualified Census Tract.

The *Audit Techniques Guide for IRC §42, Low-Income Housing Credit*¹⁶ (audit techniques guide) defines eligible basis as “depreciable residential rental property. Eligible basis includes the costs associated with the residential rental units, common areas provided as amenities, functionally related facilities, community service facilities, facilities used to provide supportive services for the homeless, and land improvements (under limited circumstances).”

The audit techniques guide also specifies certain cost categories not includable in eligible basis as follows:

- Development Costs: “Development of a low-income project involves 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): Acquiring the project site. Specific activities may include locating suitable sites, performing economic and feasibility studies, market studies, and negotiating the purchase price.”
- Organizational and Partnership Costs: “...legal and accounting fees for preparing legal documents and contracts, making regulatory filings, etc.” are not includable in basis. “Services associated with the partnership’s organization, syndicating partnership interests, or securing an allocation of IRC Section 42 credit, are not includable in eligible basis.”
- Cost Certifications: “...the cost of preparing the cost certifications is excluded from eligible basis because this cost is incurred to secure an allocation of the IRC Section 42 credit.”
- Cost of Securing Financing: “Generally the cost of securing (project) funding is not includable in eligible basis....common costs include: interest on bridge or construction loans,

¹⁶ Audit techniques guide(s) provide Internal Revenue Service (IRS) examiners with “industry-specific examination techniques and include common, as well as, unique industry issued, business practices and terminology.”

permanent loan credit enhancement, permanent loan origination fees and closing costs, recording and title insurance costs, and reserves required by lender.”

- Land Surveys: “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 surveys are inextricably associated with the land, are not depreciable, and are excluded from eligible basis.”

As part of the final underwriting process, housing projects must submit Certified Public Accountant (CPA) Final Cost Certifications to the State housing credit agency. The CPA Final Cost Certification details the project’s total costs and serves as the final eligible cost basis of the project. Our analysis of the certifications and supporting documentation identified \$188,640 of ineligible costs included in the cost bases of two low-income housing projects: West Haven and Terrace. This resulted in excess 1602 Program payments totaling \$208,447 after applying the Census Track Boost and 85 percent of eligible basis maximum award restriction as explained below in the Tables 1 and 2. DCA management stated that the overpayments were made because it did not perform 100 percent reviews of eligible bases and relied on the CPA’s Final Cost Certifications.

West Haven

West Haven was subawarded and received \$5,274,687 in 1602 Program payments. Our analysis of the CPA Final Cost Certification and supporting documentation identified \$132,780 of ineligible costs included in West Haven’s eligible basis. As a result, West Haven received an excess payment of \$146,721. We recalculated West Haven’s eligible cost basis and excess 1602 Program payment as illustrated in Table 1.

Table 1: West Haven Senior Apartments		
Cost Description	Ineligible Cost Per Section 42 of the IRC	
Property Appraisal	\$6,500	\$0
Market Study	\$8,920	\$0
Boundary and Topographical Survey	\$7,675	\$0
Real Estate Attorney	\$84,344	\$69,725
Accounting	\$13,475	\$675
Construction Loan Interest	\$11,866	\$11,866
Total Ineligible Costs	\$132,780	\$82,627
Subaward Re-calculation	OIG	
Original Eligible Basis	\$4,773,473	\$4,773,473
Reduction to Eligible Basis	(132,780)	(82,267)
Adjusted Eligible Basis	\$4,640,693	\$4,691,206
Qualified Census Tract Boost	130%	130%
Adjusted Qualified Basis	\$6,032,901	\$6,098,568
Maximum Section 1602 Subaward Percentage	85%	85%
Maximum 1602 Program Subaward Amount	\$5,127,966	\$5,183,783
1602 Program Disbursement	\$5,274,687	\$5,274,687
Excess 1602 Program Payments	\$146,721	\$90,904

Source: Office of Inspector General (OIG) analysis and recalculation of West Haven Senior Apartment's CPA Final Cost Certification

Overall, DCA agreed that excess 1602 Program payments were made but in the amount totaling \$90,904, and not \$146,721 as recalculated in Table 1. Of the specific costs in question, DCA agreed that all \$11,866 in construction loan interest was ineligible, but disputed that \$23,095 of costs associated with property appraisals (\$6,500), market studies (\$8,920), and boundary and topographical surveys (\$7,675) were considered necessary soft costs related to the development and construction of the project, and therefore, should have been included in the project's eligible basis. However, as noted above, the audit techniques guide specified these development costs are not includable in the project's eligible basis.

DCA also disputed \$14,619 of the \$84,344 ineligible costs related to real estate attorney fees. According to DCA, the fees (\$69,725) related to setting up 1602 Program subaward agreements, project development, and construction financing and were eligible. DCA

also claimed that \$12,800 of the \$13,475 of accounting expenses were eligible because they were necessary and required soft costs for the development and construction of the project. However, as noted above, the audit techniques guide specified that certain legal fees are considered organizational and partnership costs that are not includable in basis. DCA agreed that the remaining \$675 related to income tax preparation should not have been included in the eligible basis.

In July 2015, DCA instructed West Haven to repay \$90,904. Accordingly, West Haven remitted \$90,904 to Treasury in August 2015. However, we question the remaining excess 1602 Program payment of \$55,817.

Terrace

Terrace was subawarded and received \$9,071,963 in 1602 Program payments. Our analysis of the CPA Final Cost Certification and supporting documentation identified \$55,860 of ineligible costs included in Terrace's eligible basis, which resulted in an excess payment of \$61,726. We recalculated Terrace's eligible cost basis and excess 1602 Program payment as illustrated in Table 2.

Table 2: The Terrace at Edinburgh		
Cost Description	Ineligible Cost Per Section 42 of the IRC	Ineligible Cost Per DCA
Property Appraisal	\$2,500	\$0
Market Study	\$5,000	\$0
Boundary and Topographical Survey	\$11,168	\$0
Real Estate Attorney	\$23,827	\$5,154
Accounting	\$12,575	\$0
Title and Recording Fees	\$790	\$790
Total Ineligible Costs	\$55,860	\$5,944
Subaward Re-calculation	OIG	DCA
Original Eligible Basis	\$8,209,920	\$8,209,920
Reduction to Eligible Basis	(\$55,860)	(\$5,944)
Adjusted Eligible Basis	\$8,154,060	\$8,203,976
Qualified Census Tract Boost	130%	130%
Adjusted Qualified Basis	\$10,600,279	\$10,665,169
Maximum 1602 Subaward Percentage	85%	85%
Maximum 1602 Program Subaward Amount	\$9,010,237	\$9,065,393
1602 Program Disbursements	\$9,071,963	\$9,071,963
Excess 1602 Program Payments	\$61,726	\$6,570

Source: OIG analysis and recalculation of The Terrace at Edinburgh's CPA Final Cost Certification

Overall, DCA agreed that excess 1602 Program payments were made, but in the amount totaling \$6,570, and not \$61,726, as recalculated in Table 2. Of the specific costs in question, DCA agreed that \$5,154 of the real estate attorney fees and \$790 of the title and recording fees should not have been included in eligible basis. However, DCA stated that appraisals (\$2,500), market studies (\$5,000), boundary and topographical surveys (\$11,168), and accounting costs (\$12,575) were incurred by the project owner to meet the requirements established by DCA to provide "Section 1602 Exchange Assistance" and were includable in eligible basis. As noted above in the audit techniques guide, these developmental costs, as well as certain legal fees, are considered organizational and partnership costs and are not includable in the project's basis.

In February 2016, DCA instructed Terrace to repay \$6,570 to Treasury after recalculating the eligible basis. Terrace remitted the

funds to Treasury in April 2016. However, we question the remaining excess 1602 Program payment of \$55,156.

DCA Management Response

In its written response, DCA management noted that the “IRC §42 Low-Income Housing Credit Guide” (the “Credit Guide”) released in 2015, which our conclusions were based on, was an updated version of the “IRC §42 Low-Income Housing Credit Audit Technique[s] Guide.” According to DCA management, the audit techniques guide should not be used as a “bright-line rule.” These guides are prepared by the Examination Division of the IRS for use in training IRS auditors and do not have (and are not intended to have) the authority of a statute, regulation, IRS Chief Counsel ruling or ruling by a court.

DCA management also responded that expenditures for property appraisals, market studies, boundary and topographical surveys, attorney, and accounting fees were incurred by reason of (or directly benefit) the development and production of qualified low-income housing buildings and are indirect costs required to be capitalized by Section 263A of the IRC.¹⁷ Management noted that such costs should be included in eligible basis of the low-income building, for the purposes of calculating low-income housing tax credits or for purposes of receiving a subaward under “Section 1602” but would proceed with recapture based on direction of Treasury.

As part of its response, DCA management included a joint memorandum from the CPA firm, Tidwell Group LLC, and the law firm Kutak Rock LLP. The memorandum provided an examination of the legal authorities and tax precedents believed to be applicable to LIHTC and Tax Credit Exchange (TCE) programs and how the capitalization rules of IRC Sections 263¹⁸ and 263A apply to eligible basis rules of Section 42 of the IRC. It was asserted that the “Audit Technique Guide” fell within the category of IRS internal

¹⁷ 26 U.S.C. §263A – “Capitalization and inclusion in inventory costs of certain expenses.” This section describes types of indirect costs that should be capitalized in a property’s basis, including in real estate production.

¹⁸ 26 U.S.C. §263 – “Capital expenditures.” This section sets forth the general rules for capitalizing expenditures rather than fully deducting them in the year incurred.

documents, and considered informal guidance having no legal bearing. It was also asserted that the audit report's analysis, based on the guide, was incorrect as Sections 263 and 263A were the relevant authorities. The memorandum also referred to the Recovery Act requirement that State Housing Agencies were to make sub-awards in the same manner and subject to the same limitations as an allocation of housing credit dollar amounts under Section 42 of the IRC. The memorandum stated, "Thus, for the purpose of determining "Eligible Basis" there is no distinction between taxpayers claiming LIHTCs and taxpayers receiving sub-awards under the TCE program." It was further stated that "the receipt of a sub-award is not the receipt of permanent financing. Rather, the subaward is a form of cash assistance made by the State Housing Agency to sub-awardees that will never be repaid, except in the event of recapture during the 15 year compliance period. The sub-award is not taxable income under the federal tax laws."

The memorandum included an analysis of the capitalization of costs under IRC Sections 263 and 263A, asserting that direct costs and a properly allowable portion of indirect costs of real or tangible personal property produced by a taxpayer must be capitalized to the property produced. It was also asserted, that under Section 263A and Treasury Regulation (Treas. Reg.) 1.263A,¹⁹ the term "produce" includes construct, build, install, manufacture, develop, or improve. Property produced may include land, buildings, land improvements, and other tangible property owned by the taxpayer for federal income tax purposes. In addition to production activities, the memorandum stated that Treas. Reg. 1.263(a)²⁰ provides that a taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property, and that, in determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Treas. Reg. 1.263A also provides that any cost required to be capitalized by IRC Section 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

¹⁹ 26 C.F.R. §1.263A – "Uniform Capitalization of Costs" (August 1993)

²⁰ 26 C.F.R., §1.263(a) – "Capital Expenditures," (November 1960)

The memorandum cited the 1995 tax court case, *Von Lusk v. Commissioner*, (104 T.C. 207 (1995)), as consistent with the premise that that indirect development costs must be capitalized and that certain expenses incurred by a real estate developer before actual physical work began on undeveloped land are subject to Section 263A of the IRC. The Court held, among other things, that the developer's activities, such as obtaining building permits and zoning variances, negotiating permit fees, and similar activities, represent the "first steps in the development of the property."

As part of its response, DCA management also provided a discussion of the nature and calculations of the costs questioned in our audit report for the West Haven and the Terrace projects. Management's characterization of these costs was already included as part of this audit report above, and therefore, not summarized again here. See appendix 4 for DCA management's response in its entirety.

It should be noted that early in our audits of States awarded 1602 Program funds, we reached out to IRS for assistance in understanding the eligible costs under Section 42 of the IRC. In this regard, the IRS Senior Program Analyst in charge of assisting examiners' performance provided the audit techniques guide (referred to as the Credit Guide in DCA's response) to aid us in assessing projects' eligible bases. It provides explanation and application of Sections 42, 263, and 263A of the IRC and Treas. Reg. 1.263A regarding capitalization of expenditures in determining the character of claimed costs. The audit techniques guide cites tax court rulings that support IRS' definition of eligible and ineligible costs under IRC Section 42. As such, it was used as criteria and guidance. It links the applicable authorities and provides the common practice of IRS Examiners in evaluating eligible basis of low-income housing projects.

We acknowledge the applicability of capitalization rules under Section 263A of the IRC regarding indirect costs associated with property appraisals, market studies, boundary and topographical surveys, attorney fees, and accounting fees. However, we do not agree that the nature of the indirect costs questioned in this report were the same as those characterized in the *Von Lusk v. Commissioner* tax court case. The costs described in this case

differed from certain activities associated with the questioned costs for the West Haven and the Terrace projects. The nature of these costs were associated with either obtaining permanent financing (in this case, the 1602 Program payments) or acquiring land, which were ineligible costs based on applicable criteria as referenced in the audit techniques guide. The boundary and topographical surveys and attorney fees in question were inextricable from land. Costs questioned related to the property appraisals, market studies, and accounting fees were associated with securing permanent financing. In the CPA cost certifications for West Haven and Terrace, the 1602 Program payments were certified as permanent financing sources. As such, we found the memorandum and analysis provided by DCA management to be incorrect in characterizing 1602 Programs funds as “the receipt of a sub-award is not the receipt of permanent financing.”

The conclusions described above were also supported in our earlier consultations with the IRS Senior Program Analyst. We were advised that any cost that could be closely characterized or related to permanent financing or for land could not be included in eligible basis. As such, the excess 1602 Program payments made to West Haven (\$55,817) and the Terrace (\$55,156) were for the reimbursements of ineligible costs and remain in question.

Compliance and Asset Management

As required by Section 1602 of the Recovery Act, DCA established compliance and asset management oversight functions to ensure that low-income housing projects comply with Section 42 of the IRC and remain viable during the 15-year compliance period.

Section 1602 of the Recovery Act also required that State housing credit agencies impose conditions and/or restrictions, including recapture requirements, on subawardees to ensure low-income housing projects remain qualified under Section 42 of the IRC during the 15-year compliance period. OFAS further stipulated in its terms and conditions that recapture requirements be included in State credit housing agencies’ written subaward agreements. Furthermore, State housing credit agencies were required by OFAS to have procedures in place for monitoring 1602 Program subawardees to identify and correct issues of noncompliance

during the compliance period. In the event of noncompliance, State housing credit agencies must impose consequences such as possible State program debarment and the recapture of 1602 Program funds, payable to Treasury.²¹

In the case of DCA, the requisite recapture requirements were included in its subaward agreements in the event of subawardee noncompliance. DCA structured its 1602 Program subawards as tax credit exchange funds, subject to recapture in the event a low-income building does not remain qualified during the 15-year compliance period. Projects had commenced the first year of the 15-year compliance period. DCA's compliance monitoring procedures included performing on-site inspections of project buildings, common areas, grounds, and units for suitability of occupancy and any health and safety hazards. DCA also reviewed project and tenant files for the number of units set aside as low-income housing, the number of occupants, the annual income certifications within low-income households, and rents charged among other project compliance requirements. There were no matters impacting compliance with Section 42 of the IRC at the time of our review.

DCA's policy requires that an annual asset management review be performed on each 1602 Program project to ensure the long-term viability of the projects. DCA asset management included the following:

- review of project financial management documents for risk management techniques and insurance coverage;
- establishment of lease-up, operating, emergency and replacement project reserves; management of operating reserves and replacement reserves (including approval of expenditures);
- analyses of annual operating budget, debt coverage, cash flow trends, and other financial information; and
- review of project budgeting, accounting, and internal controls.

²¹ Treasury, "Section 1602—Payments to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits for 2009 Recapture Guidance"

DCA found no matters impacting the long-term viability of low-income housing projects at the time of our review. DCA's continued compliance monitoring and asset management review for the remainder of the 15-year compliance period should ensure that 1602 Program projects continue to be qualified low-income buildings.

Asset Management Fees

1602 Program requirements allow State housing credit agencies to "collect reasonable fees from a subawardee to cover expenses associated with performance of its duties under Section 1602(c)(3) of the Act, Compliance and Asset Management. Reasonable fees are amounts customarily charged for the same or similar services and in no event may exceed costs."

DCA collected asset management fees totaling \$5,866,798 from all 45 subawardees to cover the future costs of performing asset management functions throughout the projects' 15-year compliance periods, which is expected to end in 2026. In turn, subawardees were reimbursed with 1602 Program funds. While collecting asset management fees in advance is not prohibited by 1602 Program requirements, it is a matter of concern that the total cost of performing asset management over the 15-year performance period may be significantly less than the \$5,866,798 collected by DCA given that actual costs were unknown at the time fees were collected.

The breakout of DCA's actual asset management costs are provided in Figure 1.

Figure 1



Source: OIG summary of DCA asset management costs for FY 2012 through FY 2017.

Since DCA’s asset management is ongoing, we do not question the \$5,866,798 of asset management fees collected at the time of this audit. Nonetheless, this a matter requiring closer attention on the part of OFAS in monitoring DCA’s compliance with all 1602 Program requirements.

DCA Management Response

In its written response, DCA management acknowledged its continued responsibilities to provide asset management oversight of “Section 1602” properties and to use asset management funds collected for that purpose. DCA management noted that it will

continue to document its services and costs going forward and ensure that the fees collected from subawardees do not exceed actual costs. See appendix 4 for DCA management's response in its entirety.

We believe the documentation of services and costs as stated in DCA management's response will assist Treasury in evaluating DCA's actual asset management costs going forward.

Quarterly and Annual Reporting

OFAS requires that State housing credit agencies submit financial status and project performance reports for each low-income housing project on a quarterly basis during the development stage as well as other reports deemed necessary to ensure compliance with provisions of Section 1602. In its post sub-award reporting guidance, OFAS also requires that State housing credit agencies provide two additional certification reports. The first report is to certify each project's placed in-service date and whether 1602 Program funds used were equal to or less than 85 percent of the project's eligible basis. The second report is required each year thereafter for the project's annual compliance throughout the 15-year compliance period once the project is placed in service.

We found that DCA complied with OFAS' reporting requirements. That is, DCA submitted quarterly project performance reports during each project's developmental stage and annual certification reports after the project was placed in service.

Recommendations

We recommend that Treasury's Fiscal Assistant Secretary do the following:

1. Ensure that DCA provides sufficient support of other eligible costs used to offset the \$170,500 of excess 1602 Program payments made to 14 subawardees for unallowable legal fees. For any costs that cannot be sufficiently supported, ensure that DCA reimburses Treasury.

Treasury Management Response

Management generally agreed with our recommendation in stating that it will work with DCA to obtain sufficient support demonstrating that \$170,500 in reimbursement for erroneously charged legal fees were used for other project costs. OFAS will take appropriate action regarding any amounts that cannot be supported.

OIG Comment

Management's response meets the intent of our recommendation. Management will need to provide the due date for implementing its specific corrective action in JAMES.

2. Ensure that DCA reimburses Treasury the \$55,817 of excess 1602 Program payments made to West Haven as a result of including ineligible costs in the project's cost basis.

Treasury Management Response

Management generally agreed with our recommendation stating that it will work with [Treasury] tax counsel and DCA to determine whether or not certain costs were properly included in the basis of the Section 1602 property. If OFAS concludes that the costs questioned were not properly included in the basis, it will require DCA, in accordance with the "Section 1602" recapture guidance, to make reasonable efforts to obtain reimbursement from the project owner.

OIG Comment

Management's response meets the intent of our recommendation. Management will need to provide the due date for implementing its specific corrective action in JAMES.

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3. Ensure that DCA reimburses Treasury the \$55,156 of excess 1602 Program payments made to Terrace as a result of including ineligible costs in the project's cost basis.

Treasury Management Response

Management generally agreed with our recommendation stating that it will work with [Treasury] tax counsel and DCA to determine whether or not certain costs were properly included in the basis of the Section 1602 property. If OFAS concludes that the costs questioned by the OIG were not properly included in the basis it will require DCA, in accordance with the Section 1602 recapture guidance, to make reasonable efforts to obtain reimbursement from the project owner.

OIG Comment

Management's response meets the intent of our recommendation. Management will need to provide the due date for implementing its specific corrective action in JAMES.

4. Require DCA to provide support, going forward, for its actual costs to perform asset management functions over the remaining 15-year compliance period to ensure that fees collected from subawardees do not exceed actual costs.

Treasury Management Response

Management generally agreed with our recommendation stating that it will seek support from DCA for its actual costs to perform asset management functions and compare those cost to the fees collected from subawardees.

OIG Comment

Management's response meets the intent of our recommendation. Management will need to provide the due date for implementing its specific corrective action in JAMES.

* * * * *

We appreciate the courtesies and cooperation extended by your staff during this audit. Major contributors to this report are listed in appendix 6. A distribution list for this report is provided as appendix 7. If you have any questions, you may contact me at (202) 927-5784 or Nick Slonka, Audit Manager, at (202) 927-8772.

/s/

Donna Joseph
Deputy Assistant Inspector General for Audit

In September 2012, we initiated an audit of the Georgia Department of Community Affairs (DCA) as part of our audits of State housing credit agencies funded under the Department of the Treasury's (Treasury) Payments to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credit Allocations for 2009 (1602 Program) authorized by section 1602 of the American Recovery and Reinvestment Act of 2009 (Recovery Act). The objective of these audits was to assess whether State housing credit agencies awarded funds under Treasury's 1602 Program complied with the program's overall requirements and the "Grantee Terms and Conditions" (together referred to as 1602 Program requirements). To meet our objective, we assessed whether DCA properly received and subawarded 1602 Program funds, implemented compliance and asset management processes, and met Treasury's reporting requirements.

We statistically selected DCA from the universe of 55 states and territories eligible to receive 1602 Program funds. We caution, however, that our sample was randomly selected to avoid bias and not for the purpose of projecting results to the universe or concluding on the effectiveness of the 1602 Program. Our audit scope comprised \$195,559,945 of 1602 Program funds awarded to DCA in July and December of 2009. Of this amount, DCA subawarded and disbursed \$195,011,467 to 45 low-income housing projects from which we statistically selected and reviewed 12 projects (comprising \$40,358,461) to further assess subaward compliance with 1602 Program requirements. Our subaward sample was not for the purpose of projecting testing results across all 45 projects but to ensure each project had an equal chance of being selected. As part of our testing of compliance at the subaward level, we also selected a non-statistical sample comprising at a minimum 50 percent of the disbursements made for each project totaling \$33,474,576. As DCA did not subaward \$548,478 of its 1602 Program funds by the 1602 Program deadline of December 31, 2011, it returned such amount to the General Fund.

In October 2012, we identified one subaward that received 1602 Program payments in excess of the maximum eligible amount stipulated in the 1602 Program requirements (i.e. 85 percent of its eligible basis including the 130 percent Qualified Census Tract boost). As a result, we reviewed an additional six low-income

housing projects that were at risk of receiving 1602 Program overpayments in excess of their maximum subaward amounts. Our testing of these six low-income housing projects was specifically limited to determining if the additional projects received 1602 Program overpayments.

In performing our work, we reviewed applicable laws and regulations governing the 1602 Program to include the Recovery Act and Section 42 of the Internal Revenue Code, as well as Treasury's policies and procedures, and guidance provided in *Frequently Asked Questions and Answers*. We also consulted with an Internal Revenue Service Senior Policy Analyst and a Senior Program Analyst for low-income housing tax credits to obtain more specifics on calculating eligible basis and followed the *Audit Techniques Guide for IRC §42, Low-Income Housing Credit*, used by tax examiners to test low-income housing eligible cost basis. We visited DCA in Atlanta, Georgia, where we interviewed key personnel of DCA and reviewed documents used to support Georgia's "Low-income Housing Grant Election Amount" and its selection of subawards, low income housing projects' existence, cash disbursements in our sample, and conformance with compliance monitoring, asset management, and 1602 Program reporting requirements. Specifically, we reviewed and/or tested the following documents:

- DCA's signed "Grantee Terms and Conditions" with Treasury stipulating all 1602 Program compliance requirements;
- DCA's "Annual Low-Income Credit Agencies Report" ("IRS Form 8610") supporting Georgia's low-income housing credit allocations for calendar years 2009 and 2010;
- DCA's "Qualified Allocation Plan" specifying the selection criteria for identifying eligible projects to be subawarded;
- project developers' market studies supporting low-income housing development needs in specified Georgia communities;
- project developers' documentation demonstrating that "good faith efforts" were made to obtain financing prior to receiving a subaward;
- DCA's financial feasibility studies demonstrating the financial solvency and viability of low-income housing projects;

- DCA’s signed “Exchange Assistance Agreements” with low-income housing project developers specifying subaward amounts and 1602 Program terms and conditions;
- subawardee draw requests supporting cash disbursements;
- projects’ certificates of occupancy reports supporting existence of low-income housing units;
- projects’ certified public accountants final cost certification reports verifying costs included as part of each project’s eligible cost basis;
- DCA’s compliance monitoring and asset management reports supporting the continued viability of 1602 Program projects for the duration of the 15-year compliance period; and
- DCA’s quarterly financial and project performance reports and annual certification reports provided to Treasury ensuring that the 1602 Program subaward was less than or equal to 85 percent of the project’s eligible basis, and that projects remain qualified projects throughout the 15 year compliance period.

We performed our fieldwork between September 2012 and April 2017, which included site visits to three low-income housing projects located in Atlanta, Barnesville, and Locust Grove, Georgia.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

A questioned cost is a cost that is questioned by the auditor because of an audit finding: (1) which resulted from an alleged violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances. Questioned costs are to be recorded in the Joint Audit Management Enterprise System (JAMES). The questioned costs will also be included in the next Office of Inspector General Semiannual Report to the Congress.

<u>Recommendation Number</u>	<u>Questioned Costs</u>
Recommendation 1	\$170,500
Recommendation 2	\$55,817
Recommendation 3	\$55,156

The questioned costs relate to funds that the Department of the Treasury awarded to the Georgia Department of Community Affairs under the Payments to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits for 2009 (1602 Program). As discussed in the audit report, the questioned costs consist of (1) \$170,500 of unallowable legal fees paid to 14 subawardees using 1602 Program funds; (2) \$55,817 of excess 1602 Program payments due to ineligible costs included in the cost basis of subawardee, West Haven Senior Apartments; and (3) \$55,156 of excess 1602 Program payments due to ineligible costs included in the cost basis of subawardee, The Terrace at Edinburgh.

Grants to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits for 2009

GRANTEE TERMS AND CONDITIONS

1. Authority

a. Section 1602 of the American Recovery and Reinvestment Tax Act of 2009 (Act) authorizes the United States Department of the Treasury (Treasury) to issue grants to State housing credit agencies in lieu of low-income housing credits.

b. The grantee has authority to receive Section 1602 grants.

2. Grantee Eligibility

a. The grantee is the housing credit agency for one of the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, American Samoa, Guam, or the Northern Mariana Islands which files Form 8610, Annual Low-Income Housing Credit Agencies Report with the Internal Revenue Service.

b. The grantee shall be the sole recipient of the Section 1602 funds in the State and must coordinate with other housing credit agencies within the State (including any constitutional home rule cities) to determine how much of their 2009 credit ceiling the other agencies would elect to take in the form of a grant election amount and will provide to those agencies their proportionate share.

c. The grantee shall enter into written agreement with any other participating housing credit agencies within the State, binding the participating agency to comply with the terms and conditions applicable to the grantee or designated state agency in the sections 3 through 10 of these terms and conditions.

d. The grantee is the party responsible to Treasury for all grant matters.

3. Eligible Projects

a. The grantee shall only select projects for subawards which are qualified low-income buildings under Section 42 of the Internal Revenue Code (the Code).

b. The grantee must ensure that the subaward is consistent with the requirement of section 42(m)(2) of the Code that the subaward made for a project [building(s)] does not exceed the amount necessary to ensure the financial feasibility of the project and its viability as a project throughout the credit period.

4. Use of Grant Funds

a. The grantee is receiving an initial grant election amount. The grantee may apply for additional grant funds through 2010. If the Treasury Department approves the request, the Treasury Department will amend the award to increase the grant amount.

b. The grantee shall use all grant amounts to make subawards, or for transfer to other agencies to make subawards. The subawards shall be in the form of cash assistance and are not required to be repaid unless there is a recapture event with respect to the qualified low-income building. The grantee shall not use grant election amounts for any other purpose, including administrative costs. The grantee may collect reasonable fees from a subawardee to cover expenses associated with performance of its duties under Section 1602(c)(3) of the Act, Compliance and Asset Management. Reasonable fees are amounts customarily charged for the same or similar services and in no event may exceed costs.

c. The grantee may disburse grant funds to subawardees in 2009 and 2010. The grantee may disburse grant funds to subawardees in 2011 provided the subaward has been made to the subawardee on or before December 31, 2010 and the subawardee has, by the close of 2010, paid or incurred at least 30 percent of the subawardee's total adjusted basis in land and depreciable property that is reasonably expected to be part of the low-income housing project for which the disbursements are made.

d. The subawards shall finance the construction or acquisition and rehabilitation of qualified low-income buildings in accordance with Section 1602(c) of the Act.

e. The grantee shall make subawards in the same manner and shall be subject to the same limitations as an allocation of housing credit dollar amount allocated under Section 42(m) of the Code, except for the additional determinations required in subsection g of this section.

f. Prior to making any subaward, the grantee shall establish a written process for making a determination that applicants for subawards have demonstrated a good faith effort to obtain investment commitments for tax credits in lieu of a subaward.

g. Prior to making any subaward, the grantee shall make a determination that the applicant for the subaward has demonstrated a good faith effort to obtain investment commitments for tax credits in lieu of the subaward.

5. Written Agreements and Disbursements to Subawardees

a. The grantee shall execute a legally binding written agreement with the entity receiving a subaward. The grantee and the subawardee must execute the written agreement before any Section 1602 funds are disbursed to the subawardee.

b. The written agreement must set forth (explicitly, or incorporated by reference) all Section 1602 program requirements, including the requirements of Section 42 of the Code, applicable to the subaward.

c. The written agreement shall impose conditions or restrictions, including a requirement providing for recapture, so as to assure that the qualified low-income building remains a qualified low-income building during the 15-year compliance period. The written agreement may include the extended low-income housing commitment under Section 42(h)(6)(B) of the Code.

d. The written agreement shall require the subawardee to provide sufficient information to the grantee to report on the use of grant funds as required by section 8 of these terms and conditions.

6. Asset Management

a. The grantee shall perform asset management functions so as to ensure compliance with Section 42 of the Code and the regulations thereunder (including Title 26 Code of Federal Regulations section 1.42.9), and the long-term viability of the buildings funded by a subaward under the Act in accordance with Section 1602(c)(3) of the Act.

7. Compliance with the 2009 State Housing Credit Ceiling

a. The grantee shall track (1) the credit equivalent of all grant election amounts to ensure that the 2009 State Housing Credit Ceiling is appropriately reduced as required by section 42(i)(9)(A) of the Code and (2) total grant election amounts to ensure that these amounts do not exceed the amount authorized by section 1602(b).

b. The grantee shall track the total of credits allocated under Section 42(h)(1) of the Code.

c. The grantee shall ensure that the credit equivalent of all elected grant amounts through 2010, plus the credits allocated under Section 42(h)(1) of the Code during 2009, do not exceed the State housing credit ceiling for 2009.

8. Reporting

a. The grantee shall provide periodic reports as required by Treasury. A financial status report and a project performance report are required on a quarterly basis, due 10 working days after the end of the quarter. Quarters end on March 31, June 30, September 30, and December 31.

b. The performance report has the following elements on each project receiving a subaward during the quarter:

- Name of recipient entity
- Name of project
- Brief description of project
- Location of project: city/county, State, zip code
- Number of construction jobs created
- Number of construction jobs retained
- Number of non-construction jobs created
- Number of non-construction jobs retained
- Number of total housing units newly constructed
- Number of total housing units rehabilitated
- Number of low-income housing units newly constructed
- Number of low-income housing units rehabilitated

c. The grantee shall submit any other reports that Treasury deems necessary to comply with Section 1602 of the Act and American Recovery and Reinvestment Act guidance.

9. Recapture

- a. The grantee shall include in any subaward a requirement providing for recapture to assure that the building remains a qualified low-income building during the 15-year compliance period.
- b. The grantee shall notify subawardees that any amount subject to recapture becomes a debt owed to the United States payable to the General Fund of the Treasury and enforceable by all available means against any assets of the recipient entity.

10. Financial Management

- a. The grantee must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the designated State housing credit agency must be sufficient to permit preparation of required reports and permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes. Effective control and accountability must be maintained for all grant funds.
- b. The grantee shall open a new account (Grant Account) with a financial institution for the purpose of receiving grant election amounts, for making distributions of grant election amounts to other agencies within the State, and for making subawards.
- c. The grantee must maintain program, financial, and accounting records sufficient to demonstrate that grant funds were used in accordance with the Section 1602 program and these terms and conditions. The Treasury as the awarding office, the cognizant Treasury inspector general, and the Comptroller General of the United States, or any of their authorized representatives, shall have the right of access to facilities and to any pertinent books, documents, papers, or other records (electronic and otherwise) of grantees, which are pertinent to the grant, in order to make audits, examinations, excerpts, and transcripts.
- d. The grantee shall minimize the time between the receipt of grant funds and the disbursement of those funds to subawardees. Federal funds cannot be drawn by the grantee from the U.S. Treasury in advance of need. The grantee shall not place in escrow or advance lump sums to project owners. Once funds are drawn from the grantee's U.S. Treasury account, they must be expended as a subaward by the grantee within three days, or if grant funds are transferred by the grantee to another agency, as a subaward by that agency within three days following the date of transfer by the grantee.
- e. The grantee shall promptly return to its Grant Account any subawards returned to the designated State housing credit agency from subawardees and shall expend returned amounts as subawards before additional grant amounts are drawn from the Treasury.

11. Disallowance, Suspension, and Termination

- a. If the grantee materially fails to comply with any term of the award, whether stated in a Federal statute or regulation, the terms and conditions herein, in a State plan or application, a

notice of award, or elsewhere, Treasury may take one or more of the following actions, as appropriate in the circumstances:

- Temporarily halt cash payments pending correction of the deficiency by the grantee
- Disallow all or part of the cost of the activity or action not in compliance
- Wholly or partly suspend or terminate the current award
- Withhold further awards for the program
- Take other remedies that may be legally available

In taking an enforcement action, Treasury will provide the grantee the opportunity for a hearing, appeal, or other administrative proceeding to which the grantee is entitled under any statute or regulation applicable to the action involved.

b. The grantee must immediately report any indication of fraud, waste, abuse, or potentially criminal activity pertaining to grant funds to Treasury and the cognizant Treasury inspector general.

12. Return of Unused Grant Funds

a. The grantee shall return to the Treasury by January 1, 2011 any grant election amounts not used to make subawards by December 31, 2010. This requirement does not prevent the State housing credit agency from continuing to disburse funds to subawardees after December 31, 2010 provided:

- (1) A subaward has been made to the subawardee on or before December 31, 2010;
- (2) The subawardee has, by the close of 2010, paid or incurred at least 30 percent of the subawardee’s total adjusted basis in land and depreciable property that is reasonably expected to be part of the low-income housing project; and
- (3) Any funds not disbursed to the subawardee by December 31, 2011 must be returned to the Treasury by January 1, 2012.

Signature

Under penalties of perjury, I declare that I have examined the terms and conditions in this application and that the designated State housing credit agency agrees to and will ensure that these terms and conditions will be followed. I declare that I am an authorized official of the designated State housing credit agency and am authorized to bind the State housing credit agency to these Terms and Conditions.

Name		Title	
Phone		Email	
Signature		Date signed	

Nathan Deal
Governor



Christopher Nunn
Commissioner

August 14, 2018

Theresa Cameron
Director, Financial Assistance Audits
Department of the Treasury - Office of the Inspector General
875 15th Street, NW
Washington, DC 20005

Re: **OIG Draft Audit Report – Section 1602 Program**
Georgia Department of Community Affairs

Dear Ms. Cameron:

Thank you for providing a draft copy of the OIG Audit Report concerning the award of Section 1602 funds to the Georgia Department of Community Affairs (“DCA”). DCA appreciates the professionalism of the Office of Inspector General staff and their careful review of our Section 1602 program.

The Audit Report found that DCA generally met the eligibility and compliance requirements set forth in both Section 42 of the Internal Revenue Code and Section 1602 of the American Recovery and Reinvestment Act of 2009; however, DCA did not meet all requirements. Below is a summary of the draft findings and DCA’s response to those findings.

Finding 1 – Legal Fees

In the absence of 1602 guidance regarding the reimbursement of fees, DCA initially charged sub awardees the legal cost of closing Section 1602 awards. These billed legal fees were included in a draw request submitted by sub awardees and approved by DCA. Upon learning that these fees were not allowable, the fees were returned by DCA to the sub awardee. The OIG properly found that DCA reimbursed fourteen sub awardees a total of \$170,500 for legal fees that were deemed not eligible under the 1602 Program requirements. Although DCA repaid the sub awardee, it did not verify that the \$12,500 reimbursed to individual sub awardees was replaced with other eligible costs **until** receipt of the required cost certification. **At that time, DCA verified that the legal fee reimbursement was replaced with other eligible costs and verified in the cost certification.**

DCA agrees that the repayment of funds to the sub awardee created a “moment in time” overpayment of Section 1602 funds under DCA’s stringent internal procedures for oversight of Section 1602 as noted in the audit report. However, this “moment in time” imbalance was corrected when the sub awardee replaced the legal fee expense with other eligible incurred costs during

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project construction. Also, while the “moment in time” imbalance was a technical violation of DCA procedures and goal of reviewing every expenditures, it is unlikely that any Section 1602 funds were paid prior to incurring an eligible cost. This is because DCA policies required that only 95% of hard construction costs be paid as they were incurred and that 5% be held back until the final contractor cost certification was completed. This additional DCA risk mitigation policy made it unlikely that the sub awardee received use of any Exchange funds before eligible costs were incurred- even after reimbursement of the subject legal fees by DCA-meeting the expressed goal of DCA’s policies. DCA’s practices and procedures were to trace 1602 funds and review 100% of draws submitted by sub awardees. The policies also included a contractor cost certification and a full cost certification at the conclusion of the process. The legal fee issue arose subsequent to DCA’s stringent draw review when Treasury determined that the legal fees charged by DCA were ineligible costs but was identified at final cost certification as contemplated by DCA policies.

DCA met Treasury regulations and guidance for administering Section 1602 which states that:

“The sub-awards were required to be made in the same manner and were subject to the same limitations as an allocation of housing credit dollar amounts by state housing credit agencies under IRC § 42” and as noted in the Treasury Q&A below, tracing of funds was not required.

4g. Question: Are sub awardees required to “trace” how the Section 1602 funds are used in the project? Answer: No. Sub awardees are not required to trace (i.e., track the sources and uses of each expenditure in the development project) the use of Section 1602 funds. This follows the practice of LIHTCs. (Treasury Q&A published for Section 1602.)

Section 1602 administration did not require DCA to “match” equity with specific costs. Based on the final cost certifications submitted by the sub awardees, 85% of the eligible basis costs for each project was sufficient to justify the amount of 1602 funds provided to the sub awardee by DCA. It is important to note that **these certified costs did not include legal fees**. Therefore, DCA allocated the correct amount of Section 1602 funds to each property. There is no excess payment made as the cost certification shows sufficient eligible costs (without the legal fees) for the 1602 funds.

In summary, DCA acknowledges the audit finding. However, it requests that the Inspector General recommendation that the reimbursed legal costs be returned to the Department of Treasury be reconsidered as no repayment or recapture is required under the regulations as the allocated funds were justified by eligible basis.

Finding 2- Eligible Basis reductions for West Haven and Terrace

The OIG initially found that excess 1602 payments totaling \$208,447 were made as a result of two sub awardees including ineligible costs per Section 42 of the IRC in the eligible bases of their low-income housing projects. The audit report states that “ineligible costs... associated with property

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appraisals, market studies, boundary and topographical surveys, real estate attorney fees, accounting fees, and title and recording fees” were ineligible under Section 42 of the IRC. Of the \$208,447 in excess 1602 Program payments, DCA returned recaptured program funds to Treasury in payments of \$13,112 in July 2015, \$77,792 in August 2015, and \$6,570 in April 2016. The Office of Inspector General has recommended that DCA recapture the following amounts:

- \$55,817 of ineligible costs included in the cost basis of West Haven Senior Apartments (West Haven); and
- \$55,156 of ineligible costs included in the cost basis of The Terrace at Edinburgh (Terrace)

The OIG has stated unequivocally that costs incurred for property appraisals, market studies, boundary and topographical surveys cannot be included as eligible basis. The draft audit finding characterizes these costs as “services that are not associated with the low income buildings, and therefore are not includable in eligible basis”. The OIG’s conclusion was based on the “IRC §42 Low-Income Housing Credit Guide” (the “Credit Guide”) released in 2015, which is an updated version of the “IRC §42 Low-Income Housing Credit Audit Technique Guide” (“Audit Guide”). However, the Audit Technique Guide should not be used as a bright-line rule. The Audit Technique Guides are prepared by the Examination Division of the IRS for use in training IRS auditors and do not have (and are not intended to have) the authority of a statute, regulation, IRS Chief Counsel ruling or ruling by a court. This is reflected in a statement on the cover of the Audit Guide, which reads: “[t]his material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.” While the referenced documents if prepared as part of the acquisition of the site might be excluded, the project specific use of these documents allow the cost to be included in the eligible basis calculation for West Haven and Terrace. Attached are documents from both the accountant preparing the cost certification and the lawyer for the sub awardee which confirmed the use of the documents and the basis for including the costs in eligible basis.

In summary, DCA reasonably determined that the expenditures for property appraisals, market studies, boundary and topographical surveys, attorney, and accounting fees, were incurred by reason of (or directly benefit) the development and production of qualified low-income housing buildings and are indirect costs required to be capitalized under IRC § 263A. Such costs should be included in the eligible basis of the low-income building, for the purpose of calculating LIHTCs or for the purpose of receiving a sub-award under Section 1602. However, DCA will proceed with recapturing these amounts from the sub awardees upon direction from the Treasury.

Finding 3 – Asset Management Fees

In addition, OIG found that DCA established a process for monitoring the long-term viability of projects and their compliance with 1602 Program requirements and met all Treasury quarterly and annual reporting requirements. While OIG found no matters regarding DCA’s performance of



Appendix 4
Georgia Department of Community Affairs Response

compliance and asset management functions, it did note a matter of concern regarding DCA's collection of \$5,866,798 in asset management fees from all 45 sub awardees to cover the future costs of performing asset management functions.

DCA acknowledges its continued responsibility to provide asset management oversight of Section 1602 properties and to use asset management funds collected for that purpose. DCA will continue to document its services and costs going forward and ensure that the fees collected from sub awardees do not exceed actual costs.

Again, DCA appreciates the professionalism of the OIG team that conducted the audit. If you need any further assistance, please do not hesitate to contact us.

Regards,



Carmen Chubb
Deputy Commissioner





Memo

To: Georgia Department of Community Affairs

From: Tidwell Group, LLC and Kutak Rock LLP

Chadd Weisert (614) 528-1465 (Tidwell) and Jill Goldstein (402) 231-8749 (Kutak)

Date: August 1, 2018

RE: Georgia DCA Response to Treasury OIG Preliminary 1602 Audit Findings

Tidwell Group, LLC ("Tidwell") represents the Vantage Group, LLC and its subsidiaries ("Vantage"). Tidwell is a certified public accounting firm with offices in Atlanta Georgia, Birmingham Alabama, Columbus Ohio, and Austin Texas. The firm has extensive experience representing real estate developers, investors, and state housing credit agencies participating in the Low Income Housing Tax Credit ("LIHTC") program.

Kutak Rock LLP ("Kutak") has represented Vantage on certain LIHTC transactions. Kutak is a national firm of more than 500 lawyers with offices in Atlanta, Chicago, Denver, Fayetteville, Irvine, Kansas City, Little Rock, Los Angeles, Minneapolis, Oklahoma City, Omaha, Philadelphia, Richmond, Rogers, Scottsdale, Spokane, Washington, D.C. and Wichita. With one of the most active tax credit practices in the country, Kutak Rock LLP is a recognized industry leader in this complex area of law. For more than two decades the firm has represented a range of participants in LIHTCs, historic rehabilitation tax credits (HTCs) and state tax credit transactions.

Given Tidwell's and Kutak's expertise in Low-Income Housing Tax Credits, Tidwell and Kutak submit this brief to address the complex tax issues inherent in the interpretation of Section 42 of the Internal Revenue Code of 1986 (herein "IRC") commonly referred to as the Low-Income Housing Tax Credit ("LIHTC") and Section 1602 of the American Recovery and Reinvestment Act, commonly referred to as the Tax Credit Exchange program ("TCE").

To that end, this brief, examines the legal authorities and tax precedence applicable to the LIHTC and TCE programs, and explains how the capitalization rules of IRC §263 and §263A apply to the eligible basis rules of IRC § 42.

Legal Authorities and Audit Technique Guide

Before discussing the legal authorities and tax issues associated with the application of the LIHTC and TCE programs, a brief review of statutory interpretation and the order of precedence is appropriate.

The U.S. Constitution is the highest authority in the land. Federal statutes are the next highest authority and are controlling authority unless they are inconsistent with the Constitution or were enacted outside of the bounds of Congress's lawmaking powers. Title 26 of the United States Code, often referred to as the "Internal Revenue Code", as updated from time to time by various Public Laws is the primary source of federal tax law.

After the US Constitution and Federal Statutes, the authority with the most weight are Judiciary holdings. In interpreting a statute, the first rule of statutory interpretation is the plain meaning rule which focuses on the ordinary meaning of plain language.¹ Likewise, when interpreting the statutory text, Courts interpret a statute to "fit if possible all parts into an harmonious whole."² A provision that may seem ambiguous in isolation is clarified by the remainder of the statutory scheme. Another common tool Courts use in interpreting statutes is the legislative history behind the statute and the Joint Committee on Taxation's post-enactment report.

Beyond the statutory language and judiciary holdings, Treasury Regulations have the most authoritative weight. In general, Treasury Regulations interpret and give direction on complying with federal law. Regulations can be legislative, or interpretive in type. Legislative regulations are specific grants by Congress directing Treasury to fill in the gaps in a statute. In contrast, interpretive regulations do not establish substantive law, instead they are intended to clarify it.

In addition to the above controlling authorities, the IRS will make pronouncements with varying degrees of authoritative weight. Generally IRS pronouncements can be classified into five groups: 1) IRS rulings published for the general public, 2) IRS rulings directed at individual taxpayers and not intended for wider use, 3) IRS literature and statements disseminated to the public but not published in the Internal Revenue Bulletin, 4) Internal documents issued by various divisions of the Treasury Department and IRS to give guidance to other divisions within the IRS, and 5) other miscellaneous pronouncements.

Items published for the general public in the Internal Revenue Bulletin ("IRB") are authoritative. Likewise IRS rulings directed at individual taxpayers are authoritative with respect to the individual taxpayer to which they are addressed. Items not published in the Internal Revenue Bulletin, may not be cited as legal authority.

Audit Technique Guides ("ATG") fall within the fourth group-- internal documents. These documents are intended to help IRS examiners during field audits by providing insight into issues and accounting methods unique to specific industries. ATGs explain industry specific examination techniques and provide guidance to IRS examiners on how to audit

¹ See *Tennessee Valley Authority v. Hill*, 437 U.S. 153 (1978).

² *FDA v. Brown & Williamson Tobacco Corp.*, 529 US 120 (2000).

specific industry segments, but as noted on page 1 of the ATG for IRC § 42, **“The document is not an official pronouncement of law”** and may not be cited or relied upon as such. As a result, although the ATG is a useful summary of how the IRS will audit tax returns claiming credits under LIHTC program, the positions taken within the document (some of which are not consistent with existing precedence) are merely informal guidance that have no legal bearing.

From our review of the emails and files from the Office of Inspector General, it appears the LIHTC ATG is the primary source that is being cited and used to determine whether certain expenditures are properly capitalized. This analysis is incorrect. As previously mentioned, and as further detailed below, IRC § 263 and § 263A are the relevant legal authority to be used.

The LIHTC & TCE Programs

IRC § 42 allows a 10 year nonrefundable income tax credit for the investment in newly constructed or substantially rehabilitated qualified low-income buildings placed in service after December 31, 1986. The amount of the LIHTC for any taxable year in the credit period is equal to the applicable percentage of the qualified basis of each qualified low-income building (as defined in IRC § 42(c)).

IRC § 42(h)(1) provides, generally, that the amount of credit under IRC § 42 for any taxable year for any building shall not exceed the housing credit dollar amount allocated to the building. IRC § 42(h)(3)(A) provides, in part, that the aggregate housing credit dollar amount that a State housing credit agency may allocate for any calendar year is limited to that year's State housing credit ceiling (Ceiling).

Under IRC § 42(h)(6) no credit shall be allowed with respect to any building unless an extended low income housing commitment is in effect as of the end of such taxable year.

However, in 2009 Congress recognized that the effectiveness of LIHTCs in attracting private capital to invest in the construction, acquisition, or rehabilitation of qualified low-income housing buildings was being undermined by economic disruptions caused by the Great Recession. The financial institutions were not making loans or equity investments because of the volatile economy. This “credit freeze” was stalling housing development projects. As a result, Congress enacted legislation to provide an economic stimulus and fill the financing gaps. Section 1602 of The American Recovery and Reinvestment Act of 2009 (herein referred to as “ARRA” or the “Act”) established a program which allowed taxpayers to receive grant monies in lieu of tax credits.³ Under

³ See The American Recovery and Reinvestment Act of 2009: Full Summary of provisions from Senate Finance, House Ways & Means Committees (February 12, 2009).

the act, the State Housing Agencies' allocations of LIHTCs that they would have received in 2009 were reduced by the grant monies they received.⁴

The Act required the State Housing Agencies "to make sub-awards [of the grant monies]."⁵ The sub-awards were required to be made in the same manner and were subject to the same limitations as an allocation of housing credit dollar amounts by state housing credit agencies under IRC § 42.⁶

Thus, for the purpose of determining "Eligible Basis" there is no distinction between taxpayers claiming LIHTCs and taxpayers receiving sub-awards under the TCE program. The receipt of a sub-award is not the receipt of permanent financing. Rather, the sub-award is a form of cash assistance made by the State Housing Agency to sub-awardees that will never be repaid, except in the event of recapture during the 15 year compliance period.⁷ The sub-award is not taxable income under the federal tax laws.⁸

Capitalization under IRC § 263(A) & IRC § 42

Generally, a taxpayer may deduct from gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred during a tax year, but no deduction is allowed for capital expenditures. Instead, capital expenditures are capitalized and if depreciable the cost of such capital expenditure is recovered under IRC § 168.

Treas. Reg. § 1.263(a)-2(a) and (d) provide that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Likewise, the uniform capitalization rules prescribe what costs associated with the production of property for the taxpayer's own use or resale must be capitalized. Section 263A provides, in part, that direct costs and a properly allocable portion of indirect costs of real or tangible personal property produced by a taxpayer must be capitalized to the property produced. Under IRC § 263A(g)(1) and Treas. Reg. § 1.263A-2(1)(i) the term "produce" includes construct, build, install, manufacture, develop, or improve. Property produced may include land, buildings, land improvements, and other tangible property owned by the taxpayer for federal income tax purposes.

⁴ See IRC 42(i)(9).

⁵ See American Recovery and Reinvestment Act of 2009, H.R.1-249.

⁶ See Notice 2010-18. In addition sub-awards made pursuant to § 1602(c) of the Act were excluded from the gross income of recipients and were exempt from taxation.

⁷ See the Department of Treasury's Section 1602 Grants to States for Low-Income Housing Projects in Lieu of Low Income Housing Credits for 2009 FAQ. <https://www.treasury.gov/initiatives/Documents/FAQs.pdf>

⁸ See Notice 2010-18.

Treas. Reg. § 1.263A-1(e)(3)(i) defines indirect costs as all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit, or are incurred by reason of, the performance of production activities. Indirect costs that are allocable to production activities then must be allocated among the properties produced.⁹

In addition to production activities, Treas. Reg. § 1.263(a)-2(f)(2)(i) provides that a taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph Treas. Reg. § 1.263(a)-2(f)(2)(ii).

Inherently facilitative amounts include:¹⁰

- Transporting the property (for example, shipping fees and moving costs);
- Securing an appraisal or determining the value or price of property;
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
- Application fees, bidding costs, or similar expenses;
- Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
- Examining and evaluating the title of property;
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
- Conveying property between the parties, including sales and transfer taxes, and title registration costs;
- Finders' fees or brokers' commissions, including contingency fees (defined in paragraph (f)(3)(iii) of this section);
- Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or
- Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

However, except as provided in Treas. Reg. § 1.263(a)-2(f)(2)(ii), amounts paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property do not facilitate the acquisition of real property if it relates to activities

⁹ Rev. Rul. 2002-9; See also §1.263A-1(f); §1.263A-2(a)(1)(i).

¹⁰ See Treas. Reg. § 1.263(a)-2(f)(2)(ii).

performed in the process of determining whether to acquire the real property and which real property to acquire.¹¹

Finally, Treas. Reg. § 1.263A-2(a)(3)(i) provides that any cost required to be capitalized by §263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Von-Lusk v. Commissioner, 104 T.C. 207 (1995) is consistent with the premise that indirect development costs must be capitalized. There the Court held that certain expenses incurred by a real estate developer before actual physical work began on undeveloped land are subject to §263A. The court found that the developer's activities, such as obtaining building permits and zoning variances, negotiating permit fees, and similar activities, represent the "first steps in the development of the property." The court further noted that the pursuit of building permits and zoning variances, negotiating permit fees, and similar activities "are ancillary to actual physical work on the land and are as much a part of a development project as digging a foundation or completing a structure's frame. The project cannot move forward if these steps are not taken."

The capitalization rules of IRC § 263 and §263A are relevant to IRC § 42 because the amount of the low-income housing credit determined under IRC § 42 for any taxable year in a 10-year credit period shall be an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.¹² The qualified basis of any qualified low-income building is an amount equal to the applicable fraction (defined in IRC § 42(c)(1)(B)) of the eligible basis of such building. The term "qualified low-income building" means, in part, any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply.¹³ Additionally, IRC § 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in the building.

Based on the above, the eligible basis of a low-income housing building under IRC § 42(d)(1) includes (1) the adjusted basis of depreciable property subject to § 168 that qualifies as residential rental property under IRC § 103, and (2) the adjusted basis of depreciable property subject to IRC § 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building.¹⁴

¹¹Treas. Reg. § 1.263(a)-2(f)(2)(iii).

¹² IRC § 42(a).

¹³ IRC § 42(c)(2). Section 201(a) of the 1986 Act modified property subject to the accelerated cost recovery system (ACRS) under IRC § 168 for property placed in service after December 31, 1986.

¹⁴ PLR 200916007.

As a result, the expenditures for property appraisals¹⁵, market studies¹⁶, boundary and topographical surveys¹⁷, attorney, and accounting fees¹⁸, that are incurred by reason of (or directly benefit) the development and production of qualified low-income housing buildings are indirect costs required to be capitalized under IRC § 263A. Such costs therefore are to be included in the eligible basis of the low-income building, for the purpose of calculating LIHTCs or for the purpose of receiving a sub-award under the TCE program.

¹⁵ See Treas. Reg. § 1.263(a)-2(f)(2)(ii).

¹⁶ See *Blitzer v. U.S.* 231 Ct. Cl. 236, 684 F.2nd 874, 92-2 U.S. Tax Cas. (CCH) P 9465, 50 A.F.T.R. 2d 82-5293 (1982), which provided that "[t]o the extent that the services are ancillary to the acquisition or construction of the apartment units the expenditure is capital, amortizable over the life of such assets. This would clearly include such services as the making of the feasibility study...."

¹⁷ See *Tunnel v. U.S.*, 367 F. Supp. 567, 74-1 U.S. Tax Cas. (CCH), P 9122, 33 A.F.T.R.2d 74-362 (D. Del.1973), judgment vacated, 512 F. 2nd 1192, 75-1 U.S. Tax Cas. (CCH) P 9306, 35 A.F.T.R.75-995 (3d Cir. 1975) which provided that the cost of establishing boundaries is depreciable as the boundaries would be valueless if the project ceased to exist.

¹⁸ See *Shainberg v. C.I.R.*, 33 T.C. 241, 1959 WL 935 (T.C. 1959), acq.1960-2 CB 3, providing that accounting costs incurred as part of construction and development of a commercial real estate project were "of the type [that] are an integral part of the total cost of the new building" and therefore depreciable.

West Haven Senior Village OIG Audit response to DCA

Property appraisal - \$6,500: This expense is related to an appraisal for construction financing through USDA's 538 Loan Program, Lancaster Pollard being the prospective construction lender, and is includable in eligible basis. Although the commitment letter says permanent financing, the USDA 538 Loan Program is a guarantee program, whereby USDA guarantees the lender repayment of 90% of the loan, should the borrower default. Because the loan was to be used to construct the complex, and the appraisal used to validate the construction loan amount, the cost is eligible basis cost.

Market Study - \$8,920: OIG appears to incorrectly conclude that a market study is commissioned for purposes of acquiring land. It is common practice for an owner to research publicly available census/demographic data and population trends for a potential site and/or commission an appraiser to conduct a land appraisal to further determine local economic forces and property values. Said research was conducted by the owner prior to executing a contract to purchase a given property, or ordering a market study conducted by a third-party analyst. West Haven's partners satisfied itself as to the desirability of the local demographics and population trends, and secured property control on 10-11-07. Notably, the market study was commissioned in May 2008, the market study update was commissioned in August 2009, and the \$420 and \$3,500 to Novogradac was expended in June 2008. These Market Study fees are a necessary and required expense that informs the developer of feasibility of constructing a proposed unit mix, unit size, unit count and unit/project amenities that would be most beneficial. These types of costs are inherently facilitative amounts specified in Treasury Regulation Section 1.263(a)-2(f)(2)(ii) as costs that need to be capitalized and included in eligible basis.

Boundary and Topographical Survey - \$7,675: A boundary survey provides not only the perimeter of a property, but is also used to establish set-backs for constructing buildings and other improvements. As the Owner is not a land speculator, and only surveyed the property for its use in developing and constructing the buildings and improvements, the partnership argues that this cost is 100% includable in eligible basis.

Topographical surveys are conducted specifically to assist in architectural and engineering design, and ultimately construction of the buildings and improvements. Thus, topo survey of \$6,250 (= \$5,500 + \$750) is includable in eligible basis.

Drainage easements of \$175 (\$100+\$75) were required as part of the construction plans, and as such, are eligible basis cost.

Real Estate Attorney - \$69,725: Based on the summary provided to us by DCA, it appears OIG is excluding nearly 100% of legal from eligible basis, concluding that it is all organizational and partnership cost not includable in the project's basis. The partnership does not understand, nor agree, with that

conclusion. The legal fees related to construction financing should be included in eligible basis. These type of legal fees are inherently facilitative amounts included in amounts that must be capitalized under Treasury Regulation Section 1.263(a)-2(f)(ii).

Inarguably the 1602 funds were used to construct the improvements, and as such, all professional fees related to the loan are included in eligible basis. Accordingly, the partnership provided DCA with a detailed breakdown of the total legal costs of \$84,344, which showed that \$14,619 was ineligible basis cost, thus leaving \$69,725 as eligible basis cost.

Accounting - \$12,800: Regarding accounting costs, the Internal Revenue Code Section 263(A), the Regulations issued thereunder and the IRS Audit Technique Guide all conclude *“Costs incurred during the construction period to account for the costs of construction are indirect costs that directly benefit, or are incurred by reason of, the taxpayer’s improvement and, therefore, are capitalized to the basis of the property improved under IRC 263 (a) and 263A. The accounting costs should be allocated among the property improved, and to the extent the cost of the improved property is includable in eligible basis, the improved property’s allocated share of the accounting costs are also includable in eligible basis. Accounting costs include, for example, accounting for costs according to the construction contract, securing advances from a construction loan or submitting documentation to HUD for reimbursement.”* Clearly 1602 Exchange provided construction financing for the project. Accordingly, the \$2,500 expense for the 30% Test is specific to construction financing and is eligible basis. The \$7,500 expense for project’s cost certification is directly associated with accounting for costs according to the construction contract and securing advances from the construction financing, and therefore is included in eligible basis. Also, the tax returns filed during construction for 2010 (\$675) are apportioned to eligible basis per the attached calculation.

The \$2,800 cost associated with the 10% Test is specific to the allocation of tax credits, and is therefore, ineligible basis cost.

Appendix 4
 Georgia Department of Community Affairs Response

West Haven - adjustments to Eligible Basis

TDC per Cost Cert	\$	5,337,160.00	
Eligible Basis per Cost Cert	\$	4,773,473.00	
<u>Reductions to original Eligible Basis</u>			
Ineligible cost per DCA	\$	(82,627.00)	
Accounting - 10% Test	\$	(2,800.00)	
Subtotal Reductions	\$	(85,427.00)	
Temp Adjusted Eligible Basis	\$	4,688,046.00	
Proration of Accounting Fees			
TDC per Cost Cert	\$	5,337,160.00	
Less 2009/2010 Tax Returns	\$	(675.00)	
Subtotal	\$	5,336,485.00	A
Temp Adjusted Eligible Basis	\$	4,688,046.00	
Less 2009/2010 Tax Returns	\$	(675.00)	
Subtotal	\$	4,687,371.00	B
Proportion of Eligible Basis to TDC		87.84%	= B / A
Eligible basis portion of 2009/2010 tax returns	\$	592.90	C
Final Adjusted Eligible Basis	\$	4,688,638.90	= B + C

Terrace at Edinburgh OIG Audit response to DCA

Property appraisal - \$2,500: This expense is actually market study update commissioned on 8-6-09 – please see additional commentary below regarding “Market Study”.

Market Study - \$5,000: OIG appears to incorrectly conclude that a market study is commissioned for purposes of acquiring land. It is common practice for an owner to research publicly available census/demographic data and population trends for a potential site and/or commission an appraiser to conduct a land appraisal to further determine local economic forces and property values. Said research was conducted by the owner prior to executing a contract to purchase a given property, or ordering a market study conducted by a third-party analyst. Terrace’s owner satisfied itself as to the desirability of the local demographics and population trends, and secured property control on 4-4-08. Notably, the market study was commissioned on 5-16-08, and the market study update was commissioned on 8-6-09. Market studies are a necessary and required expense that informs the developer of feasibility of constructing a proposed unit mix, unit size, unit count and unit/project amenities that would be most beneficial. For that reason, the partnership argues that a market study is a cost associated with residential units and 100% of the cost should be included in eligible basis for the development. Market studies are inherently facilitative amounts included in amounts that must be capitalized under Treasury Regulation Section 1.263(a)-2(f)2(ii).

Boundary and Topographical Survey - \$11,168: A boundary survey provides not only the perimeter of a property, but is also used to establish set-backs for constructing buildings and other improvements. As the Owner is not a land speculator, and only surveyed the property for its use in developing and constructing the buildings and improvements, the partnership argues that this cost is 100% includable in eligible basis.

Topographical surveys are conducted specifically to assist in architectural and engineering design, and ultimately construction of the buildings and improvements. Thus, topo survey of \$6,800 is includable in eligible basis.

As-built survey is conducted to verify the actual location of constructed buildings and other improvements, and thus \$5,500 is includable in eligible basis.

Wetlands Delineation is necessary to determine if the land is suitable for the construction of the contemplated improvements. Because this delineation will necessarily need to be redone contemporaneously when the depreciable asset is replaced (because wetland boundaries can and do change over time), then the \$2,400 cost incurred for the delineation is depreciable and is includable in eligible basis.

Real Estate Attorney - \$23,827: Based on the summary provided to us by DCA, it appears OIG is excluding nearly 100% of legal from eligible basis (all but \$185), concluding that it is all organizational and partnership cost not includable in the project's basis. The partnership does not understand, nor agree, with that conclusion. The legal fees related to construction financing should be included in eligible basis. These type of legal fees are inherently facilitative amounts included in amounts that must be capitalized under Treasury Regulation Section 1.263(a)-2(f)2(ii).

Inarguably the 1602 funds were used to construct the improvements, and as such, all professional fees related to the loan are included in eligible basis. Accordingly, the partnership provided DCA with a detailed breakdown of the total legal costs of \$24,012, which showed that \$7,039.43 was ineligible basis cost, thus leaving \$16,972.57 as eligible basis cost.

Accounting - \$12,575: Regarding accounting costs, the Internal Revenue Code Section 263(A), the Regulations issued thereunder and the IRS Audit Technique Guide all conclude *"Costs incurred during the construction period to account for the costs of construction are indirect costs that directly benefit, or are incurred by reason of, the taxpayer's improvement and, therefore, are capitalized to the basis of the property improved under IRC 263 (a) and 263A. The accounting costs should be allocated among the property improved, and to the extent the cost of the improved property is includable in eligible basis, the improved property's allocated share of the accounting costs are also includable in eligible basis. Accounting costs include, for example, accounting for costs according to the construction contract, securing advances from a construction loan or submitting documentation to HUD for reimbursement."* Clearly 1602 Exchange provided construction financing for the project. Accordingly, the \$3,500 expense for the 30% Test is specific to construction financing and is eligible basis. The \$7,500 expense for project's cost certification is directly associated with accounting for costs according to the construction contract and securing advances from the construction financing, and therefore is included in eligible basis. Also, the tax returns filed during construction for 2009 (\$675) and 2010 (\$675) are apportioned to eligible basis per the attached calculation. Lastly, the \$225 cost for preparing the General Partner's 2010 tax return is not includable in eligible basis.

Appendix 4
 Georgia Department of Community Affairs Response

Terrace at Edinburgh - adjustments to Eligible Basis

TDC per Cost Cert	\$	9,244,138.00
Eligible Basis per Cost Cert	\$	8,209,920.00

Reductions to original Eligible Basis

Boundary survey/plat - H&C Surveying	\$	(600.00)
Boundary survey/land legal desc - H&C Surveying	\$	(200.00)
Legal - Kutak	\$	(1,007.50)
Legal - Kutak	\$	(596.93)
Legal - Kutak	\$	(1,385.00)
Legal - Kutak	\$	(4,050.00)
Accounting - GP tax return	\$	(225.00)
Title & Recording Fees	\$	(790.00)
Subtotal Reductions	\$	(8,854.43)

Temp Adjusted Eligible Basis	\$	8,201,065.57
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Proration of Accounting Fees

TDC per Cost Cert	\$	9,244,138.00
Less 2009/2010 Tax Returns	\$	(1,350.00)
Subtotal	\$	9,242,788.00

A

Temp Adjusted Eligible Basis	\$	8,201,065.57
Less 2009/2010 Tax Returns	\$	(1,350.00)
Subtotal	\$	8,199,715.57

B

Proportion of Eligible Basis to TDC		88.71%	= B / A
Eligible basis portion of 2009/2010 tax returns	\$	1,197.65	C

Final Adjusted Eligible Basis	\$	8,202,263.22	= B + C
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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

Donna Joseph
Department of the Treasury
Office of Inspector General
Washington, DC 20005

Dear Ms. Joseph:

Thank you for the opportunity to review and comment on the Office of the Inspector General's draft report titled "Audit of Georgia Department of Community Affairs' (DCA) Payment Under 1602 Program."

The report finds makes four recommendations which the Office of the Fiscal Assistant Secretary's (OFAS) responds to below.

With respect to the first recommendation, OFAS will work with DCA to obtain sufficient support demonstrating that \$170,500 in reimbursements for erroneously charged legal fees were used for other project costs. OFAS will take appropriate action regarding any amounts that cannot be supported.

With respect to the second and third recommendations, federal tax law governs the determination regarding what costs are required to be capitalized into the basis of property. Such determinations are highly dependent on particular facts and circumstances. OFAS will work with tax counsel and with DCA to determine whether or not certain costs were properly included in the basis of the Section 1602 property. If OFAS concludes that the costs questioned by the OIG were not properly included in basis it will require DCA, in accordance with the Section 1602 recapture guidance, to make reasonable efforts to obtain reimbursement from the project owner.

Finally, with respect to the fourth recommendation, OFAS will seek support from DCA for its actual costs to perform asset management functions and compare those costs to the fees collected from subawardees.

We appreciate your work on the report and value your feedback.

Sincerely,

A handwritten signature in black ink, appearing to read "D. Lebryk", written over a faint, large watermark of the word "DRAFT" in the background.

David A. Lebryk
Fiscal Assistant Secretary

Appendix 6
Major Contributors To This Report

Theresa Cameron, Audit Director
Nick Slonka, Audit Manager
Paul Harris, Supervisory Program Analyst
Gerald Kelly, Auditor-In-Charge
Usman Abbasi, Referencer

Department of the Treasury

Deputy Secretary
Fiscal Assistant Secretary
Deputy Assistant Secretary, Fiscal Operations and Policy
Director, Office of Grants and Asset Management
Director, Office of Housing and Energy
Office of Strategic Planning and Performance Improvement
Office of the Deputy Chief Financial Officer, Risk and Control
Group

Office of Management and Budget

OIG Budget Examiner

Georgia Department of Community Affairs

Executive Director

United States Senate

Committee on Banking, Housing, and Urban Affairs
Committee on Finance
Committee on Homeland Security and Governmental Affairs

United States House of Representatives

Committee on Oversight and Reform
Financial Services Committee



Treasury OIG Website

Access Treasury OIG reports and other information online:

<http://www.treasury.gov/about/organizational-structure/ig/Pages/default.aspx>

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Gulf Coast Restoration Hotline – Call toll free: 1-855-584.GULF (4853)

Email: Hotline@oig.treas.gov

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