

# PROPERTY COMPLIANCE REPORT

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## Revenue Procedure 2005-37 Provides Guidance for Complying with the IRS Good Cause Protection Requirement

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On July 29, 2004, the Internal Revenue Service (IRS) released Revenue Ruling 2004-82, which interprets Internal Revenue Code (IRC) Section 42 as requiring that tenants not be evicted for other than good cause during the entire 30-year extended use commitment. On June 21, 2005, the IRS released Revenue Procedure 2005-37, which clarifies what documentation needs to be executed to meet the good cause requirement and for the investor to continue claiming low-income housing tax credits (LIHTCs).

### Background: Requirements of Section 42

IRC §42(h)(6)(A) states that tax credits are not allowed unless an extended use commitment is in effect as of the end of the taxable year (for properties allocated credit after 1989). IRC §42(h)(6)(B) requires that the commitment contain a number of items, such as income eligibility requirements and rent restrictions during the period. IRC §42(h)(6)(D) states that the minimum extended use period the state may require is 30 years from the first tax credit year. IRC §42(h)(6)(B)(i) states that the regulatory agreement must prohibit the eviction or "termination of tenancy" for other than good cause. One issue is whether this good cause protection was meant only for the three-year period following foreclosure or the qualified contract purchase, as industry participants previously believed, or whether the protection must be in place for the entire 30-year extended use commitment.

### Rev. Rul. 2004-82

Question #5 in Revenue Ruling 2004-82 addressed the issue and noted that the good cause protection language in §42(h)(6)(B)(i) was instituted by Congress in 1990 and §42(h)(6)(E)(ii) already had the requirement of good cause protection for the three years following foreclosure or qualified contract purchase. Therefore, the IRS

concluded that Congress intended to require good cause protection to all tenants for the entire 30-year period. The revenue ruling further stated that regulatory agreements must specifically state this requirement.

### Rev. Proc. 2005-37

Revenue Procedure 2005-37 indicates that the good cause eviction language requirement in regulatory agreements is satisfied when the regulatory agreement has general language that states the project must comply with Section 42. A new regulatory agreement must be executed if this general language does not exist. In the more typical case, where the regulatory agreement contains general language about complying with Section 42 requirements, the following must be completed:

- The state agency must notify each owner in writing of the requirement before December 31, 2005;
- The owner must certify to the state annually (as part of the normal annual certification), that the requirement has been met for that year; and
- If the owner did not meet the requirement, the state agency must report the noncompliance to the IRS on Form 8823.

If the regulatory agreement does not contain the above requirements, IRC §42(h)(6)(J) indicates that credits cannot be recaptured for any year prior to the date it is determined that the regulatory agreement is deficient and that there is a one-year period to execute the requirement in order to continue claiming credits. However, the IRS is not applying this provision in the case of Revenue Procedure 2004-82 because it states that if the regulatory agreement is deficient and not corrected, not only are future credits lost but they are lost for all previous years as well. The revenue procedure also re-states this position. It is not clear whether the IRS simply made a mistake in

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reading that provision of Section 42 or whether it based its conclusion on the interpretation of the intent of Congress (as opposed to the actual wording used) or from other unknown guidance. In any event, the conservative response is to comply with the revenue ruling, even if the IRS' interpretation of the consequences of not complying appears to differ from the Internal Revenue Code.

## Good Cause

The remaining issue is what the good cause protection requirement means. First, there is no clear definition of "good cause," either at the federal or state level, that covers all situations. Some federal housing programs do detail the definition vaguely. Many or all state allocating agencies have not specifically addressed their preferred definition of good cause. Unless the states or the IRS/HUD address the definition, the courts will decide the issue, either in accordance with other state housing laws or in accordance with the personal opinion of a deciding judge. In some states and in some housing programs, good cause protection has been interpreted to mean that a tenant can not be evicted unless there is failure to pay rent or has committed serious violations (for example, see 24 CFR 966.4(1)(2) for a list of possible reasons for eviction from federal public housing programs).

The amount of time needed to evict a tenant, even for nonpayment of rent, will differ from locality to locality. Needless to say, if this type of interpretation were to apply to all tax credit properties, the quality of living would be expected to decline substantially because properties would have a difficult time evicting tenants who are threatening or disruptive. For tax credit properties, it could also result in a decrease in a property's revenue through greater damage to units or through the amount of time needed to evict for nonpayment of rent. Of course, if a state allocating agency publishes a list of legitimate reasons for eviction, the problem may not be eliminated because a tenant attorney could interpret the list to be all-encompassing, meaning that a violation not specifically stated on the list can never be grounds for eviction.

California (reportedly at the urging of tenant attorneys) recently decided to require properties to execute specific documents relating to good cause projection in conjunction with the lease. Since the properties already are required to comply with Section 42, the only effect of this additional documentation requirement is to notify the tenants that they have this protection. Therefore, the practical effect is that properties may be less likely to violate the provision if the tenant is aware of the right, or will result in more lawsuits filed by tenants if they perceive the right to have been violated. Not surprisingly, property owners are concerned about the potential cost of fighting lawsuits that in many cases are frivo-

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lous, and therefore may choose or be forced to keep in a property those tenants who are disruptive to other tenants or are violating the terms of the lease.

To make matters more complicated, the question remains: do the words "eviction or termination of tenancy" only mean that a property manager can not evict without good cause or that a property manager can not refuse to renew a lease without good cause? The answer is not clear because it was not specifically defined in the Internal Revenue Code, Revenue Ruling 2004-82, or Revenue Procedure 2005-37. Logically speaking, it would seem that "termination of tenancy" includes refusing to renew a lease. The reason is that if Congress had meant termination of tenancy to refer to eviction, then why would it state the same thing twice: "eviction" OR "termination of tenancy"? Of course, it is possible there was a drafting error and Congress simply stated the same thing twice in a different manner. For federal public housing programs, it appears that the words "termination of tenancy" includes refusal to renew a lease (see 24 CFR 966.4(l)(2)). The issue for tax credit properties has arisen in certain state courts, such as Minnesota, and at least in some cases the ruling was that the property does not have the right to refuse to renew a lease. Unless the issue is addressed specifically by the IRS, it appears that it probably will be interpreted that properties can not refuse to renew a lease without good cause. ❖

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