

Chapter 8 Category 11e Changes in Eligible Basis

Definition

This category is used to report violations associated with the Eligible Basis of a building or any occurrence that result in a decrease in the Applicable Percentage of a building, which is discussed in Chapter 9. This chapter addresses noncompliance affecting the Eligible Basis.

The low-income housing credit amount is based on certain costs associated with a building (*eligible basis*) and the portion of the building (*applicable fraction*) that low-income households occupy. The cost of acquiring and rehabilitating, or constructing a building constitutes the building's *Eligible Basis*. The portion of the Eligible Basis attributable to low-income units is the building's *Qualified Basis*. The Qualified Basis is multiplied by a factor (*Applicable Percentage*) so that the credit is limited to 70 percent or 30 percent of the Qualified Basis.¹ In summary, the annual credit is:

$$\text{Eligible Basis} \times \text{Applicable Fraction} = \text{Qualified Basis}$$

$$\text{Qualified Basis} \times \text{Applicable Percentage} = \text{Annual Credit}$$

Generally, under IRC §42(f)(1), the annual credit can be claimed for 10 taxable years, beginning with the taxable year in which the building is placed in service; or, at the election of the taxpayer, the succeeding year². Under IRC §42(f)(2)(A), there is a special rule for the first year of the credit period. Any reduction in the credit allowable for the first year of the credit period by reason of the rule is allowable for the first taxable year following the credit period. (See IRC §42(f)(2)(B).) In addition, under IRC §42(f)(3), if the qualified basis as of any taxable year in the 15-year compliance period (after the first year) exceeds the qualified basis as of the close of the first year of the credit period, then the applicable percentage applied to the excess Qualified Basis is two-thirds of the Applicable Percentage that would otherwise apply.

A cost incurred in the construction of a low-income housing building is includable in Eligible Basis under IRC §42(d)(1) if the cost is:

1. Included in the adjusted basis of depreciable property subject to IRC §168 and the property qualifies as residential rental property under IRC §103, or
2. Included in 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, or
3. Included in the adjusted basis of depreciable property under IRC §168 (other than 1 or 2 above) that is used throughout the tax year in providing any community service facility, as described in IRC §42(d)(4)(C)(iii).

¹ IRC §42(b)(2)(B).

² IRC §42(f)(1)(B).

Eligible Basis may include the cost of facilities for use by tenants to the extent there is no separate fee for using the facilities and the facilities are available on a comparative basis to all tenants. It may also include the cost of amenities if the amenities are comparable to the cost of amenities in other units.

Example 1: Laundry Room and Coin Operated Washers and Dryers

An owner included the cost of a building housing a laundry facility in the eligible basis. For security reasons, the room kept locked, but every household has a key and has access at any time. The owner installed coin operated washers and dryers.

The owner can include the cost of the building in eligible basis; i.e., all tenants have access to the facility. However, because the tenants must pay an additional fee to use the washers and dryers, the appliances should not be included in eligible basis.

Commercial Use

Eligible Basis cannot include any parts of the property used for commercial purposes. Residential rental property may qualify for the credit even though a portion of the building in which the residential rental units are located is used for a commercial use; i.e., commercial office space. No portion of the cost of such nonresidential rental property may be included in eligible basis.

The cost of mixed-use property; i.e., commercial and the residential rental units, must be allocated according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the qualifying residential rental units and the nonqualifying commercial property. Proposed Treas. Reg. §1.103-8(b)(4)(v)(c) provides two examples of methods generally considered to be reasonable when allocating costs:

1. Allocating the cost of common elements based on the ratio of the total floor space in the building that is to be used for nonqualifying property to all other floor space in the building is generally a reasonable method. For example, in the case of a mixed-use building where a part is to be used for commercial purposes, the cost of the building's foundation must be allocated between the commercial portion and residential rental units based on floor space.
2. In the event that an allocation of costs based on floor space does not reasonably reflect the relative benefits to be derived (directly or indirectly) by the residential rental units and the nonqualifying property, then another method must be used. For example, based on the floor space computation, a building is 50 percent residential rental property and 50 percent commercial space used as a shopping center. However, only 25 percent of the parking lot space will be used to service tenants of the residential units. The cost of constructing the parking lot must be allocated based on the proportion of parking lot used by the tenants of the residential units (25%) and for the commercial portion of the building (75%).

Federal Grants

Under IRC §42(d)(5)(A), the Eligible Basis must be reduced if a federal grant is made to fund the cost of a building. Federal grants are funds which originate from a federal source and which do not require repayment. The Eligible Basis of the building must be reduced by the amount of the grant that is federally funded. The Eligible Basis is

reduced in the year the grant is made for the building and all subsequent years in the compliance period. A building is out of compliance as of the date the federal grant is made if the Eligible Basis is not reduced and the reduction would have resulted in a decrease in qualified basis.

Example 1: Grant Used to Replace Property Included in Eligible Basis

An owner constructed an LIHC building that was placed in service on September 1, 2003, and 2003 is the first year of the credit period. The owner included the cost of kitchen appliances installed in the low-income units' kitchens; i.e., the dishwashers, refrigerators, and stoves.

During 2010, the owner replaces the worn out appliances using funds received from a federally sourced grant. The eligible basis must be reduced for the amount of grant used to purchase and install the new appliances.

Eligible Basis is not reduced if the proceeds of a federal grant are used as a rental assistance payment under section 8 of the United States Housing Act of 1937, a qualifying program³ of rental assistance administered under section 9 of the United States Housing Act of 1937 or any comparable rental assistance program as designated by the IRS.⁴

Under Rev. Rul. 2002-65, rental assistance payments made to a building owner on behalf or in respect of a tenant under the Rent Supplement Payment program (12 U.S.C. §1701s) or the Rental Assistance Payments program (12 U.S.C. §1715z-1(f)(2)) are not grants made with respect to a building or its operation under IRC §42(d)(5). Thus, proceeds from these programs do not require a reduction of Eligible Basis.

Buildings Placed in Service On or Before July 30, 2008

If, during any taxable year of the 15-year compliance period of a low-income building placed in service on or before July 30, 2008, a grant is made with respect to any building *or the operation* thereof, and any portion of such grant is funded with Federal funds (whether or not includible in gross income), the eligible basis of such building and all succeeding taxable years shall be reduced by the portion of such grant that is so funded.

Example 2: Federally-Funded Grant Used to Operate LIHC Building

An owner constructed an LIHC building that was placed in service on September 1, 1998, and 1998 is the first year of the credit period. On June 25, 2009, the owner receives a grant funded with Federal funds to buy computers that will be used by the office staff to operate the LIHC building.

³ *See Treas. Reg. §1.42-16(c) for definition of qualifying residential assistance program.*

⁴ *Treas. Reg. §1.42-16.*

The eligible basis of the building must be reduced by the amount of the grant used to purchase the computers. The reduction in eligible basis is a credit recapture event under IRC §42(j).

Buildings Placed in Service After July 30, 2008

IRC §42(d)(5)(A) was amended as part of the Housing Assistance Tax Act of 2008⁵ and now provides that the eligible basis of a building shall not include any costs financed with the proceeds of a federally funded grants. Federally-sourced grants used for the operation of an LIHC building do not require a reduction of the eligible basis.

Example 3: Federally-Funded Grant Used to Operate LIHC Building

An owner constructed an LIHC building that was placed in service on September 1, 2008, and 2008 is the first year of the credit period. On June 25, 2009, the owner received a grant funded with Federal funds to buy computers that will be used by the office staff to operate the LIHC building. No reduction of the building's eligible basis is required.

Funds not Considered Grants

None of the following⁶ shall be considered a grant made with respect to a building (eligible basis) or its operation:

1. Rental assistance under section 521 of the Housing Act of 1949,
2. Assistance under section 538(f)(5) of the Housing Act of 1949,
3. Interest reduction payments under section 236 of the National Housing Act,
4. Rental assistance under section 202 of the Housing Act of 1959,
5. Rental assistance under section 811 of the Cranston-Gonzalez National Affordable Housing Act,
6. Modernization, operating and rental assistance pursuant to section 202 of the Native American Housing Assistance and Self-Determination Action of 1996,
7. Assistance under title IV of the Stewart B. McKinney Homeless Assistance Act,
8. Tenant-based rental assistance under section 212 of the Cranston-Gonzalez National Affordable Housing Act,
9. Assistance under the AIDS Housing Opportunity Act,
10. Per diem payments under section 2012 of title 38, United State Code,

⁵ *See section 3003(d) of the Act.*

⁶ *From the explanation of the Housing Assistance Tax Act of 2008 prepared by the Joint Committee on Taxation.*

11. Rent supplements under section 101 of the Housing and Urban Development Act of 1965,
12. Assistance under section 542 of the Housing Act of 1949, and
13. Any other ongoing payment used to enable the property to be rented to low-income tenants.

Loans Funded with Federal Grants

No basis reduction is required for loans made to owners of qualified low-income housing projects from the proceeds of federally-funded grants.

Resident Managers and Maintenance Personnel

Residential rental property, for low-income housing credit purposes, includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project.⁷ Under Treas. Reg. §1.103-8(b)(4), facilities that are functionally related and subordinate to residential rental projects are considered residential rental property. Treas. Reg. §1.103-8(b)(4)(iii) provides that facilities functionally related and subordinate to residential rental projects include facilities for use by the tenants, such as swimming pools and similar recreational facilities, parking areas, and other facilities reasonably required for the project. The examples included in Treas. Reg. §1.103-8(b)(4)(iii) of facilities reasonably required by a project specifically include units for resident managers or maintenance personnel.

Rev. Rul. 92-61 holds that the adjusted basis of a unit occupied by a full-time resident manager is included in the Eligible Basis of a qualified low-income building under IRC §42(d)(1), but the unit is excluded from the applicable fraction under IRC §42(c)(1)(B) for purposes of determining the building's Qualified Basis. The unit is considered a facility reasonably required for the benefit of the project and the resident manager and/or maintenance personnel are not required to be income qualified. If the owner is charging rent for the unit, the Service may determine that the unit is not reasonably required by the project because the owner is not requiring the manager to occupy the unit as a condition of employment.⁸ Later conversion of the unit into a residential rental unit will not change the Eligible Basis.

Security Officers

For deterring crime in and around an LIHC project, it may be necessary and reasonably required by the project for the owner to provide a security presence by leasing a residential rental unit to a Security Officer, who may be an off-duty law enforcement officer, security person in private industry, or *other qualified person*. In return for performing safety and security services that contribute to the management and control of the LIHC property, the Security Officer may be provided an on-site unit.

Typically, a security officer provides on-site presence during the evening and nighttime hours to respond to any emergencies and disturbances, and to respond to residents' requests for assistance, including complaints, unauthorized visitors, improper parking, and unauthorized use of community facilities. Other encouraged activities may include conducting resident criminal background investigations,

⁷ H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

⁸ The rental value of the housing provided to a full-time resident manager required to live onsite as a condition of employment is considered to be wages. In this situation, however, these wages are not taxable income and are not subject to employment taxes. See IRC §§ 119(a)(2) and 3121(a)(19).

neighborhood watch programs, and educational activities for primary school-age residents.

The adjusted basis of the unit occupied by a security officer is includable in the Eligible Basis of the building under IRC §42(d)(1) as a facility reasonably required for the benefit of the project. However, the unit is excluded from the Applicable Fraction of the building under IRC §42(c)(1)(B). The security officer is not required to be income qualified. If the owner is charging rent for the unit, the Service may determine that the unit is not reasonably required by the project because the owner is not requiring the security officer to occupy the unit as a condition of employment. (See footnote 4.) Later conversion of the unit into a residential rental unit will not change the Eligible Basis.

Model Units

Model units are maintained primarily during a project's rent-up period to show prospective tenants the desirability of the project's units. If the project maintains full occupancy thereafter, the model can be dismantled and the unit rented. This makes economic sense because model units do not generate rental income for a project owner. However, at a large apartment complex, it is standard industry practice to continuously maintain a model unit for marketing purposes and to be competitive. The unit can be shown immediately to prospective tenants at any time without disturbing tenants in occupied units. By increasing competitiveness, model units contribute to the economic viability of the LIHC project

A model unit is considered a rental unit under IRC §42; see e.g., PLR 9330013, Issue # 3, July 30, 1993. Therefore, a model unit's cost is included in the building's eligible basis and in the denominator of the applicable fraction when determining a building's qualified basis.

Example 1: Model Unit Never Rented as LIHC Unit

An owner included the cost of a model unit in the eligible basis for a 100% LIHC building with 49 units (other than the model unit). The owner anticipates that the model unit will be maintained throughout the compliance period and will never be rented to an income qualified household.

The cost of the unit should be included in the building's eligible basis. However, the maximum applicable fraction that the owner can claim is 49/50, or 98%.

Example 2: Model Unit Converted to LIHC Unit

An owner included the cost of a model unit in the eligible basis for a 100% LIHC building with 49 units (other than the model unit). The owner used the unit as a model for the first three years, but in April of year four of the compliance period, the unit was rented to an income qualified tenant.

The cost of the unit should be included in the building's eligible basis and in years one through three of the credit period, the maximum applicable fraction that the owner can claim is 49/50, or 98%. In year four and

subsequent years, the owner will follow the rules outlined in IRC §42(f)(3) for increases in qualified basis; i.e., the “2/3 credit” rules.

**Community
Service
Facilities**

As part of the Community Renewal Tax Relief Act of 2000, a new IRC §42(d)(4)(C) was added to include property used to provide services to nontenants as part of the eligible basis used for determining the LIHC amount.

There are specific requirements:

1. The property must be located in a qualified census tract. (See former IRC §42(d)(5)(C)(ii) for buildings placed in service prior to July 31, 2008, and IRC §42(d)(5)(B)(ii) for buildings placed in service after July 30, 2008.)
2. The property must be subject to the allowance for depreciation and not otherwise accounted for.
3. The property must be used throughout the taxable year in providing any community service facility.
4. Under IRC §42(d)(4)(C)(iii), a community service facility must be designed to service primarily individuals whose income is 60 percent or less of the area median income. According to Rev. Rul. 2003-77, the requirement is satisfied if the following conditions are met:
 - The facility must be used to provide services that will improve the quality of life for community residents; i.e., day care, career counseling, literacy training, education (including tutorial services), recreation, and out-patient clinical health care.
 - The owner must demonstrate that the services provided at the facility will be appropriate and helpful to individuals in the area of the project whose income is 60 percent or less of area median income. This may, for example, be demonstrated in the market study required under IRC §42(m)(1)(A)(iii), or a similar study.
 - The facility must be located on the same tract of land as one of the buildings that comprises the qualified low-income housing project.
 - If fees are charged for the services provided, they must be affordable to individuals whose income is 60 percent or less of the area median income.

For buildings placed in service on or before July 30, 2008, the increase in the adjusted basis of any building that includes the community service facility cannot exceed 10 percent of the eligible basis of the qualified low-income housing project of which it is a part. All community service facilities that are part of the same qualified low-income housing project are treated as one facility. For buildings placed in service after July 30, 2008, the allowable community service facility cannot exceed (1) 25 percent of the eligible basis of the qualified low-income housing project of which it is a part and does not to exceed \$15,000,000 plus (2) 10 percent of the eligible basis of the project in excess of (1) above.

Example 1: LIHC Project Includes Community Service Facility

An owner received a credit allocation in 2001. The project is located in a qualified census tract and consists of six residential rental buildings. There are five floors in each building with 5,000 square feet each, for a total of 25,000 square feet per building. The square footage for the entire project is 150,000 square feet. The cost per square foot is \$100 and, assuming that the costs are not disproportionately distributed in the building, the total Eligible Basis is \$15,000,000. The cost of any community service facilities included in Eligible Basis is limited to $\$15,000,000 \times .10 = \$1,500,000$.

The entire first floor of one building is a day care facility for children of residents in the community. Half of the first floor of a second building is a facility used to provide activities and medical services for seniors in the community. The combined square footage of the two facilities is $5,000 + 2,500 = 7,500$ square feet. The cost is $\$100 \times 7,500$ square feet = \$750,000. Since the combined cost of the two facilities is less than 10% of the total Eligible Basis, the entire cost of the facilities is included in Eligible Basis.

In Compliance

The Eligible Basis of a building is determined at the end of the first year of the credit period. As long as there is no reduction in the Eligible Basis amount upon which the credit is based, the property is in compliance.

Out of Compliance

The Eligible Basis of a property is reduced when space that originally qualified as residential rental property changes character or space that was originally designated for use by qualified tenants is no longer available to them. Typical noncompliance may involve converting common areas to commercial property, or charging fees for facilities (such as a swimming pool), the cost of which were included in the Eligible Basis.

The date of noncompliance is the specific date the residential space is converted to commercial space or when a fee is charged.

Back in Compliance

Common areas and tax credit rental units may be converted to commercial space. Whether the cost of these converted spaces can be restored to Eligible Basis by changing the properties back into common areas or tax credit rental units has not been determined. In these instances, the state agency should not report the building back in compliance. Instead, the state agency should contact the IRS National Office LIHC Program Analyst for instructions.

References

1. IRC §42(d)
2. Treas. Reg. §1.42-16
3. Proposed Treas. Reg. §1.103-8(b)(4)(iii)
4. Proposed Treas. Reg. §1.103-8(b)(4)(v)(c)
5. Rev. Rul. 92-61, 1992-2 C.B. 7
6. Rev. Rul. 2002-65, 2002-43 I.R.B. 729
7. Rev. Rul. 2003-77, 2003-29 I.R.B. 75
8. Rev. Rul. 2004-82, 2004-35 I.R.B. 350