

Chapter 11
Category 11g
Gross Rent(s) Exceed Tax Credit Limits

Definition

This category is used to report noncompliance with the rent restrictions outlined in IRC §42(g)(2). Items to consider when determining whether the rent is correctly restricted include services provided, revisions to HUD income limits, rent calculation methods, changes in the tenant's income, Section 8 tenants, Rural Housing Service (formerly FmHA) rents, supportive services, and deep rent skewing.

Determination on a Tax Year Basis

Under IRC §42(g)(2)(A), a unit qualifies as an LIHC unit when the gross rent does not exceed 30 percent of the imputed income limitation applicable to such unit under IRC §42(g)(2)(C). The income limit for a low-income housing unit is based on the minimum set-aside election made by the owner under IRC §42(g)(1), but is never less than the income limit applicable for the earliest period the building (which contains the unit) was included in the determination of whether the project is a qualified low-income housing project.

Because the Code defines the maximum gross rent as a percentage of the imputed income limitation (which is an annual amount) and the qualified basis for computing the credit is determined as of the close of the owner's taxable year, state agencies must determine whether the owner is in compliance with the gross rent limits on a tax year basis.

Example 1: Gross Rent Limits on a Tax Year Basis

An LIHC property owner elected the 40-60 minimum set-aside and is a calendar year taxpayer. 2006 is the first year of the credit period and the imputed income limit for two bedroom units is \$31,080. The maximum rent, before consideration of fees and allowances, that the owner can charge in calendar year 2006 is $.30 \times \$31,080$, which equals \$9,324.00.

Determination on a Monthly Basis

IRC §42(g)(2)(B) defines gross rent and excludes the following amounts, which are listed here and discussed separately within this chapter:

1. Payments under section 8 or a comparable rental assistance program;
2. Fees paid to the owner by any governmental program of assistance for supportive services; and
3. Rental payments to the owner to the extent the owner makes equivalent payments to the Rural Housing Service under the section 515 program.

IRC §42(g)(2)(B) also requires that the gross rent include any utility allowance "determined by the Secretary after taking into account such determinations under section 8 of the United State Housing Act of 1937." (See Chapter 18 for complete discussion.) For Section 8, tenant rent is the portion of the Total Tenant Payment the tenant pays *each month* to the owner for rent. Tenant rent is calculated by subtracting

the utility allowance from the Total Tenant Payment.¹

Because HUD determines a tenant's rent on a monthly basis, state agencies must determine whether the owner is in compliance with the gross rent limits each month of the owner's current tax year.

Example 1: Gross Rent Limits on a Monthly Basis

As in Example 1 above, an LIHC property owner elected the 40-60 minimum set-aside and is a calendar year taxpayer. The imputed income limit for two bedroom units in 2006 is \$31,080. The maximum rent, before consideration of fees and allowances, that the owner can charge in calendar year is $.30 \times \$31,080$, which equals \$9,324.00. On a monthly basis, the owner can charge, before consideration of fees and allowances, no more than \$777.00, computed as $\$9,324.00 \div 12$ months.

Fees - Provision of Services

Units may be residential rental property notwithstanding the fact that services *other than housing* are provided. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent (Treas. Reg. §1.42-11). A service is optional when the service is not a condition of occupancy and there is a reasonable alternative. Charges for non-optional services such as a washer and/or dryer hookup fee and built-in/on storage sheds (paid month-to-month or a single payment) would always be included within gross rent. No separate fees should be charged for tenant facilities (i.e., pools, parking, recreational facilities) if the costs of the facilities are included in eligible basis. *Assuming they are optional*, charges such as pet fees, laundry room fees, garage, and storage fees may be charged in addition to the rent; i.e., they are not included in the rent computation.

Fees – Condition of Occupancy

Under Treas. Reg. §1.42-11(a)(3), the cost of services that are required as a condition of occupancy must be included in gross rent even if federal or state law required that the services be offered to tenants by building owners.

1. Refundable fees associated with renting an LIHC unit are not included in the rent computation. For example, security deposits and fees paid if a lease is prematurely terminated² are one-time payments that are not considered in the rent calculation.
2. Required costs or fees, which are not refundable, are included in the rent computation. Examples include fee(s) for month-to-month tenancy and renter's insurance.

Fees for preparing a unit for occupancy must not be charged; owners are responsible³ for physically maintaining LIHC units in a manner suitable for occupancy.

Fees - Application Processing

Application fees may be charged to cover the actual cost of checking a prospective tenant's income, credit history, and landlord references. The fee is limited to recovery of the actual out-of-pocket costs. No amount may be charged in excess of the average

¹ HUD Handbook 4550.3, Chapter 5, paragraph 5-26(A)

² Leases commonly include fees for early termination of the rental agreement. The fact that the lease contains terms for this contingency is not indicative of transient use.

³ See IRC §42(i)(3)(B)(i) and Treas. Reg. §1.42-5(g).

expected out-of-pocket costs of checking tenant qualifications at the project. It is also acceptable for the applicant to pay the fee directly to the third party actually providing the applicant's rental history. See PLR 9330013, Issue 1, for an example.

Changes to HUD Income Limits

Rents must be calculated using HUD⁴ income limits. The lowest rents owners will be required to charge (gross rent floor) are based on the income limits in effect when the building is allocated credits, unless the owner elects⁵ (and notifies the housing credit agency of the election) to treat the rent floor as taking effect on the date the building is placed in service. This rule applies to properties receiving credit allocations or determination letters under IRC §42(m)(2)(D) after October 6, 1994. For allocations and determination letters after 1989 and before October 7, 1994, owners and state agencies may use a date based on a reasonable interpretation of IRC §42. Before 1990, the gross rent floor took effect at the time the building was placed in service. See IRC §42(g)(2)(A). If the income limits increase, there is no noncompliance as long as the rents are at or below the maximum rents in effect at that time. However, if the income limits are reduced, the maximum rent charged, as well as the gross rent floor, should be reviewed.

Example 1: HUD Income Limit Reduced (Credit Allocation Date)

The owner elected the 40/60 minimum set-aside on Form 8609. HUD issues reduced income limits effective 1/1/2000. The revised maximum 60% gross rent is \$400, which is *below* the calculated maximum rent floor of \$500 in effect at the time the owner received the credit allocation. The owner has been charging \$450 rent and a \$50 utility allowance. There is no noncompliance; owner may rely on his gross rent floor and continue to charge \$500 in total rent.

Example 2: HUD Income Limit Reduced (Placed-in-Service Date)

The owner elected the 40/60 minimum set-aside on Form 8609 and elected to treat the rent floor as taking effect on the date the building was placed in service on July 12, 1999. HUD then issued reduced income limits effective 1/1/2000. The revised maximum 60% gross rent is \$400, which is *above* the calculated rent floor of \$300 at the time the owner placed the building in service. The owner *may* charge rent of \$350 and a \$50 utility allowance, for a total of \$400.

Calculation Methods

Pre-1990: Gross rent for properties receiving tax credit allocations or bond-financed buildings placed in service before January 1, 1990 and for which the election⁶ to determine rents based on number of bedrooms was not made, may not exceed thirty percent (30%) of the HUD-determined median income limit adjusted for the actual number of people in the household for the area in which the property is located. Under this method, the maximum allowable rent varies with the number of individuals occupying the unit. This is the method used prior to the Revenue Reconciliation Act of 1989.

⁴ Owners have 45 days to implement revised income limits after they are published by HUD or HUD's effective date for the new list, whichever is later. See Rev. Rul. 94-57, 1994-2 C.B. 5.

⁵ See Rev. Proc. 94-57, 1994-2 C.B. 774.

⁶ See Rev. Proc. 94-9, 1994-1 C.B. 555.

Post-1989: For properties receiving tax credit allocations or placing bond-financed buildings in service after December 31, 1989⁷ and for pre-1990 properties subject to the bedroom election under Rev. Proc. 94-9, maximum gross rents are computed based on the number of bedrooms in the unit. Units with no separate bedroom are treated as being occupied by one person and units with separate bedrooms are treated as being occupied by 1.5 persons per each separate bedroom.

Example 1: Computation of Maximum Allowable Gross Monthly Rent

The owner of an LIHC building with 1 and 2-bedroom units elects the 40-60 minimum set-aside. For 2009, HUD provides the following information:

	1 PERSON	2 PERSON	3 PERSON	4 PERSON	5 PERSON
30% OF MEDIAN	16550	18900	21250	23600	25500
VERY LOW INCOME	27550	31500	35400	39350	42500
LOW-INCOME	43050	49200	55350	61500	66400

For a 1-bedroom unit, the unit is treated as occupied by 1.5 persons. The income limit is computed by averaging the “very low income” income for a 1-person household and a two-person household. (Note: Averaging is necessary whenever the number of persons deemed to occupy the unit is not a whole number.) The result is then multiplied by 1.2 to compute 60% of AMGI.

$$[(\$27,550 + \$31,500) \div 2] \times 1.2 = \$35,430.00$$

The maximum allowable annual rent is computed by multiplying the income limit for 1.5 persons by 30 percent.

$$\$35,430 \times .30 = \$10,629.00$$

The maximum allowable monthly rent is computed by dividing the maximum allowable annual rent by 12 months.

$$\$10,629 \div 12 \text{ months} = \$885.75 \text{ per month}$$

For a 2-bedroom unit, the unit is treated as occupied by 3 persons. The maximum annual rent is computed as:

$$\$35,400 \times 1.2 \times .30 = \$12,744.00$$

The maximum monthly rent is computed as:

$$\$12,744.00 \div 12 \text{ months} = \$1,062.00 \text{ per month}$$

Note: The bedroom method calculation may be applied only for households moving into units *after* the date the bedroom election was made. Units with households

⁷ IRC §42(g)(2)(C)

living in the property before the date of the election will continue to be charged rents based on the number of family members actually living in the unit until such time as a turnover in occupancy occurs.

Example 2: Rent Exceed Limit - Bedroom Election

Assume credits were allocated in 1988 and the owner elected by February 7, 1994 to use the bedroom election to calculate rent. A one-person household moved into a 2-bedroom unit on February 1, 1994 and paid the maximum one-person gross rent of \$300 and a \$50 utility allowance. Following the bedroom election, the owner raises this household's rent to the maximum two-bedroom rent of \$500, plus a \$50 utility allowance, for a total rent of \$550.

This is not allowable because the household moved into the unit before the date of the election and the rent of \$550 is over the allowable maximum. Rent in this unit may only be changed to the bedroom calculation method on the date a new household moves in. The owner must immediately reduce the rent charge to \$300 rent, plus a \$50 utility allowance. Date of correction is the date of the lease amendment.

Tenant Income Rises Above Limit

A unit shall continue to be treated as a low-income unit if the income of the occupants initially met the income limitation and the unit continues to be rent-restricted⁸. The owner may also be subject to the Available Unit Rule and the Vacant Unit Rule. (See Chapters 14 and 15.)

Section 8 Tenants

The gross rent limit applies only to payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, are not included in gross rent. Congress further intended that any comparable state or local government rental assistance not be included in gross rent. See IRC §42(g)(2)(B)(i) and the General Explanation of the Tax Reform Act of 1986.

Example 1: Household Portion of Rent is Below Limit

A Section 8 household moved into a unit on January 1, 2000; the maximum LIHC gross rent is \$500 and market rate is \$600. Household pays \$200 and the assistance pays \$400; the total rent is \$600. There is no noncompliance since the household portion of rent is below the maximum LIHC rent allowed.

The portion of the rent paid by Section 8 tenants can exceed the LIHC rent ceiling as long as the owner receives a Section 8 assistance payment on behalf of the resident. If no subsidy is provided, the tenant may not pay more than the LIHC rent ceiling.

Example 2: Tenant's Portion of Rent Exceeds Rent Limit

A Section 8 household with an annual income of \$18,000 applies for an LIHC unit for which the rent is restricted to \$500 and for which the

⁸ IRC §42(g)(2)(D)(i)

market rate rent is \$750. Assistance will pay a maximum of \$500, and the applicant's portion is \$600 (40 percent of income). Since the applicant is required to pay \$600, Section 8 will pay \$150. There is no noncompliance.

Note: This example reflects HUD's requirement under the Section 8 housing choice program. The family share may not exceed 40 percent of the family's share monthly adjusted income when the family initially moves into the unit or signs the first assisted lease for a unit. Additional information available at

www.hudclips.org/sub_nonhud/jtml/pdfforms/7420g06.pdf.

Rural Development (FmHA) Rents

Originally, the rent restrictions for projects with Rural Development assistance were computed using the general rules for LIHC housing. Beginning in 1991, however, gross rent does not include any rental payment to the owner of the unit to the extent such owner pays an equivalent amount to the USDA Rural Housing Service⁹ under section 515 of the Housing Act of 1949. See IRC §42(g)(2)(B)(iv). In other words, as long as the owner pays Rural Development the rent amount over the limit (all of the overage) that unit is in compliance.

Example 1: Rent Above Limit (Owner Pays Rural Development, formerly known as FmHA)

Assume a 1991 credit allocation to a property with Rural Development assistance. The maximum gross LIHC rent is \$500 and the household's calculated rent under Rural Development regulations is \$650, which the owner charges. The owner provides documentation that the \$150 above the tax credit maximum has been remitted directly to Rural Development. There is no noncompliance.

Supportive Services

After 1989, gross rent does not include any fee for a supportive service paid to the owner by any governmental program or tax-exempt organization if the amounts paid for rent and assistance are not separable.¹⁰ Under Treas. Reg. §1.42-11, supportive services mean any service designed to enable residents to be independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. Examples of supportive services include transportation, housekeeping, or planned social activities. Supportive services do not include continual or frequent nursing, medical, or psychiatric services.

Example 1: 1990 Credit Allocation

Assume a 1990 credit allocation. The maximum gross rent is \$500 and the owner receives a monthly payment of \$600 from a tax-exempt organization to assist the household with the living expense of handicapped persons so that such persons can live independently and avoid placement in a hospital. There is no noncompliance as long as the owner provides documentation that the assistance is inseparable from the rental of the unit and complies with above rule.

⁹ Formerly known as the Farmer's Home Administration

¹⁰ IRC §42(g)(2)(B)(iii) and Revenue Reconciliation Act of 1989

Deep Rent Skewing

Under IRC §142(d)(4)(B)¹¹, an owner can elect to provide housing to households with incomes of 40% or less of the Area Median Gross Income (AMGI). The election is made on Form 8609, Low-Income Housing Certification, line 10d. The project qualifies if:

1. 15 percent or more of the low-income units are occupied by individuals whose income is 40 percent or less of the AMGI;
2. The gross rent with respect to each low-income unit in the project does not exceed 30 percent of the applicable income limit which applies to the individuals occupying the unit; and
3. The gross rent with respect to each low-income unit in the project does not exceed ½ of the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

Assistance Provided Under the HOME Investment Partnership Act or NAHASDA

For buildings placed in service on or before July 30, 2008, IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnerships Act (HOME) or the Native American Housing and Assistance and Self-Determination Act (NAHASDA) of 1996 with respect to any building will not be treated as a below market Federal loan if 40 percent or more of the residential units *in the building* are occupied by individuals whose income is 50 percent or less of the Average Median Gross Income (AMGI). The rule is applicable for the entire extended use period under IRC §42(h)(6)(D).

The rent restriction for all the low-income units, including the units used to satisfy the rules under IRC §42(i)(2)(E)(i), is based on the applicable income limitation under IRC §42(g). See Rev. Rul. 2004-82, Q&A #6.

IRC §42(i)(2)(E) reads:

(E) Buildings receiving home assistance or Native American housing assistance.

(i) In general. Assistance provided under the HOME Investment Partnerships Act (as in effect on the date of the enactment of this subparagraph [enacted Aug. 10, 1993]) or the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4101 et seq.) (as in effect on October 1, 1997) with respect to any building shall not be taken into account under subparagraph (D) if 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of area median gross income. Subsection (d)(5)(C) shall not apply to any building to which the preceding sentence applies.

(ii) Special rule for certain high-cost housing areas. In the case of a building located in a city described in section 142(d)(6) [26 USCS § 142(d)(6)], clause (i) shall be applied by substituting "25 percent" for "40 percent".

¹¹ IRC §42(g)(4) authorizes the application of deep rent skewing under IRC §142(d)(4)(B) for IRC §42 properties.

For buildings placed in service after July 30, 2008, assistance under HOME and NAHASDA are not characterized as below market Federal loans and IRC §42(i)(2)(E) was removed from the Code under section 3002(b) of the Housing Assistance Tax Act of 2008.

In Compliance

A unit is in compliance when the rent charged does not exceed the gross rent limitations on a monthly basis.

Example 1: Provision of Optional Services

An LIHC property provides hot meals twice a day for the convenience of its tenants in a common dining facility. They charge a nominal fee to cover their costs, but do not include the cost in the rent charged for the apartments. Each unit in the property includes a fully functional kitchen.

In this case, a practical alternative exists for tenants to obtain meals other than from the dining facility, and payment for the meals in the common dining facility is not required as a condition of occupancy. Thus, the cost of the meals is not included in gross rent for purposes of IRC §42(g)(2)(A) and Treas. Reg. §1.42-11(b).

Example 2: Fee for Late Payment of Rent

A tenant pays the maximum rent of \$525 for a one bedroom unit. The tenant did not pay the rent timely and was charged a late fee of \$35, as stated in the lease.

The \$35 late is a penalty for failure to perform according to the lease agreement and, therefore, the fee is not included in the rent.

Example 3: HUD Releases New Income Limits

An LIHC property owner is a calendar year taxpayer. For 2006, the imputed income limit for two bedroom units is \$31,080 and the maximum rent the owner can charge is \$9,324.00 annually or \$777.00 monthly.

HUD releases new income limits for 2007 on March 20, 2007. The new imputed income limit for two bedroom units is \$31,500. The maximum rent the owner can charge is \$9,450.00 annually or \$787.50 monthly. The owner correctly adjusts the rents beginning May 1, 2007.

Out of Compliance

A unit is out of compliance if the rent exceeds the limit on a tax year basis or on a monthly basis. A unit is also considered out of compliance if an owner charges impermissible fees.

Example 1: Rent Exceeds Limit on a Monthly Basis

The maximum rent for a two-bedroom unit is \$800 per month. The owner charges \$795. In addition to rent, the owner charges a one-time \$35 hookup fee for the tenant's washer and dryer the month a tenant moves in. A new tenant moves in on June 1, 2007 and pays \$830 for rent the first month. For July through December, the tenant pays \$795.

The one-time hookup fee is included in rent for one month. The rent of \$830 for June exceeded the monthly limit.

Example 2: Failure to Remit Rent in Excess of LIHC Limit (Rural Housing)

A property with Rural Development assistance received an allocation of credit in 2001. The maximum gross LIHC rent for a one-bedroom unit is \$600. A household moves into a one-bedroom unit on July 1, 2007 and pays \$675 rent each month based on the household's calculated rent under Rural Development regulations. However, the owner fails to remit the rent in excess of the LIHC limit (\$75) to Rural Development.

The owner is out of compliance every month beginning July 1, 2007 when the household moved in.

Example 3: Owner Charges Impermissible Fee

The owner charges new tenants a one-time optional fee of \$125 to clean a unit before move-in; i.e., the new tenant may move into the unit as the previous tenant left it (which is not suitable for occupancy) or pay the fee to the owner to clean and prepare the unit for occupancy. A new tenant paid the \$125 cleaning fee and moved into the unit on March 15, 2008.

It is not permissible for owners to charge tenants a fee for maintaining low-income units in a condition suitable for occupancy under IRC §42(i)(3). Under Treas. Reg. §1.42-5(g), compliance with the requirements of IRC §42 is the responsibility of the owner of the building for which the credit is allowable. The unit is out of compliance as of March 15, 2008.

1. If the noncompliance is the result of noncompliance with the utility allowance requirements, the error should be noted under category 11m, Owner did not properly calculate utility allowance.
2. If the noncompliance is the result of a systemic error, also evaluate whether the minimum set-aside under IRC §42(g)(1) was met. See Chapter 9.

Example 4: Tenant Income Rises Above Limit

A household was initially income qualified and moved into a unit on 1/1/2000. The maximum LIHC gross rent is \$500. At recertification, the owner increased the rent to the market rate of \$1,000.

The unit is out of compliance, beginning on the date the rent was increased above the maximum of \$500.

Back in Compliance

Once a unit is determined to be out of compliance with the rent limits, the unit ceases to be a low-income unit for the remainder of the owner's tax year. A unit is back in compliance on the first day of the owner's next tax year if the rent charged on a monthly basis does not exceed the limit. An owner cannot avoid the disallowance of the LIHC by rebating excess rent or fees to the affected tenants.

Example 1: Overcharged Rent

The owner of a 100% LIHC building leased all the units to IRC §42 eligible tenants during 2007, the third year of the credit period. However, the owner inadvertently overcharged rent to tenants occupying 3 bedroom apartments. The error impacted 15 out of 75 units. The owner is a calendar year taxpayer.

The Applicable Fraction for 2007 is $60/75$, which equals 80 percent. The unit is back in compliance on January 1, 2008 if the owner correctly limits the rent for all units.

Example 2: Overcharged Rent Impacted Minimum Set-Aside

The owner leased the rental units in a 100% LIHC building to IRC §42 eligible tenants by the end of the first year of the credit period. However, the owner overcharged rent for all the units and, as a result, failed to meet the minimum set-aside for the first year of the credit period.

The building does not qualify for LIHC.

References

1. Rev. Rul. 91-38, 1991-2 C.B. 3
2. Rev. Rul. 98-47, 1998-2 C.B. 399
3. Rev. Rul. 2004-82, 2004-35 I.R.B 350