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## MEMORANDUM

**date:** April 9, 2008

**to:** Eric Solomon, Assistant Secretary of the Treasury (Tax Policy)

**from:** Alan S. Cohen
Telephone Number: (212) 318-6543

**subject:** Summary of Code Section 42 Overincome Tenant Issue

**cc:** Affordable Housing Tax Credit Coalition Board Members

This memorandum summarizes the position of the Affordable Housing Tax Credit Coalition (the "Coalition") that, for purposes of the low-income housing tax credit ("Housing Tax Credit") rules under Section 42 of the Internal Revenue Code of 1986, as amended (the "Code"), a project owner's non-renewal of leases of tenants whose income, following initial tenancy, rises above the maximum eligible income limit should not cause such project to fail to be a qualified low income housing project.

This memorandum has been prepared for discussion purposes only and does not constitute official correspondence or attorney work product with respect to any specific taxpayer.

## I. SUMMARY OF FACTS

A taxpayer (the "Taxpayer") owns a project (the "Project") consisting of residential rental apartment buildings. The Taxpayer has complied with the requirements of Code Section 42 and intends to claim Housing Tax Credits with respect to the Project. The Taxpayer elected the 40/60 minimum set-aside under Code Section 42(g)(1)(B), which requires that 40% or more of the residential units in the Project be rent-restricted and occupied by individuals whose income is 60% or less of area median gross income ("AMGI"). The Taxpayer has claimed a qualified basis in the Project equal to its eligible basis, since all units in the Project have been leased to tenants whose income is at or below 60% of AMGI and at rents not in excess of 30% of the imputed income limit under Code Section 42(g)(2).

The Project is located in a state ("State") that offers a State property tax abatement to owners of residential rental housing if the owner rents to households that are "low-income" households as defined by the U.S. Department of Housing and Urban Development ("HUD"). HUD generally defines "low-income" as an annual income not in excess of 80% of the median income for the area, as determined by HUD.[1]

[1] *See, e.g.*, 24 C.F.R. § 5.603.

Additionally, the Project has been constructed on land owned by the municipality in which the property is located or by a nonprofit foundation whose charter limits its purpose to providing housing to low-income tenants. The property has been leased to the taxpayer under a ground lease (the "Ground Lease"), which provides that the use of the property is limited to housing for low-income tenants, as defined by HUD.

All residents in the Project initially satisfied the income and restricted rent requirements for the Project to be eligible for both Housing Tax Credits and the State property tax abatement. For subsequent years, if the Taxpayer determines during the annual tenant income recertification that a tenant's income has increased to more than 80% of AMGI, upon the expiration of the tenant's lease the lease is not renewed and the tenancy is terminated. Such termination is done in compliance with the laws of the State and in accordance with the terms of the Ground Lease (or alternatively in accordance with a long-term regulatory agreement or land use restriction agreement). The unit is then leased to other tenants whose income and rent meet the applicable provisions of Code Section 42 and allow for such unit to continue to be eligible for the State property tax abatement and to comply with the Ground Lease.

## II. ISSUES RAISED

Does the failure to renew leases of overincome tenants as described above violate the provisions regarding overincome tenants in Code Section 42(g)(2)(D)(i) (the "Unit Protection Rule")?

Is the Taxpayer, by electing the State property tax abatement and entering into the Ground Lease, unable to claim Housing Tax Credits with respect to the Project on account of the Project failing to consist of qualified low-income buildings "at all times" during the compliance period as required by Code Section 42(c)(2)?

## III. DISCUSSION

### *A. Legal Context*

In order to be eligible for Housing Tax Credits, a residential rental project must satisfy one of the minimum set-aside tests provided in Code Section 42(g)(1), either (i) a minimum of 20% of the residential units are rent-restricted and occupied by tenants whose income does not exceed 50% of AMGI, or (ii) a minimum of 40% of the residential units are rent-restricted and occupied by tenants whose income does not exceed 60% of AMGI. For purposes of complying with the applicable minimum set-aside, the determination of tenants' income is made on a continuing, annual basis.[2] Additionally, for a unit to be a qualified unit (a "Housing Tax Credit Unit"), gross rent for such unit must not be greater than 30% of the imputed income of the tenant.[3]

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[2] *See* General Explanation of the Tax Reform Act of 1986, Prepared by the Staff of the Joint Committee on Taxation ("1986 TRA Blue Book"), at 162.

[3] Code Sec. 42(g)(2)(A).

The Unit Protection Rule provides as follows:

> "Except as provided in clause (ii) [which provision requires that the next available unit be leased to an income qualified tenant at restricted rents if a tenant's income exceeds 140% of the maximum qualified income of 50% or 60% of area median income (the "Next Available Unit Rule"[4])], notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under [Code Section 42(g)(1)], such unit shall continue to be treated as a low-income unit if the income of such occupants initially met such income limitation and such unit continues to be rent-restricted."[5]

Therefore, under the Unit Protection Rule, Housing Tax Credits may continue to be claimed with respect to a unit if a tenant initially satisfied the applicable income limitation, even if the tenant's income increases to a level up to 140% of the applicable income limitation, provided that such unit continues to be rent-restricted. If the tenant's income increases above 140% of the applicable income limitation, then the Code provides that such tenant's unit will continue to be a qualified low-income unit provided that during the period of noncompliance each unit of a comparable or smaller size that becomes vacant is rented to tenants who satisfy the applicable income limitation. If any comparable unit that is available or becomes available is rented to a nonqualified tenant during this period, then the Next Available Unit Rule ceases to apply to all comparably-sized or larger overincome units and such units cease to be qualified low-income units.[6]

### B. *The Unit Protection Rule is a Safe Harbor for Owners, Not a Legal Prohibition Against Non-Renewal of Leases for Overincome Tenants*

The Unit Protection Rule and the Next Available Unit Rule provide statutory mechanisms by which the owner of a qualified low-income project can ensure compliance with the applicable minimum set-aside and may continue to claim Housing Tax Credits and avoid recapture of Housing Tax Credits with respect to an apartment unit even in situations where a tenant's income increases above the applicable income limitation.

The legislative history to the provisions of Code Section 42 dealing with the compliance period for a low-income housing project and the penalties for noncompliance states that "[o]wners and operators of low-income housing projects on which a [Housing Tax Credit] has been claimed must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered."[7] The legislative history goes on to describe the Unit Protection Rule and the Next Available Unit Rule as two ways for

[4] Code Sec. 42(g)(2)(D)(ii).

[5] Code Sec. 42(g)(2)(D)(i), added by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239).

[6] Treas. Reg. § 1.42-15(f).

[7] 1986 TRA Bluebook, at 166.

such "[o]wners and operators of low-income housing projects" to satisfy the continuous compliance requirement for the applicable minimum set-aside test.[8]

The legislative history also provides that Congress did not intend for owners and operators of low-income housing projects to evict overincome tenants for purposes of complying with the applicable minimum set-aside test and avoiding credit recapture penalties. Congress intended owners and operators of low-income housing projects to avail themselves of the relief provisions such as the Next Available Unit Rule for purposes of bringing a building back into compliance and avoiding a Housing Tax Credit recapture penalty.[9] However, there is nothing in this stated intent in the legislative history that suggests a legal prohibition against the non-renewal of an overincome tenant's lease for purposes other than compliance with the applicable minimum set-aside and avoidance of a Housing Tax Credit recapture penalty. Rather, when read in its entirety, this section of the legislative history supports the proposition that minimum set-aside compliance relief provisions, such as the Next Available Unit Rule, are intended to provide flexibility and relief to owners and operators of low-income housing projects for purposes of complying with the applicable minimum set-aside requirement in Code Section 42(g)(1).

The relief provisions in Code Section 42(g)(2)(D) provide a right of the owner of a low-income housing project to continue to claim Housing Tax Credits with respect to units leased to tenants whose income rises above the maximum income requirements, provided that such owner does not benefit from such tenant by charging rents in excess of the otherwise permissible maximum rents. Code Section 42(g)(2)(D), its legislative history, the Treasury Regulations promulgated thereunder,[10] and the Treasury Department's preamble to such regulations[11] do not support the legal conclusion that Code Section 42(g)(2)(D) prohibits the owner of a low-income housing project from not renewing the leases of overincome tenants, particularly when an owner decides not to renew the leases of overincome tenants for reasons unrelated to continued compliance with the applicable minimum set-aside, such as to comply with the requirements for a state property tax abatement.

### C. *Overincome Tenants Do Not Have a Legal Right to Long-Term Occupancy of Housing Tax Credit Units*

Code Section 42(g)(2)(D) and the Treasury Regulations promulgated thereunder[12] set forth the mechanical rules for owners of low-income housing projects to obtain the compliance relief provided by the Unit Protection Rule and the Next Available Unit Rule, but do not provide a continuing legal right of overincome tenants to continue to occupy the Housing Tax Credit Units.

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[8] *See* id.

[9] *See* 1986 TRA Bluebook, at 166.

[10] Treas. Reg. § 1.42-15.

[11] *See* T.D. 8732.

[12] *See* Treas. Reg. § 1.42-15.

A primary policy goal of Code Section 42 is evident in the language of Code Section 42(m), which requires that each state credit agency allocate its respective annual Housing Tax Credit amounts pursuant to a qualified allocation plan which gives preference to, among other factors:

(i) projects serving the lowest income tenants, and

(ii) projects obligated to serve qualified tenants for the longest periods of time.[13]

Interpreting Code Section 42(g)(D)(2) as extending to overincome tenants a legal right to continued occupancy of Housing Tax Credit Units would undermine the policy goals of serving low-income tenants and providing long-term affordable housing to low-income tenants, as stated in the statutory language of Code Section 42(m)(1)(B). Such a legal right to continued occupancy would result in units which would otherwise be available to qualified low-income tenants being occupied by tenants who do not need the subsidy provided by Code Section 42. Further, the rent restrictions under Code Section 42(g)(2)(A) continue to apply to a Housing Tax Credit Unit even after the occupant of the unit becomes an overincome tenant.[14] Thus, a legal right to continued occupancy of Housing Tax Credit Units would effectively give initially-qualifying tenants, regardless of subsequent increases in income, a right to occupy the units at controlled rents for the entire 30 year tax credit compliance period required under Code Section 42. We find no indication that this was intended in the legislative history of Code Section 42 or in the express language of Code Section 42(g)(2)(D). In fact, such a policy could result in low-income housing projects serving relatively wealthy tenants and being obligated to continue serving such wealthy tenants for the longest period of time, in direct conflict with the statutorily mandated preferences for allocations of Housing Tax Credits by state credit agencies in Code Section 42(m) and at the expense of the owner and the U.S. taxpayers who ultimately pay for the Housing Tax Credit subsidy.

As described above, the legislative history indicates that Congress did not want to mandate the removal of overincome tenants. However, Congress certainly did not intend that the Housing Tax Credit subsidy for the development of affordable housing for low-income tenants would become a long-term entitlement program providing below-market rents to tenants who no longer need such subsidy.

### *D. Comparable Federal Rules and Federal Housing Policy Allow for Non-Renewal of Leases of Overincome Tenants*

Interpreting Code Section 42(g)(2)(D)(i) as giving overincome tenants a continued right to occupy a Housing Tax Credit Unit conflicts with HUD regulations governing the operation of public housing projects which expressly permit a public housing agency to evict or terminate the occupancy of an

[13] *See* Code Sec. 42(m)(1)(B).

[14] *See* Code Sec. 42(g)(2)(D)(i).

overincome tenant except in cases where the overincome tenant is the beneficiary of either of two specified subsidies.[15]

Under U.S. Department of Agriculture ("USDA") regulations governing the Rural Housing Service and direct multi-family housing loans and grants from USDA sources, overincome tenants are generally required to vacate the property by the later of 30 days after receiving notice of ineligibility from the landlord or the termination of the existing lease.[16] Landlords of such properties are required to give overincome tenants notice of ineligibility.[17] Thus, termination of the occupancy of overincome tenants is mandatory.

These examples are not exhaustive of the federal rules regarding the right to terminate occupancy by non-qualified tenants of federally-subsidized residential rental projects. In providing the owners and operators of such projects with the ability to terminate such occupancies, these rules allow for the efficient implementation of the general federal housing policies underlying the respective federal programs. A similar general federal housing policy applies to the Housing Tax Credit program. Accordingly, absent a legal requirement or sound and compelling contrary policy, the Housing Tax Credit rules should be applied consistently with comparable federal rules in allowing for the efficient implementation of the relevant federal housing policy, which in the case of the Housing Tax Credit program is the creation and operation of affordable housing available to tenants satisfying the applicable income limitation.

### *E. The Housing Tax Credit Program Was Intended to Work with State Housing Programs*

Various state, municipal and eleemosynary programs work together with Code Section 42 to provide for subsidies that allow housing for lower income tenants to be economically feasible. For example, the State of California provides for a property tax exemption for projects whose tenants have incomes below 80% of area median income. If a tenant's income exceeds such limit, the exemption with respect to such unit is terminated. This is an intended subsidy that makes many Housing Tax Credit projects in California, which has relatively high land and operating costs, economically feasible. If the position of the IRS were to be sustained, a landlord would be required to pay substantial property taxes on units with overincome tenants, but would not be able to recover such additional costs from the tenant, since the tenant would still have the right to restricted rental payments. Certainly Congress did not intend that a landlord would have to subject its project to additional expense in order to maintain housing for overincome tenants.

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[15] *See* 24 C.F.R. 960.261, which provides as follows:

> (a) PHAs may evict or terminate the tenancies of families who are over income, subject to paragraph (b) of this section.
>
> (b) Unless it is required to do so by local law, a PHA may not evict or terminate the tenancy of a family solely because the family is over the income limit for public housing, if the family has a valid contract for participation in an FSS program under 24 part 984. A PHA may not evict a family for being over the income limit for public housing if the family currently receives the earned income disallowance provided by 42 U.S.C. 1437a(d) and 24 C.F.R. 960.255.

[16] *See* 7 C.F.R. § 3560.158.

[17] *See* R.D. Handbook § 6.30.

Similarly, municipalities and charities provide additional subsidies, such as providing land to a Housing Tax Credit project at reduced rental rates so long as such project maintains housing for tenants with limited incomes. It is certainly intended that nonprofit institutions have a continuing role in providing affordable housing. Many of these nonprofit entities have charter limitations that require that their purposes be limited to providing assistance to lower income persons. These subsidies and continued participation could be jeopardized if overincome tenants have a continuing right to occupy apartment units subsidized with Housing Tax Credit equity.

### *F. Conclusion*

The Taxpayer 's non-renewal of the leases of overincome tenants is not a violation of any applicable law or regulation. In light of the State property tax abatement eligibility requirements, the Taxpayer's purpose for not renewing the leases of overincome tenants is not contrary to Congressional intent as expressed in the legislative history to Code Section 42(g)(2)(D). Further, allowing the Taxpayer to choose not to renew the leases of overincome tenants is consistent with comparable federal rules and with general federal housing policy. Accordingly, the Taxpayer's non-renewal of the leases of overincome tenants is not a violation of Code Section 42(g)(2)(D) and such non-renewal of leases does not undermine the qualification of the buildings in the Project as qualified low-income buildings "at all times" during the compliance period as required by Code Section 42(c)(2).

### *G. Proposed Solution*

The Treasury Department or Internal Revenue Service should publish guidance providing that a the failure to renew a lease of a tenant who initially qualified but whose income has exceeded the applicable income limitation does not violate the provisions of Section 42(g)(2)(D) of the Code.

# SECTION 42 - HOUSING TAX CREDITS

## OVERINCOME TENANTS – TERMINATION OF TENANCY

## I. ISSUE

Do tenants whose income increases over the Section 42 qualified income levels have a continuing right to remain in such unit at low-income rents?

## II. THE LAW

Code Section 42 provides a tax credit for housing rented to tenants having income at or below 50% or 60% of area median income and at restricted rents that are 30% of imputed income.

Code Section 42(g)(2)(D)(i) provides that "notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under paragraph (i), such unit shall continue to be treated as a low-income unit if the income of such occupant initially met such limitation and such unit continues to be rent restricted." (the "Unit Protection Rule").

## III. THE PROBLEM

The Service has proposed a position that the Unit Protection Rule is not a safe harbor for owners, but provides a tenant that initially meets the income requirements with a continuing right to occupancy at restricted rents notwithstanding lease termination. This right continues until at least the end of the 15 year initial compliance period and can continue for up to 30 years. This right continues regardless of tenant income.

The Service's position conflicts with federal housing policy and various state programs.

The Service's position also conflicts with the stated goals of Section 42 contained in Section 42(m) to provide for

(i) projects serving the lowest income tenants; and

(ii) projects obligated to serve qualified tenants for the longest period of time.

## IV. PROPOSED SOLUTION

An interpretive release either in the form of a Revenue Procedure or Chief Counsel Memorandum should be released providing that the failure to renew a lease of a tenant who initially qualified but whose income has exceeded the applicable income limitation does not violate the provisions of Code Section 42(g)(2)(D)(i).