Guide for Completing Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

The scope of this guide is limited to guidelines for preparing Form 8823 for submission to the IRS. Taxpayers are responsible for evaluating the tax consequences of noncompliance with IRC §42.

Audit Technique Guide

This 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.

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Originally drafted in collaboration with the
National Council of State Housing Agencies and
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Explanations of Revisions

1. Asterisks used to identify revisions in the October 2009 version of the guide have been removed and now reflect significant changes made for the January 2011 version of the guide.

2. Changes have been made through the text to correct typing and formatting errors. These changes, which do not impact the meaning of the text, are not identified.

3. Chapter 1, Exhibit 1, Step 4: The text was updated to explain that a Form 8823 must be filed with the IRS to report the correction of previously reported noncompliance (back in compliance) if corrected within three years after the end of the correction period.

4. Chapter 4:
   - Page 4-1: The citation for nonmetropolitan areas in #1 of the list has been updated to reflect the correct Code section; i.e., IRC §42(d)(5)(B)(iv)(IV).
   - Page 4-14: Clarification that assets disposed of for less than fair market value within two years of the effective date of a tenant's initial certification or recertification, including assets placed in irrevocable trusts, are included as an asset in the determination of the tenant's income.
   - Page 4-21: The list of items specific excluded from income now includes a separate line item for the value of food stamps (line #3).

5. Chapter 6: CCA 201042025 was added to the list of references.

6. Chapter 7, page 7-1: a note has been added to item #4 on the list to explain that for tax years ending after July 30, 2008, if all the low-income buildings in the *project* are 100% low-income buildings, owners are not required to complete annual tenant income recertifications.

7. Chapter 11, page 11-4: The second of three equations included in Example 1 has been corrected and now reads, "$35,430 x .30 = $10,629.00" instead of "$31,430 x .30 = $10,629.00."

8. Chapter 12, page 12-3: The first sentence of the second paragraph of Example 1 has been revised to read, "Although each unit fell out of compliance…." to reflect Treas. Reg.§1.42-9(c); i.e., the unit is treated as a residential rental unit that is not a low-income unit.

9. Chapter 18: The "Out of Compliance" and "Back in Compliance" sections have been significantly expanded to provide additional discussion and examples. The text clarifies that determinations of noncompliance are made when gross rent exceeds the maximum gross rent limit as the result of computational or procedural errors.

Chapter 1
Introduction

Background

State Agency Responsibilities

State and local housing credit agencies (herein referred to as "state agencies") are responsible for monitoring low-income housing credit (LIHC) properties for compliance with the requirements of Internal Revenue Code (IRC) §42; for example, health and safety standards, rent ceilings and income limits, and tenant qualifications. State agencies perform desk audits, inspect housing, and review tenant files.[1] When noncompliance is identified or the state agency becomes aware of a disposition of a building, the state agencies are required to notify the Internal Revenue Service using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition.

Briefly, a state agency performs a desk audit, conducts a site visit, or reviews the owner's tenant files and provides the owner with a summary report of its findings. If the report indicates noncompliance, the owner is expected to respond to the state agency within a maximum of 90 days to provide clarification or document that issues of noncompliance have been addressed. Then, the state agency determines whether the owner was always in compliance, has corrected the noncompliance, or remains out of compliance. The time to correct the noncompliance may be extended up to a total of 6 months with state agency approval. Regardless of whether the owner remedied the noncompliance or remains out of compliance, a Form 8823 must be filed with the IRS.

If the state agency reports that the owner is out of compliance, the IRS sends a notification letter to the owner identifying the type of noncompliance reported on Form 8823. The notification letter also states that the owner should not include any nonqualified low-income housing units when computing the tax credit under IRC §42 and that the noncompliance may result in the recapture of previously claimed credits. The notification letter also instructs the owner to contact the state agency to resolve the issue.

Once the noncompliance is resolved, the state agency should file a "back in compliance" Form 8823. If the noncompliance is corrected within three years after the end of the correction period, the state agency must file a Form 8823.[2] See Exhibit 1 at the end of this chapter for a complete description of the process.

IRS Analysis of Forms 8823 Submitted by State Agencies

Forms 8823 are routinely analyzed by the IRS. Based on categories of noncompliance, and without regard to subsequent "back in compliance" Forms 8823, taxpayers are evaluated to determine whether an audit of the owner's tax return is needed.[3] The taxpayer's tax returns and all Forms 8823 filed for the property are evaluated. If it is determined that an audit is warranted, the complete file is sent to the appropriate IRS field office. The taxpayer is then notified that an audit has been scheduled. It should be noted that this is not the only

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[1] State agencies perform "desk audits" of information submitted to their office rather than inspecting the documents at the property site; e.g., annual reports required under Treas. Reg. §1.42-5(c).
[2] Treas. Reg. §1.42-5(e)(3).
[3] Forms 8823 are immediately analyzed for audit potential when received from the state agencies. Subsequent receipt of Forms 8823 noting correction of previously reported noncompliance do not impact the original evaluation. Under Treas. Reg. §1.42-5(e)(3), if the noncompliance is corrected within three years, the state agency is required to file another Form 8823 reporting the corrected noncompliance and documenting the date the taxpayer was back in compliance. From the owner's perspective, the best strategy is to address noncompliance identified by the state agency quickly so that the initial Form 8823 will indicate that the noncompliance was

method for selecting for audit tax returns on which the low-income housing credit has been claimed and, at the examiner's discretion, the audit may be expanded to include additional issues or tax returns.

Authority of Guide

The guide is not a legal authority. The guide provides state agencies with a single accumulative reference of current legal authorities needed for determining whether a state agency must file Form(s) 8823 with the IRS under Treas. Reg. §1.42-5(e)(3), along with guidelines and examples of the law's application to specific fact patterns.

1. The scope of the guide is limited and does not address the tax consequences of noncompliance. Taxpayers are responsible for evaluating the tax consequences of noncompliance with IRC §42.

2. The guide should not be used or cited by taxpayers as authority for setting or sustaining a technical position when filing tax return for any tax period for which the taxpayer is subject to IRC §42 requirements.[4] Taxpayers can rely upon and cite the Internal Revenue Code and formal IRS guidance[5] as referenced extensively in the text and footnotes.

3. The guide, or chapters of the guide, may become obsolete if the underlying authority is revised subsequent to the Guide's revision date. Examples include: (1) IRC §42 is revised by Congress, (2) the IRS provides formal guidance, or (3) HUD revises the definition or treatment of income as explained in HUD Handbook 4350.3, Chapter 5.

   The guide (or chapter) is obsolete as of the effective date of the revised legal authority. State agencies and owners should disregard affected text and legal references.

   The Guide's revision date is identified on the cover, in the index, and at the bottom of every chapter page.

Purpose of Guide

The fundamental purpose of this guide is to provide standardized operational definitions for the noncompliance categories listed on Form 8823. It is important that noncompliance is consistently identified and categorized. Resulting benefits include:

1. Consistent interpretation and application of IRC §42 requirements among states;

2. Consistent reporting of noncompliance to the IRS; and

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corrected. From the IRS' point of view, the owner's responsiveness is indicative of due diligence, but does not preclude initiating an audit.

[4] In limited circumstances, pending the release of formal IRS guidance, the guide may specifically state that guidelines presented in the guide will be used by the IRS to evaluate a taxpayer's compliance. See Chapter 14 for an example.

[5] For example, Treasury regulations, revenue procedures, revenue rulings, and notices can be relied upon as formal IRS guidance. Although often providing insight into IRS interpretation, private letter rulings are binding only for the taxpayer who requested the ruling and should not be cited as authority.

3. Enhanced program administration by the IRS; i.e., timely processing of the forms and identification of appropriate follow-up actions by the IRS.

Content of Guide

The guide includes instructions for completing Form 8823, and guidelines for determining noncompliance and reporting property dispositions. The guide reflects current rules under IRC §42, Treasury regulations under IRC §42, other guidance published by the Department of Treasury and the IRS, and IRS administrative procedures for the LIHC program.

Generally, the noncompliance categories listed on Form 8823 are addressed in separate chapters. There are three categories of noncompliance for which there are two chapters because multiple issues are reported under the same category. They are:

1. Category 11e, Changes in Eligible Basis or the Applicable Percentage

2. Category 11h, Project not available to the general public

3. Category 11q, Other

For convenience, the term "owner" in the singular is used, although low-income housing properties often have more than one owner and state agencies must identify each owner in a schedule attached to the Form 8823 when filing the form.

Depending on the problem, noncompliance may extend to one or more housing units within an LIHC building, may apply to the whole building, or may encompass the entire project. Units, buildings, or projects that are out of compliance with the requirements of IRC §42 are referred to as "nonqualified" units, buildings, or projects.

Organization of Chapters

Generally (as applicable) each chapter includes the following sections.

Definitions - Brief descriptions are provided to explain the basic compliance issue being addressed. The intent is to sufficiently define the category of noncompliance so that state agencies will uniformly select the same category for the same issues.

In Compliance - Descriptions and examples are used to illustrate fundamental compliance with IRC §42 and its regulations.

Out of Compliance - Descriptions and examples are used to illustrate common noncompliance issues.

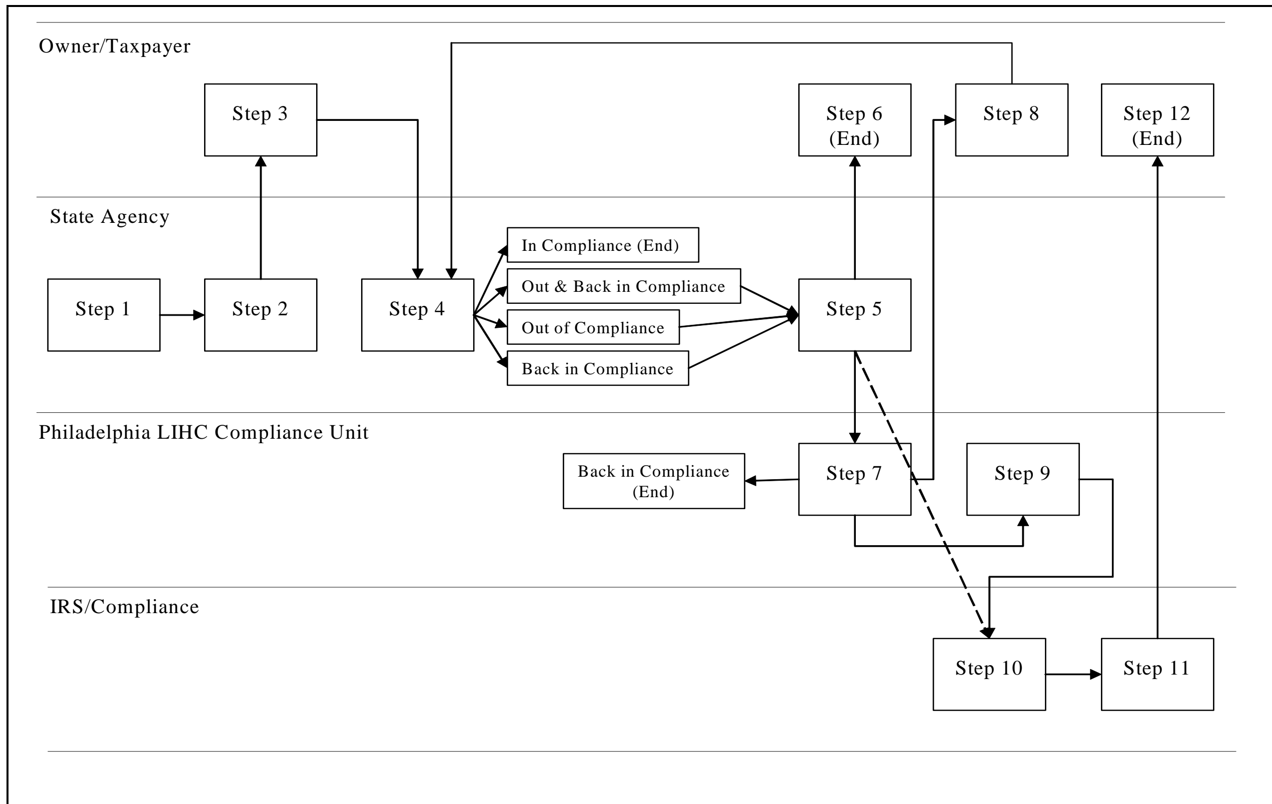
Back in Compliance - This section includes explanations and examples illustrating how noncompliance can be corrected. Treas. Reg. §1.42-5(e)(4) allows a corrective action period, not to exceed 90 days, for the owner to remedy the noncompliance. The state agency can extend this period for up to a total of 6 months if there is good cause. Suggested correction periods are noted in the discussions.

References - A list of references is included at the end of each chapter. Specific references or explanations of relevant rules under IRC §42, the Treasury regulations under IRC §42, or other published guidance, may be included in the text or identified in footnotes.

Reference

Treas. Reg. §1.42-5

Exhibit 1-1
Reports of Noncompliance (Form 8823)
Process Map & Explanations



The chart above is a process map demonstrating the steps of the Form 8823 process. The map is divided into four horizontal paths representing the groups involved in the process. The steps of the process are placed in the path of the group involved as the steps move from left to right across the map. The top path is for the owner/taxpayer, the second path down is for the state agency, the third path down is for the Philadelphia LIHC Compliance Unit, and the bottom path is for IRS/Compliance.

Step 1 The state agency performs a desk audit, conducts a site visit, or reviews the owner's tenant files.

Step 2 The state agency prepares and promptly provides the owner with a summary report describing issues of noncompliance. The letter may also identify administrative or technical issues, recommend changes to improve future management of the property, or suggest corrective actions to remedy noted noncompliance issues.

Step 3 The owner responds to the state agency within a maximum of 90 days, which can be extend up to a total of 6 months with the state agency's approval. Generally, the state agency specifies a time period appropriate for the type of noncompliance. The owner's response may provide clarifications and document that corrective actions have been implemented; i.e., how the noncompliance issues have been addressed.

Step 4 When the owner's response is received, the state agency determines whether the owner provided:

1. clarification establishing that the owner was always in compliance,
2. documentation that issue(s) of noncompliance have been remedied within the correction period (out and back in compliance).
3. no documentation that issue(s) of noncompliance had been remedied within the correction period (out of compliance), or
4. documentation that issue(s) of noncompliance have been remedied, but the noncompliance was not corrected until after the end of the correction period. *If corrected within three years after the end of the correction period,* a Form 8823 *must be* submitted to the IRS to report the correction of previously reported noncompliance (back in compliance).

Step 5 If the state agency determines that the owner was always in compliance, findings are not required to be reported to the IRS. However, the state agency should notify the owner that the issue is considered closed and no Form 8823 will be filed.

If the state agency determines that either the owner remedied the issue of noncompliance or remains out of compliance, then a Form 8823 must be filed with the Internal Revenue Service at the Philadelphia Service Center (PSC). As noted by the dashed line between steps five and ten, the state agency may send a copy of the Form 8823 directly to IRS Headquarters.

Step 6 The state agency sends the owner a copy of the Form 8823 concurrent to filing the Form 8823 with the IRS.

Step 7 Upon receipt of the Form 8823 at the PSC, the "back in compliance" Forms 8823 are processed without contacting the owner. The "out of compliance" Forms 8823 are assigned to technicians to prepare owner notification letters. The letters are specific to the type of noncompliance reported on Form 8823, and explain that noncompliance may result in the loss and recapture of the tax credit.

Step 8 The owner receives the notification letter. The letter instructs the owner to contact the state agency to resolve the issue (Step Four). If the noncompliance is resolved within three years, a "back in compliance" Form 8823 must be filed with the IRS and a copy sent to the owner concurrently. (Note: some issues of noncompliance cannot be remedied.)

Step 9 Simultaneous to notifying the owner, the PSC processes the Forms 8823 and transcribes the information into a database.

Step 10 Forms 8823 are immediately evaluated when received from the state agencies and IRS databases are routinely analyzed to determine whether an audit of the owner's tax return is needed. The taxpayer's three latest filed income tax returns and all Forms 8823 filed for the project are evaluated.

Step 11 If it is determined that an audit is warranted, the case file is sent to the appropriate field office for examination.

Step 12 The taxpayer is notified that an audit has been scheduled.

The following pages refer to instructions for Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition. If you are unable to read the form on the following page, view this alternate version of Form 8823.

Form **8823**
(Rev. November 2009)
Department of the Treasury
Internal Revenue Service

Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition

Note: *File a separate Form 8823 for each building that is disposed of or goes out of compliance.*

OMB No. 1545-1204

Check here if this is an amended return ▶ ☐

IRS Use Only

1 Building name (if any). Check if item 1 differs from Form 8609 ▶ ☐

Street address

City or town, state, and ZIP code

2 Building identification number (BIN)

3 Owner's name. Check if item 3 differs from Form 8609 ▶ ☐

Street address

City or town, state, and ZIP code

4 **Owner's** taxpayer identification number ☐ EIN ☐ SSN

5 Total credit allocated to this BIN . . . ▶ $

6 If this building is part of a multiple building project, enter the number of buildings in the project . . . ▶

7 a Total number of residential units in this building . . . ▶

b Total number of low-income units in this building . . . ▶

c Total number of residential units in this building determined to have noncompliance issues . . . ▶

d Total number of units reviewed by agency (see instructions) . . . ▶

8 Date building ceased to comply with the low-income housing credit provisions (see instructions) (MMDDYYYY) . .

9 Date noncompliance corrected (if applicable) (see instructions) (MMDDYYYY) . . .

10 Check this box if you are filing only to show correction of a previously reported noncompliance problem . . . ▶ ☐

11	Check the box(es) that apply:	Out of compliance	Noncompliance corrected
a	Household income above income limit upon initial occupancy . . .	☐	☐
b	Owner failed to correctly complete or document tenant's annual income recertification . . .	☐	☐
c	Violation(s) of the UPCS or local inspection standards (see instructions) (attach explanation) . . .	☐	☐
d	Owner failed to provide annual certifications or provided incomplete or inaccurate certifications . . .	☐	☐
e	Changes in Eligible Basis or the Applicable Percentage (see instructions) . . .	☐	☐
f	Project failed to meet minimum set-aside requirement (20/50, 40/60 test) (see instructions) . . .	☐	☐
g	Gross rent(s) exceed tax credit limits . . .	☐	☐
h	Project not available to the general public (see instructions) (attach explanation) . . .	☐	☐
i	Violation(s) of the Available Unit Rule under section 42(g)(2)(D)(ii) . . .	☐	☐
j	Violation(s) of the Vacant Unit Rule under Reg. 1.42-5(c)(1)(ix) . . .	☐	☐
k	Owner failed to execute and record extended-use agreement within time prescribed by section 42(h)(6)(J) . . .	☐	☐
l	Low-income units occupied by nonqualified full-time students . . .	☐	☐
m	Owner did not properly calculate utility allowance . . .	☐	☐
n	Owner has failed to respond to agency requests for monitoring reviews . . .	☐	☐
o	Low-income units used on a transient basis (attach explanation) . . .	☐	☐
p	Building is no longer in compliance nor participating in the section 42 program (attach explanation) . . .	☐	
q	Other noncompliance issues (attach explanation) . . .	☐	☐

12 Additional information for any item above. Attach explanation and check box . . . ▶ ☐

13 a Building disposition by ☐ Sale ☐ Foreclosure ☐ Destruction ☐ Other (attach explanation)

b Date of disposition (MMDDYYYY)

c New owner's name

d **New owner's** taxpayer identification number ☐ EIN ☐ SSN

Street address

14 Name of contact person

City or town, state, and ZIP code

15 Telephone number of contact person ( ) Ext.

Under penalties of perjury, I declare that I have examined this report, including accompanying statements and schedules, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature of authorizing official ▶ Print name and title ▶ Date (MMDDYYYY)

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Housing credit agencies use Form 8823 to fulfill their responsibility under section 42(m)(1)(B)(iii) to notify the IRS of noncompliance with the low-income housing tax credit provisions **or** any building disposition.

The housing credit agency should also give a copy of Form 8823 to the owner(s).

Who Must File

Any authorized housing credit agency that becomes aware that a low-income housing building was disposed of or is not in compliance with the provisions of section 42 must file Form 8823.

When To File

File Form 8823 no later than 45 days after **(a)** the building was disposed of or **(b)** the end of the time allowed the building owner to correct the condition(s) that caused noncompliance. For details, see Regulations section 1.42-5(e).

Where To File

File Form 8823 with the:

Internal Revenue Service
P.O. Box 331
Attn: LIHC Unit, DP 607 South
Philadelphia Campus
Bensalem, PA 19020

Specific Instructions

Amended return. If you are filing an amended return to correct previously reported information, check the box at the top of page 1.

Item 2. Enter the building identification number (BIN) assigned to the building by the housing credit agency as shown on Form 8609.

Items 3, 4, 13b, and 13d. If there is more than one owner (other than as a member of a pass-through entity), attach a schedule listing the owners, their addresses, and their taxpayer identification numbers. Indicate whether each owner's taxpayer identification number is an employer identification number (EIN) or a social security number (SSN).

Both the EIN and the SSN have nine digits. An EIN has two digits, a hyphen, and seven digits. An SSN has three digits, a hyphen, two digits, a hyphen, and four digits, and is issued only to individuals.

Item 7d. "Reviewed by agency" includes physical inspection of the property, tenant file inspection, or review of documentation submitted by the owner.

Item 8. Enter the date that the building ceased to comply with the low-income housing credit provisions. If there are multiple noncompliance issues, enter the date for the earliest discovered issue. **Do not** complete item 8 for a building disposition. Instead, skip items 9 through 12, and complete item 13.

Item 9. Enter the date that the noncompliance issue was corrected. If there are multiple issues, enter the date the last correction was made.

Item 10. Do not check this box unless the sole reason for filing the form is to indicate that previously reported noncompliance problems have been corrected.

Item 11c. Housing credit agencies must use either **(a)** the local health, safety, and building codes (or other habitability standards) or **(b)** the Uniform Physical Conditions Standards (UPCS) (24 C.F.R. section 5.703) to inspect the project, but not in combination. The UPCS does not supersede or preempt local codes. Thus, if a housing credit agency using the UPCS becomes aware of any violation of local codes, the agency must report the violation. Attach a statement describing either **(a)** the deficiency and its severity under the UPCS, i.e., minor (level 1), major (level 2), and severe (level 3) or **(b)** the health, safety, or building violation under the local codes. The Department of Housing and Urban Development's Real Estate Assessment Center has developed a comprehensive description of the types and severities of deficiencies entitled "Dictionary of Deficiency Definitions" found at *www.hud.gov/reac* under Library, Physical Inspection, Training Materials. Under Regulations section 1.42-5(e)(3), report all deficiencies to the IRS whether or not the noncompliance or failure to certify is corrected at the time of inspection. In using the UPCS inspection standards, report all deficiencies in the five major inspectable areas (defined below) of the project: (1) Site; (2) Building exterior; (3) Building systems; (4) Dwelling units; and (5) Common areas.

1. Site. The site components, such as fencing and retaining walls, grounds, lighting, mailboxes, signs (such as those identifying the project or areas of the project), parking lots/driveways, play areas and equipment, refuse disposal equipment, roads, storm drainage, and walkways, must be free of health and safety hazards and be in good repair. The site must not be subject to material adverse conditions, such as abandoned vehicles, dangerous walkways or steps, poor drainage, septic tank back-ups, sewer hazards, excess accumulation of garbage and debris, vermin or rodent infestation, or fire hazards.

2. Building exterior. Each building on the site must be structurally sound, secure, habitable, and in good repair. Each building's doors, fire escapes, foundations, lighting, roofs, walls, and windows, where applicable, must be free of health and safety hazards, operable, and in good repair.

3. Building systems. Each building's domestic water, electrical system, elevators, emergency power, fire protection, HVAC, and sanitary system must be free of health and safety hazards, functionally adequate, operable, and in good repair.

4. Dwelling units. Each dwelling unit within a building must be structurally sound, habitable, and in good repair. All areas and aspects of the dwelling unit (for example, the unit's bathroom, call-for-aid (if applicable), ceilings, doors, electrical systems, floors, hot water heater, HVAC (where individual units are provided), kitchen, lighting, outlets/switches, patio/porch/balcony, smoke detectors, stairs, walls, and windows) must be free of health and safety hazards, functionally adequate, operable, and in good repair. Where applicable, the dwelling unit must have hot and cold running water, including an adequate source of potable water (single room occupancy units need not contain water facilities). If the dwelling unit includes its own bathroom, it must be in proper operating condition, usable in privacy, and adequate for personal hygiene and the disposal of human waste. The dwelling unit must include at least one battery-operated or hard-wired smoke detector, in proper working condition, on each level of the unit.

5. Common areas. The common areas must be structurally sound, secure, and functionally adequate for the purposes intended. The basement, garage/carport, restrooms, closets, utility rooms, mechanical rooms, community rooms, day care rooms, halls/corridors, stairs, kitchens, laundry rooms, office, porch, patio, balcony, and trash collection areas, if applicable, must be free of health and safety hazards, operable, and in good repair. All common area ceilings, doors, floors, HVAC, lighting, outlets/switches, smoke detectors, stairs, walls, and windows, to the extent applicable, must be free of health and safety hazards, operable, and in good repair.

Health and Safety Hazards. All areas and components of the housing must be free of health and safety hazards. These include, but are not limited to: air quality, electrical hazards, elevators, emergency/fire exits, flammable materials, garbage and debris, handrail hazards, infestation, and lead-based paint. For example, the buildings must have fire exits that are not blocked and have hand rails that are not damaged, loose, missing portions, or otherwise unusable. The housing must have no evidence of infestation by rats, mice, or other vermin. The housing must have no evidence of electrical hazards, natural hazards, or fire hazards. The dwelling units and common areas must have proper ventilation and be free of mold as well as odor (e.g., propane, natural, sewer, or methane gas). The housing must comply with all requirements related to the evaluation and reduction of lead-based paint hazards and have available proper certifications of such (see 24 C.F.R. part 35).

Project owners must promptly correct exigent and fire safety hazards. Before leaving the project, the inspector should provide the project owner with a list of all observed exigent and fire safety hazards. Exigent health and safety hazards include: air quality problems such as propane, natural gas, or methane gas detected; electrical hazards such as exposed wires or open panels and water leaks on or near electrical equipment; emergency equipment, fire exits, and fire escapes that are blocked or not usable; and carbon monoxide hazards such as gas or hot water heaters with missing or misaligned chimneys. Fire safety hazards include missing or inoperative smoke detectors (including missing batteries), expired fire extinguishers, and window security bars preventing egress from a unit.

Item 11d. Report the failure to provide annual certifications or the provision of certifications that are known to be incomplete or inaccurate as required by Regulations section 1.42-5(c). As examples, report a failure by the owner to include a statement summarizing violations (or copies of the violation reports) of local health, safety, or building codes; report an owner who provided inaccurate or incomplete statements concerning corrections of these violations.

Item 11e. For buildings placed in service before July 31, 2008, report any federal grant made with respect to any building or the operation thereof during any tax year in the compliance period. For buildings placed in service after July 30, 2008, report any federal grant used to finance any eligible basis costs of any building. Report changes in common areas which become commercial, when fees are charged for facilities, etc. In addition, for buildings placed in service before July 31, 2008, report any below market federal loan or any obligation the interest on which is exempt from tax under section 103 that is or was used (directly or indirectly) with respect to the building or its operation during the compliance period and that was not taken into account when determining eligible basis at the close of the first year of the credit period. For buildings placed in service after July 30, 2008, report any obligation the interest on which is exempt from tax under section 103 that is or was used (directly or indirectly) with respect to the building or its operation during the compliance period and that was not taken into account when determining eligible basis at the close of the first year of the credit period.

Item 11f. Failure to satisfy the minimum set-aside requirement for the first year of the credit period results in the permanent loss of the entire credit.

Failure to maintain the minimum set-aside requirement for any year after the first year of the credit period results in recapture of previously claimed credit and no allowable credit for that tax year. No low-income housing credit is allowable until the minimum set-aside is restored for a subsequent tax year.

Item 11h. All units in the building must be for use by the general public (as defined in Regulations section 1.42-9 and further clarified in section 42(g)(9)), including the requirement that no finding of discrimination under the Fair Housing Act occurred for the building. Low-income housing credit properties are subject to Title VIII of the Civil Rights Act of 1968, also known as the Fair Housing Act. The Act prohibits

discrimination in the sale, rental, and financing of dwellings based on race, color, religion, sex, national origin, familial status, and disability. See 42 U.S.C. sections 3601 through 3619.

It also mandates specific design and construction requirements for multifamily housing built for first occupancy after March 13, 1991, in order to provide accessible housing for individuals with disabilities. The failure of low-income housing credit properties to comply with the requirements of the Fair Housing Act will result in the denial of the low-income housing tax credit on a per-unit basis.

Individuals with questions about the accessibility requirements can obtain the Fair Housing Act Design Manual from HUD by calling 1-800-245-2691 and requesting item number HUD 11112, or they can order the manual through *www.huduser.org* under Publications.

Item 11i. The owner must rent to low-income tenants all comparable units that are available or that subsequently become available in the same building in order to continue treating the over-income unit(s) as a low-income unit. All units affected by a violation of the available unit rule may not be included in qualified basis. When the percentage of low-income units in a building again equals the percentage of low-income units on which the credit is based, the full availability of the credit is restored. Thus, only check the “Noncompliance corrected” box when the percentage of low-income units in the building equals the percentage on which the credit is based.

Item 11q. Check this box for noncompliance events other than those listed in 11a through 11p. Attach an explanation. For projects with allocations from the nonprofit set-aside under section 42(h)(5), report the lack of material participation by a non-profit organization (i.e., regular, continuous, and substantial involvement) that the housing credit agency learns of during the compliance period.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . . 11 hr., 43 min.
Learning about the law or the form . . . . 3 hr., 16 min.
Preparing and sending the form to the IRS . . . . 3 hr., 36 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send Form 8823 to this address. Instead, see *Where To File* on page 2.

Exhibit 1-3
IRS Noncompliance Notification Letter
Letter 3464 (SC/CG) 5-2001

DEPARTMENT OF THE TREASURY
Internal Revenue Service Center
Philadelphia, PA 19255-0549

Date:

INTERNAL REVENUE SERVICE

Person to Contact:
Employee I.D. Number:
Fax Number:

Owner TIN:
Building Identification Number:
Reference:
Year:

Dear [Name]

The state housing credit agency referenced above has reported, on Form 8823, Low Income Housing Credit Agencies Report of Noncompliance or Building Disposition, that you are not in compliance with Internal Revenue Code Section 42 requirements and regulations for the Building Identification Number (BIN) shown above. (If multiple BINs are referenced, please see the list at the end of this letter.)

The noncompliance issues are:

1. ____
____

2. ____
____

3. ____
____

4. ____
____

Therefore, you should not include the non-qualified units when calculating the credit for the year shown above. Additionally, Sections 42(j)(1) and (2) require that prior credits you claimed are subject to recapture to the extent that any accelerated credit is attributable to the units, plus interest.

If you are subject to recapture, you must use Form 8611, Recapture of Low Income Housing Credit. If you filed this form with your tax return and have not claimed any credit for the year, no further action may be necessary. If you have not, please amend your return to include the recapture, and remove the credit claimed for the year of disposition. Flow-through entities should advise distributive share recipients of applicable credit and recapture requirements.

IRS receipt of Forms 8823 can increase the potential for audit of the reported projects. Therefore**,** IRS may conduct review and audit activity subsequent to this letter.

If you have questions, you may call the IRS contact listed above between the hours of 9 a.m. and 3 p.m. Eastern Time.

Although this employee may be able to help you, it is your responsibility to resolve all noncompliance issues with the appropriate state housing credit agency. Therefore, if you have questions regarding the issue(s) cited, please contact the referenced state agency.

Sincerely,

Additional Properties

BIN	Noncompliance Date

Chapter 2
Instructions for Completing Form 8823

Overview

State agencies use Form 8823 to notify the IRS of noncompliance with the requirements of IRC §42 or fulfill other reporting requirements. This chapter includes instructions for completing Form 8823.

After Building is Approved

Form 8823 should be used to report noncompliance *after* Form 8609, Low Income Housing Credit Allocation Certification, has been signed by the state agency and issued to the owner.

Before Building is Approved

There may be instances where noncompliance is identified *before* the issuance of Form 8609. If, at the time the Forms 8823 is submitted to the IRS, the owner has not received completed/signed Forms 8609 from the state agency, the Forms 8823 should be completed, but sent directly to the IRS Headquarter analyst responsible for the Low-Income Housing Credit program, rather than filing the form with the Philadelphia Service Center. Line 5, Total credit allocated to this BIN, should be zero. The IRS will consider these Forms 8823 timely filed.

Correction Period

The correction period is the period of time during which the owner of an LIHC property must correct any noncompliance identified by the state agency. The correction period begins with the date the state agency provides written notification *to the owner* that the building is not in compliance.[1] Under Treas. Reg. §1.42-5(e)(2), state agencies must provide *prompt* written notice to the owner.

Generally, the correction period may not exceed 90 days from the date of the owner's notification; *there is no minimum correction period.* However, the correction period can be extended for up to a total of 6 months if there is a good cause for granting the extension.

Form 8823 must be filed with the IRS within 45 days following the end of the correction period, whether or not the noncompliance has been corrected.

Example 1: Annual Certification Under Treas. Reg. §1.42-5(c)(1)

An owner failed to submit the annual certification that the building was in compliance with IRC §42 requirements; e.g., that annual income certifications had been received from each low-income tenant and that the units were rent-restricted, etc. The certification was due March 1, 2005 and the state agency notified the owner in writing on April 1, 2005 that the certification had not been received.

The correction period began on April 1st and ended on June 29th. The owner had 90 days, until June 29, 2005, to provide the annual certification. The Form 8823, noting noncompliance with category 11d, Owner failed to provide annual certification or provided incomplete or inaccurate

[1] See Treas. Reg. §§1.42-5(e)(4) and 1.42-5(a)(2).

certifications, must be file after June 29th, but no later than August 15, 2005.

Example 2: Extending the Correction Period

A state agency completed a physical inspection and identified noncompliance that required longer than 90 days to correct. The owner received notice of the noncompliance and the correction period began on January 15, 2004.

The state agency may extend the correction until July 15, 2004, giving the owner a total of 6 months to correct the problem. The Form 8823 must be filed with the IRS after July 15, 2004, but no later than August 25, 2004.

General Guidelines for Completing Form 8823

1. Select all applicable categories of noncompliance.

   Example 1: The state agency determined that 1 out of 10 low-income units in a building had been rented to a household with incomes that did not meet the income eligibility restrictions. Category 11a, Household income above income limit upon initial occupancy, should be selected.

   Example 2: The state agency determined that 7 out of 10 low-income units in a one-building project were rented to households with incomes that did not meet the income eligibility restrictions. As a result, the owner did not meet the 40/60 minimum set-aside for that year. Category 11a, Household income above income limit upon initial occupancy, should be selected, and category 11f, Project failed to meet minimum set-aside requirement, should be selected.

2. A separate Form 8823 must be filed for each BIN. The form must be prepared using the fillable PDF file as revised November 2009 (or later) with the bar codes.

3. When filing a "back in compliance" Form 8823, all the instances of noncompliance for a specific category must be remedied before the building is considered "back in compliance" for that category. For example, if four units are cited for violations of the UPCS inspection standards, all four units must be repaired before the building is considered back in compliance for that issue.

4. All categories of noncompliance must be resolved before filing a "back in compliance" Form 8823. Be sure to mark the "noncompliance corrected" boxes for each of the resolved issues. If more than one "noncompliance corrected" box is marked, enter the date of the most recent correction on line 9 of Form 8823.

5. An amended Form 8823 is identified by checking the box at the top of the form under the title. An amended Form 8823 should be filed with the IRS only if it is necessary to correct an error on a Form 8823 that was previously filed with the Service. For example, the wrong category is selected or an address is incorrect. A copy of the amended Form 8823 should be sent to the owner concurrent with filing the form with the IRS.

6. Descriptions of noncompliance or additional information are not required, but if submitted with the Form 8823, descriptions should be concise; however, avoid the use of canned or repetitive statements. It is helpful to identify the unit number, the date out of compliance and the date corrected, and summarize the problems with a brief description. Copies of reports and notification letters sent to the owner describing the noncompliance, electronic pictures, and newspaper articles are also helpful.

   Concisely describe the content of any additional information maintained by the state agency; e.g., physical inspection reports, photographs, written statements from tenants, etc. Do *not* send photocopies of pictures; they are not useful.

   State agencies should also include explanations when they suspect owners, managing agents, or other parties may have misrepresented factual information such as falsifying income verifications or altering tenant files.

7. State agencies should report all noncompliance of which they are aware as a result of the annual certification or periodic review of tenant files and physical inspection of the property, without regard to whether the initially outstanding noncompliance is subsequently corrected. See chapter 3 for additional discussion.

   Independently, state agencies must also report any change in the applicable fraction (such as converting LIHC units to market rate units) or eligible basis (such as converting common area to commercial space) that results in a decrease in the qualified basis as noncompliance.

8. There is no "noncompliance corrected" block available for category 11p, Project is no longer in compliance nor participating in the program. Should the state agency decide to reinstate the property, the state agency should contact the IRS Low-Income Housing Credit program analyst.

Line-By-Line Instructions

Line 1 Building Information: Ensure that the complete building (or project) name and address, including ZIP code is identified.

Line 2 BIN: Ensure that building identification number is correct. It should consist of the two letter state abbreviation, two-digit year and five-digit number assigned.

Line 3 Owner Information: Remember to check the box if the current owner's name is different than the owner shown on Form 8609. If there is more than one owner, attach a schedule listing the name, address, and EIN/SSN of each owner.

Line 4 EIN: Ensure that the identification number for the current owner is correct and check the box SSN for individual taxpayers (xxx-xx-xxxx) or EIN for business entities (xx-xxxxxxx) such as corporations and partnerships.

Line 5 Total credit allocated to this BIN: Provide the total allowable LIHC allocated to this BIN. This is computed by adding the amounts of credit allocated to the BIN on all Forms 8609, line 1b. Do not include Forms 8609 for which the compliance period has

expired.

Line 6 Number of buildings in the project: Enter the number of buildings that house residential living units and have BIN numbers assigned to the project. Do not include recreational facilities or other amenities.

Line 7

a. Number of residential units in the building: Enter the total number of both LIHC units and all other residential units. But do not include managers' units. See footnote for special rules regarding buildings placed in service prior to September 9, 1992.[2]

b. Number of low-income units in the building.

c. Number of residential units with noncompliance problems: Count each unit for which noncompliance is being identified *in this report*; do not include previously reported, but still outstanding, noncompliance. Count each unit only once, even if there are multiple compliance problems.

d. Indicate the total number of units reviewed in this building for which the Form 8823 is being filed. Count each unit being reviewed once, even if you reviewed the same unit for both the annual certification and simultaneously performed an on-site review.

Line 8 Date building ceased to comply: Enter the date that the building ceased to comply with the IRC §42 low-income housing credit requirements. If there are multiple noncompliance issues, enter the date of the earliest discovered issue. Do not complete this item to indicate the date a building (or an interest therein) was disposed of.

Line 9 Date noncompliance corrected: If entering a corrected date, make sure the appropriate "noncompliance corrected" block in lines 11a through 11o, or 11q is checked. If there are multiple categories, the date the last issue was resolved should be entered. (Note: there is no "noncompliance corrected" block for category 11p, Project is no longer in compliance nor participating in the program.)

Line 10 Correction of previously reported noncompliance: Check this box if the sole reason for filing the form is to indicate that previously reported noncompliance problems have been corrected.

Line 11a-p Noncompliance categories: Select the category that best describes the issue being reported. Be sure to check the correct box for "out of compliance" and/or "noncompliance corrected," as applicable.

Line 11q This category is used only for those issues that do not fit into the categories specified in 11a through11p. Be sure to attach an explanation.

Line 12 Additional Information: Extensive detail is not necessary, but a summary is desirable to indicate the nature and extent of the noncompliance.

[2] Note that, in some instances involving buildings placed in service, receiving an allocation of credit, or described in IRC §42(h)(4) with respect to which tax-exempt bonds were issued prior to September 9, 1992, managers' units may be included in the total number of residential units. See Rev. Rul. 92-61, 1992, 32 I.R.B. 4. The IRS will not, however, apply Rev. Rul. 92-61 unless the owner files, or has filed, a return that is consistent with the ruling.

Line 13

a. Building disposition: Check the box for the appropriate type of disposition (sale, foreclosure, destruction, or other). For "other" dispositions, attach an explanatory statement.

b. New owner's name and address: Ensure that the owner's name, address and ZIP code are correct.

c. Date of disposition: The date the ownership actually transferred should be used. If the exact date is unknown, enter the best approximation.

d. New owner's EIN: Ensure that the identification number for the owner is correct and check the SSN for individual taxpayers (xxx-xx-xxxx) or EIN for business entities (xx-xxxxxxx) such as corporations and partnerships.

Line 14

Contact Person: Identify the person the IRS should call if there are any questions and include that person's telephone number.

Signature

Signature of authorizing official: The authorizing official is a state agency official who is authorized by the state agency to sign such documents. The person need not be an executive, but may be a lower level employee within the state agency organization.

Chapter 3
Guidelines for Determining Noncompliance

Overview

State agencies are responsible for determining whether owners are compliant with the requirements of IRC §42 and its regulations. Professional judgment should be used to identify significant noncompliance issues, establish the scope and depth of the project/ building review, and apply the law and regulations to the facts and circumstances of the case in a fair and impartial manner. This chapter includes guidelines to assist the state agencies meet these responsibilities.

Current Noncompliance Issues

Initial Physical Inspection and Tenant File Review

Treas. Reg. §1.42-5(c)(2)(ii)(A) requires state agencies to conduct on-site inspections of all buildings in the project, and for at least 20 percent of the low-income units, inspect the units and review the certifications, the documentation supporting the certifications, and the rent records for the tenants in those units, by the end of the second calendar year following the year the last building is placed in service.

Under Treas. Reg. §1.42-14(d)(2)(ii), an allocation of credit may not be returned any later than 180 days following the close of the first tax year of the credit period. Therefore, it is highly recommended that the first review of the LIHC project be conducted within that timeframe. Under specific circumstances, previously allocated credits can be reclaimed and returned to the state's credit ceiling if necessary.[1] Timely review of the initial lease-up provides owners an opportunity to correct problems early in the compliance period.

Subsequent Physical Inspections and Tenant File Reviews

Treas. Reg. §1.42-5(c)(2)(ii)(B) requires that, at least once every 3 years, state agencies conduct on-site inspections of all buildings in the project and, for at least 20 percent of the project's low-income units, inspect the units and review the certifications, documentation supporting the certifications, and the rent records for all the tenants living in the units.

Example 1: Current Tenant Income (Re)Certification and Documentation

> An LIHC building was placed in service and the first tax year of the credit period was 2000. The state agency inspected the property and reviewed tenant certifications in May 2001; no noncompliance issues were identified. The next inspection and review were conducted in April 2004; the tenant files were reviewed using the most recent recertification, or initial income certifications for tenants moving into the building within the last year.

Reporting Current Noncompliance

Under Treas. Reg. §1.42-5(a), state agencies are required to report any noncompliance of which the agency becomes aware. Agencies should report all noncompliance, without regard to whether the identified outstanding noncompliance is subsequently corrected.

The inspection standard for on-site inspections of buildings and LIHC units generally requires state agencies to determine whether the building and units are suitable for

[1] See Chapter 21.

occupancy based on local health, safety, and building codes or whether the buildings and units satisfy the uniform physical condition standards established by HUD.[2]

The state agency is required to review the low-income certifications, the documentation supporting the certifications (and recertifications[3]), and the rent records for the tenants in the units selected for the physical inspection.[4] Therefore, the state agency should be reviewing the initial income certification if the tenant moved in within the last year or the most recent income recertification.

In addition, state agencies must report any change in the applicable fraction (such as converting LIHC units to market rate units) or eligible basis (such as converting common area to commercial space) that results in a decrease in the qualified basis as noncompliance.

Noncompliance issues identified and corrected by the owner prior to notification of an upcoming compliance review or inspection by the state agency need not be reported; i.e., the owner is in compliance at the time of the state agency's inspection and/or tenant file review. Small Business/Self-Employed (SB/SE) considers the date of the notification letter a "bright line" date comparable to the rules for requesting a PLR or the disclosure on From 1040X that an amended tax return is being filed after being audited by the IRS or subsequent to notification that it will be audited. See Form 1040X, line B.

Sampling Requirements

The review (or sampling) of 20 percent of the LIHC units in a project and the associated tenant files is required under the Treasury regulations. The purpose is to estimate the compliance level of all the tenant income (re)certifications by providing a "snap shot" view of the owner's activities and compliance level at a specific moment in time. Sampling reduces the labor costs, and enables state agencies to meet time constraints when dealing with large LIHC properties.

Selecting a Sample

A random selection of tenant files or LIHC units is required. The method of choosing the sample of files or units to be inspected must not give the owner advance notice of which units and tenants records are to be inspected and reviewed[5]. There is no advantage to selecting different units over the 15-year compliance monitoring cycle.

If the sample includes a currently vacant unit, then the last (re)certification for the last tenant should be reviewed. The "snap shot" is indicative of current compliance.

Interpreting the Results

The IRS uses the results of the state agencies' reviews as an indicator of the owner's level of compliance with IRC §42 requirements. If audited, the IRS can also use the results to make adjustments to the LIHC on a unit-by-unit basis as identified on Form 8823. However, the IRS cannot project the results to the entire population of LIHC units.[6]

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[2] See Treas. Reg. §1.42-5(d)(2).
[3] Treas. Reg. §1.42-5(c)(1)(iii) refers to an "annual income certification" which for clarity purposes is often referred to as a "recertification."
[4] See Treas. Reg. §1.42-5(c)(2)(ii)(A) and (B).
[5] Treas. Reg. §1.42-5(c)(2)(iii)
[6] The IRS has specific requirements for using sampling techniques as part of an income tax audit. A state agency is not required to use these more stringent techniques for random selection and sample size when conducting a compliance review.

Example 1: Applying Tenant File Review Results

A state agency conducts a tenant file review and physical inspection of a 100% LIHC single building project with 100 units. The LIHC associated with each unit is $3,000. Twenty units are inspected and the associated tenant files are reviewed. Various noncompliance issues were identified for fifteen, or 75 percent, of the twenty sampled units.

The IRS can make an LIHC adjustment of $45,000 (15 units x $3,000) for the year of the review, with a recapture of $15,000 plus interest for each of the prior years of the credit period. Although the sample results indicate significant noncompliance, the results cannot be projected to the entire population; i.e., the IRS cannot conclude that 75 of the 100 units are out of compliance and, therefore, disallow the entire LIHC because the taxpayer did not meet the minimum set-aside.

Expanding the Sample Size

In the event that extensive noncompliance is identified, state agencies should consider expanding the number of units inspected/files reviewed beyond the 20 percent sample required under Treas. Reg. §1.42-5(c)(2)(ii). Circumstances warranting consideration of expanding the sample of LIHC units reviewed include (but are not limited to):

1. Poor internal controls (significant risk of error)
2. Multiple problems
3. Significant number of nonqualified units
4. Significant number of households are not income-qualified
5. Credible information from a reliable source

Determining the Scope of the State Agency's Inspection/Review

Large, Unusual and Questionable Items (Materiality)

Large, unusual, or questionable items (LUQ's) may be material in determining whether noncompliance exists, and thus affect the scope of the state agency's inspection/review. Some factors to consider when determining the materiality of items include:

1. Comparative nature of the issue – two of one hundred of a building's rental units out of compliance for a month is not as important as a project failing the 40/60 minimum set-aside.

2. Absolute nature of the issue – violations of the physical conditions standards should be investigated thoroughly whether one or one hundred units are impacted.

3. Inherent nature of the issue – a permanent decrease in the eligible basis of the property is more significant than two units that are not available for rent for two months.

4. Evidence of intent to mislead – this may include missing, misleading or incomplete documentation.

5. Extenuating circumstances – the issue cited is very temporary or in the process of being fixed at the time of inspection.

Determining the Depth of the State Agency's Inspection/Review

Issue Development

Depth is the extent to which an issue of potential noncompliance is developed. It demonstrates the degree of intensity and thoroughness applied to make a determination of noncompliance. State agencies must use judgment to determine the depth required to satisfactorily develop an issue of noncompliance. The following factors should be considered:

1. The type and reliability of evidence available or expected,
2. Complexity of the issue, and
3. Techniques used.

It is important to obtain sufficient evidence for evaluating the owner's compliance with IRC §42 requirements. Determining the proper amount of evidence to accumulate is a judgmental decision. Factors to consider include the risk that the owner may have made errors that are individually or collectively material and the risk that tests (such as sampling) will fail to uncover material errors.

Consideration of Taxpayer Due Diligence

For most taxpayers, voluntary compliance consists of preparing an accurate tax return, filing it timely, and paying any taxes due. Compliant behavior can be demonstrated when a LIHC property owner exercises ordinary business care and prudence in fulfilling its obligations. Due diligence can be demonstrated in many ways, including (but not limited to) establishing strong internal controls (policies and procedures) to identify, measure, and safeguard business operations and avoid material misstatements of LIHC property compliance or financial information. Internal controls include:

1. Separation of duties,

2. Adequate supervision of employees,

3. Management oversight and review (internal audits),

4. Third party verifications of tenant income,

5. Independent audits, and

6. Timely recordkeeping.

Evidence

State agencies gather information to determine the owner/taxpayer's compliance with IRC §42. This determination must be made on the basis of all available facts, including facts supporting the owner's position. Evidence is something that tends to prove a fact or point in question.

Owners have the right to expect that the information they provide will be safeguarded and used only in accordance with the law. To promote and maintain owners' confidence in the privacy, confidentiality, and security protections provided by the state and IRS, the following principles should be followed.

1. No information will be collected or used (with respect to owners/taxpayers) that is not necessary and relevant for tax administration and other legally mandated or authorized purposes.

2. Information will be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates.

3. Information about taxpayers collected from third parties will be verified, to the extent practicable, with the taxpayers before a determination of compliance is made using the information.

Types of Evidence

The Internal Revenue Code requires all taxpayers to keep adequate records to support the items on their tax returns. However, not all evidence need be "books and records." The following discussion is an overview of different types of acceptable evidence of taxpayer compliance.

Documentary Evidence

Physical documentation is generally regarded as providing proof or evidence. Writings made contemporaneously with the happening of an event generally reflect the actual facts and indicate what was in the minds of the parties to the event. If possible, original documentary evidence should be reviewed.

The records to be retained by the LIHC property owner are described in Treas. Reg. §1.42-5(b). The records must be retained for at least 6 yeas after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

Owners may use electronic storage systems instead of hardcopy (paper) books and records to retain the required records.[7] However, the electronic storage system must satisfy the requirements of Rev. Proc. 97-22. In addition, the owner must satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the state agency. For example, the housing agency may require the owner to maintain hardcopy books and records.

While documentary evidence has great value, it should not be relied upon to the exclusion of other facts. Facts can also be established by oral testimony. There will be times when greater weight should be given to oral testimony than to conflicting documentary evidence. The owner should not be considered noncompliant simply because documentary evidence is incomplete to establish precise compliance when there is some evidence to support compliance.

The "Cohan Rule," as it is known, originated in the decision of Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). In Cohan, the court made an exception to the rule requiring taxpayers to substantiate their business expenses. George M. Cohan, the famous entertainer, was disallowed a deduction for travel and business expenses because he was unable to substantiate any of the expenses. The judge wrote that "absolute certainty in such

[7] Rev. Rul. 2004-82, I.R.B. 2004-35, Q&A #11

matters is usually impossible and is not necessary, the Board should make as close an approximation as it can." In general, the Tax Court has interpreted this ruling to mean that in certain situations "best estimates" are acceptable in order to approximate expenses. The Cohan Rule is a discretionary standard and can be used to support a reasonable estimate of compliance requirements.

State agencies may allow owners to reconstruct records when the situation warrants, consider incomplete or imperfect documentation, and accept credible oral testimony to determine the owner/taxpayer's overall compliance with the requirements of IRC §42.

Example 1: Incomplete Documentation

> A couple's current income recertification was timely signed by the wife, but the husband's signature is missing because he is on active military duty and stationed out of the country. The husband's income is included in the recertification and the reporting instructions for his overseas assignment are included in the file. The state agency may consider the unit in compliance, even though the husband's signature is missing.

Example 2: Reconstructing Evidence

> The tenant's income recertification was timely completed and signed. The summary records are in the file, but the income verification from the employer is missing. The state agency may allow the property manager to perfect the documentation.

<u>Oral Testimony</u>

There are times, due to taxpayer-specific circumstances, when records may not exist or are incomplete. In such cases, oral testimony may be the only evidence available. Therefore, oral statements made by the owner to the state agency represent direct evidence that must be considered. Although self-serving, *uncontradicted* statements that are *not improbable* or *unreasonable* should not be disregarded.

Example 1: Plausible Oral Testimony

> During a compliance review, an issue involving the income certification for a household was noted. However, the tenant had moved out and could not be located. The manager remembers discussing the item with the tenant, but there is no third party that can corroborate the manager's statement. If the manager's statement is plausible, the oral testimony can be considered sufficient.

The degree of reliability placed on an owner's oral testimony should be based on the credibility of the owner and surrounding circumstantial evidence supporting the owner's testimony. The following concepts are helpful when evaluating oral testimony.

a. Oral evidence should not be used in lieu of available documentary evidence.

b. If the issue involves specific recordkeeping required by law, then oral testimony alone cannot be substituted for necessary written documentation.

c. Oral testimony need not be accepted without further inquiry. If in doubt, or there are inconsistencies, attempts should be made to verify the facts from another source.

Third Party Evidence

Third party evidence is evidence obtained from someone other than the taxpayer. Credible third party evidence is used when the owner is unable to provide the information or it is necessary to verify information provided by the owner. Information about owners collected from third parties will be verified, to the extent practicable, with the owner before determinations are made using the information provided by third parties.

Evaluating Evidence

The state agencies should exercise sound judgment to make reasonable determinations and ensure that there is a basis for each item considered. This may involve considering the extent to which detailed documentation is required, examining all existing documentation, and determining the weight that should be given to oral testimony. *All* the information needed to definitively resolve an issue will seldom be available; state agencies will need to determine when there is sufficient information, or substantially enough, to make a proper determination of compliance with IRC §42.

State agencies are expected to arrive at definite conclusions based on a balanced and impartial evaluation of all available evidence. The state agencies should employ independent and objective judgment in reaching conclusions and should decide all things on their merit; free from bias and conflicts of interest. Fairness may be demonstrated by:

1. Making decisions impartially and objectively based on consistent application of procedures and tax law;

2. Treating individuals equitably;

3. Being open-minded and willing to seek out and consider all relevant information, including opposing perspectives;

4. Voluntarily correcting mistakes and refusing to take advantage of mistakes or ignorance on the part of the owner; and

5. Employing open, equitable, and impartial processes for gathering and evaluating information necessary for making decisions.

Factors to consider when evaluating evidence include the following:

1. Number and type of noncompliance issues,

2. Elements missing from the documentation,

3. Reasons why documentation is incomplete,

4. Availability of other information to substantiate compliance, and

5. Materiality of unsubstantiated documentation.

In the event that an owner provides clarification or evidence that the potential violation *does not exist,* it is not necessary to report the incident to the IRS; i.e., the owner has clarified that they are in compliance.

Workpapers

Content and Purpose

Workpapers are the state agencies' written records that provide the principal support for their project audits and the filing of Forms 8823. They should include all the information needed to conduct the inspection/review, and document contacts with the owner, the procedures applied, tests performed, information obtained, and the conclusions reached. Workpapers serve the following purposes[8]:

1. A record of the evidence gathered, procedures completed, tests performed, and analyses conducted;

2. Provide support for technical conclusions;

3. Basis for internal reviews by state agency management; and

4. Support for IRS audits of the owner's tax returns.

State agency workpapers may be used by IRS examiners to support conclusions regarding the accuracy of the owner's tax return. These papers and other documents in files may be reviewed to help establish the scope and depth of an IRS audit, establish a pattern of noncompliance, or provide evidence to support adjustments to the tax return. In some cases, the workpapers may be the only evidence.

While there are no requirements for the form or style of workpapers or documentation, workpapers should include certain "identifying" information to support IRS examinations. Workpapers should include:

1. Identity of the owner of the building being reviewed,

2. Name (or initials) of person preparing the workpapers, and

3. Date the workpapers were prepared.

Required Recordkeeping and Retention Provisions – State Agencies

For monitoring compliance with low-income housing credit requirements, Treas. Reg. §1.42-5(a)(2)(i)(A) provides that a procedure for monitoring for noncompliance must include the recordkeeping and record retention provisions of Treas. Reg. §1.42-5(b).

Under Treas. Reg. §1.42-5(e)(3)(ii), a state agency must retain the original records of noncompliance or failure to certify for 6 years beyond the state agency's filing of the respective Form 8823. In all other cases, the state agency must retain the certifications and records for 3 years from the end of the calendar year in which the state agency received the certifications and records.

[8] Internal Revenue Manual 4.10.9(3)

Availability of Workpapers to Owners

IRS agents can informally provide taxpayers with access to the workpapers associated with their own audit *that would otherwise be made available under the Freedom of Information Act.* If consistent with the state's disclosure rules, similar access to the workpapers for the compliance monitoring review can be helpful to owners; e.g., clarifying facts or preparing relevant evidence to resolve issues.

Chapter 4
Category 11a
Household Income Above
Income Limit upon Initial Occupancy

Definition

This category is used to report units that have been rented to households with incomes that do not meet income eligibility restrictions. According to IRC §42(g)(1), an owner of a tax credit property must elect to serve tenant populations with gross incomes that are either 50% or less of Area Median Gross Income (AMGI) or the National Nonmetropolitan Median Gross Income (NNMGI) when applicable,[1] or 60% or less of AMGI or NNMGI when applicable, as adjusted for family size.[2] The National Nonmetropolitan Median Gross Income (NNMGI) is applicable if:

1. IRC §1400N(c)(4), Special Rule for Applying Income Tests, is applicable. The LIHC project was (1) placed in service during 2006, 2007, or 2008, (2) is located in the Gulf Opportunity Zone, and (3) in a nonmetropolitan area (as defined in *IRC §42(d)(5)(B)(iv)(IV))*.

2. IRC §42(i)(8) is applicable.[3] The LIHC project is located in a rural area (as defined in section 520 of the Housing Act of 1949) and the NNMGI is greater than the AMGI. IRC §42(i)(8) is not applicable if the LIHC buildings are financed with tax-exempt bonds.

Under the terms of an extended use agreement, an owner may agree to service tenant populations at AMGI levels lower than identified in IRC §42(g); nonperformance of such agreements is not a reportable noncompliance event.

Annual Household Gross Income is the gross income (with no adjustments or deductions) the household anticipates it will receive in the 12-month period *following* the effective date of the income certification. The combined income of all occupants of a unit, whether or not legally related, is compared to the appropriate percentage of the AMGI for a family with the same number of members.[4]

If information is available on changes expected to occur during the year, that information is used to most accurately determine the anticipated income from all known sources during the year. Unanticipated income received after the household moves in will not affect the original determination that a household is eligible for LIHC housing.

State agencies are required to review the low-income certifications, and the supporting documentation, for the tenants in a sample of LIHC units.[5] Therefore, the state agency must review the initial income certification if the tenant moved in within the last year and the most recent income recertification for continuing tenants. For state agency reviews

[1] See IRC §§42(g)(4), 42(i)(8), 142(d)(2)(B) and 1400N(c)(4).
[2] Note: Once made, this election is irrevocable and applies to all low-income units. See IRC §§42(g)(1) and 42(i)(3)(A)(ii).
[3] IRC §42(g)(8) is applicable for determinations made after July 30, 2008. See section 3004(f) of the Housing Assistance Tax Act of 2008.
[4] See Rev. Rul. 90-89, 1990-2 C.B. 8.
[5] See Treas. Reg. §1.42-5(c)(2)(ii)(A) and (B).

conducted after July 30, 2008,[6] where the project is a 100% LIHC project and the owner is not subject to the annual income recertification requirements, the state agency will always review the initial income certification.[7]

Determining Income Limits (Area Median Gross Income)

Years Prior to 2009

To determine the appropriate household income limit figure, refer to the HUD-published table relating to "very low income," which is an income level at or below 50 per cent of the Area Median Gross Income (AMGI). HUD prepares tables and provides income figures for family sizes ranging from one to eight persons.

If the owner elected the 40/60 minimum set-aside, then the published income figures for the 50 per cent of AMGI should be multiplied by 1.2.[8] There should be no rounding of these figures, as HUD has already rounded to the nearest $50 in the tables.

Years Subsequent to 2008

Beginning with the release of AMGI tables for 2009[9], HUD is providing a separate table for IRC §§ 42 and 142(d) housing projects, which HUD now collectively refers to as "Multifamily Tax Subsidy Projects" (MTSP).

1. The tables are in the same format as in prior years. The column down the left-hand side identifies the state and area within each state. From left to right, the columns identify the income limits based on household size (1 to 8 persons).

2. The tables identify the income limits at the 50% and 60% AMGI levels needed to satisfy the minimum set-aside requirement. As a result, the instructions in Rev. Rul. 89-24 to compute 60% AMGI are no longer needed.

3. In those areas where the income limits did not decrease in 2007 and 2008 because of HUD's hold harmless policy, the tables include a second set of income limits identified as "HERA Special 50%" and "HERA Special 60%." These income limits are applicable if the owner relied on the income limits provided by HUD to determine the income limits applicable to the low-income project and determined whether households were income qualified based on those income limits (adjusted for family size) in either 2007 or 2008. If the project was in service, or placed in service during 2007 or 2008, the owner relied on the income limits provided by HUD and the HERA special income limits should be used.

[6] For reviews conducted before July 31, 2008, if the owner received a waiver of the annual income recertification requirements, the state agency reviewed the initial income certification. See Rev. Proc. 2004-38, section 5.07, 2004-2 C.B. 10, and Rev. Proc.94-64, Section 4.05, 1994-2 C.B. 797. If noncompliance with the tenant income certification requirements was sufficiently serious, consideration was given to revoking the waiver. Revocation was not required, but the Service would revoke the waiver at the state agency's request.
[7] See IRC §142(d)(3).
[8] Rev. Rul. 89-24, 1989-1 C.B. 24
[9] Section 3009 of the Housing Assistance Tax Act (HATA) amended IRC §142(d)(2) to add a new subparagraph E. IRC §142(d)(2) is cross referenced in IRC §42(g)(4) and is equally applicable to qualified low-income projects under IRC §42.

Households and Family Size

As a general rule, a "household" consists of all individuals (or tenants) residing in a unit. To determine the household income limit, all applicable income standards are adjusted for family size. For LIHC purposes, all occupants of a unit are considered in the determination of family size except the following (refer to HUD Handbook 4350.3 for complete discussion):[10]

1. Live-in aides. A person who resides with one or more elderly persons, near-elderly persons, or persons with disabilities, and who is determined to be essential to the care and well-being of the person(s); is not obligated for the support of the person(s); and would not be living in the unit except to provide the necessary supportive services. While a relative may be considered to be a live-in aide/attendant, they must meet the above requirements. The income of live-in aides is not included in the household's income.

2. Foster children and foster adults. Foster children are in the legal guardianship or custody of a State, county, or private adoption or foster care agency, yet are cared for by foster parents in their own homes under some kind of foster care arrangement with the custodial agency. A foster adult is usually an adult with a disability who is unrelated to the tenant family and who is unable to live alone.

3. Guests. A visitor temporarily staying in the unit with the consent of the tenant or another member of the household who has expressed or implied authority to consent on behalf of the tenant.

When determining family size for income limits, the owner must include the following individuals who are not living in the unit:

1. Children temporarily absent due to placement in a foster home;

2. Children in joint custody arrangements who are present in the household 50% or more of the time. If disputed, determine which parent claimed the children as dependents for purposes of filing a federal income tax return.

3. Children who are away at school but who live with the family during school recesses;

4. Unborn children of pregnant women (as self-certified by the woman);

5. Children who are in the process of being adopted;

6. Temporarily absent family members who are still considered family members if approved to live in the unit. For example, the owner may consider a family member who is working in another state on assignment to be temporarily absent;

7. Family members in the hospital, or a rehabilitation facility, for periods of limited or fixed duration are considered a family member. These persons are temporarily absent; and

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[10] IRC §142(d)(2)(B) refers to the income of individuals. The combined income of all occupants of an apartment, whether or not legally related, is compared to the appropriate percentage of the median family income for a family with the [same] number of members. See Rev. Rul. 90-89, 1990-2 C.B. 8.

8. Persons permanently confined to a hospital or nursing home. The family decides if such persons are included when determining family size for income limits. If the family chooses to include the permanently confined person as a member of the household, the owner must include income received by the confined person in calculating family income.

Changes in Family Size

Changes in the size of an existing household after the initial tenant income certification must also be addressed.

Family Size Increases

The addition of new member(s) to an existing low-income household requires the income certification for the new member of the household, including third party verification. The treatment will depend on whether the building is a mixed-use or 100% LIHC building.

Mixed-Use Projects

For mixed-use projects, the new tenant's income is added to the income disclosed on the existing household's most recent tenant income certification.[11] The household continues to be income-qualified, and the income of the new member is taken into consideration with the income of the existing household for purposes of the Available Unit Rule under IRC §42(g)(2)(D). See Chapter 14.

Example 1: Additional Person Joins Household During the Year

Jim and his two children initially income qualified and moved into an LIHC unit on March 1, 2005. The project is a mixed-use project consisting of one building with 50 low-income units and 25 market rate units. The household continued to qualify at the annual income recertification for 2006, 2007, and 2008. Jim then met Jane, and they decided to marry in October 2008. The new couple would like to live in the LIHC unit Jim occupies. Jane completes a tenant income certification.

The certification effective date continues to be March 1, 2005 and the next annual income recertification is due within 120 days before March 1, 2009.

If the household's income, when Jane's income is added to the existing household's income as determined for the March 1, 2009 annual recertification, exceeds 140 percent of the income limit (170 percent in deep rent skewed projects), then the unit is an over-income unit and the Available Unit Rule is applicable.

[11] Under IRC §142(d)(3)(A) and Treas. Reg. §1.42-5(c)(iii), owners must obtain an *annual* income certification from each low-income tenant if the low-income building is part of a mixed-use low-income project. Interim income recertifications are not required under IRC §42.

100% LIHC Projects

If the project is a 100% LIHC project,[12] then the new tenant's income is added to the income disclosed on the existing household's original income certification.

Example 2: Owner is not Subject to Annual Income Recertification Requirement

> Mary and her two daughters initially income qualified and moved into an LIHC unit on March 1, 2005. The project is a 100% LIHC project for which the owner had a waiver of the income recertification under Rev. Proc. 94-64 for periods ending before August July 30, 2008. Mary never completed an annual income recertification for 2006 through 2008, and under IRC §142(d)(3), will not be required to complete an income recertification in the future.
>
> Mary met Bill and they decided to marry in October 2008. The new couple would like to live in the LIHC unit Mary occupies. Bill completes a tenant income certification and moves into the unit on October 25, 2008.
>
> The certification effective date continues to be March 1, 2005, but no annual income recertification is required. Since the owner will always rent the next available unit to an income-qualified household as a low-income unit, the Available Unit Rule will not be violated if the household's income, when Bill's income is added to Mary's income at the time she moved in with her daughters, exceeds 140 percent of the income limit (170 percent in deep rent skewed projects).

Original Household No Longer Occupies Unit

A household may continue to add members as long as at least one member of the original low-income household continues to live in the unit. Once all the original tenants have moved out of the unit, the remaining tenants must be certified as a new income-qualified household unless:

1. For mixed-used projects, the newly created household was income qualified, or the remaining tenants were independently income qualified at the time they moved into the unit.

2. For 100% LIHC buildings, the remaining tenants were independently income qualified at the time they moved into the unit.

Example 3: Remaining Tenants Must be Income Qualified

> Michael, an income-qualified individual, moved into a two bedroom LIHC unit in a mixed-used project on May 20, 2006. Jason joined the household in October of 2007. At that time, Michael and Jason's combined income was below the limit for a two person household. In January of 2008, Michael moved out. It is not necessary for Jason to be certified as a new tenant.

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[12] The same rule applies if, before July 31, 2008, the owner received a waiver of the income recertification requirement under Rev. Proc. 2004-28 or Rev. Proc. 94-64.

However, if Michael and Jason's combined income exceeded the income limit for a two-person household in October of 2007, then Jason must be certified as an income-qualified tenant when Michael moves out.

If a state agency determines that the tenants manipulated the income limitation requirements, then the unit should not be treated as a low-income unit as of the date the household initially occupied the unit.

Example 4: New Tenants Manipulated Income Limitations

An income-qualified household consisting of one person moved into a two bedroom unit on March 15, 2005. A second tenant completed an initial income certification and joined the household soon thereafter. The combined income of the two tenants is above in income limit for a household with two members. The unit is out of compliance as of March 15, 2005.

Family Size Decreases

Decreases in family size do not trigger the immediate income certification of a new household. Subsequent annual income recertifications will be based on the income of the remaining members of the household. If the remaining household's income is more than 140 percent (170 percent in deep rent skewed projects) of the income limit at the time of the annual income recertification, then the Available Unit Rule is applicable.[13]

Example 1: Member of the Household Leaves

A married couple, with their two children, was initially income qualified and occupied a three bedroom unit. After four years, the oldest child, now 18 years old, moves out of the unit. It is not necessary to certify the remaining household as a new household. If the household's income exceeds 140 percent of the income limit (170 percent in deep-skewed projects) for a family with three members at the next income recertification, the Available Unit Rule is applicable.

Example 2: Unborn Children

A household was originally income qualified based on the inclusion of an unborn child. Four months later, the pregnancy ended in miscarriage. It is not necessary to certify the remaining household as a new tenant at the time of the miscarriage. If the income of the remaining household members exceeds 140 percent of the income limit (170 percent in deep rent-skewed projects) at the next income recertification, the Available Unit Rule is applicable.

[13] See the legislative history for IRC §42, which notes that if the tenant's income increases to a level more than 140 percent above the otherwise applicable ceiling (*or if the tenant's family size decreases so that a lower maximum family income applies to the tenant*), that tenant is no longer counted in determining whether the project satisfies the set-aside requirement. The explanation continues, stating that there is no penalty in such cases if the Next Available Unit Rule is applied.

Verifying Income and Assets

Owners must verify all known income and assets that affect eligibility. However, if the total assets for a household are $5,000 or less, the applicants may satisfy the asset requirement by signing a statement attesting to such fact.[14]

Acceptable methods of verifying information include third party verifications, reviews of documents submitted by the tenant (such as check stubs), and tenant certifications made under penalties of perjury.[15]

Third party contacts are preferred. Owners should obtain the tenant's consent for the release of information before contacting third parties. Verification forms should be directly sent to and received from third parties. If third party contacts are by telephone or interview, the conversation should be documented in the tenant's file and include all the information that would have been included in a written verification. The owner may obtain acceptable third party written verification by facsimile, e-mail, or Internet.

Owners can accept tenant-provided documents (e.g., pay stubs, Forms W-2, bank statements, etc.) when third party contacts are impossible or delayed, or third party verifications are not needed (e.g., birth certificates or divorce decrees).[16]

There will be situations where it will be difficult to estimate income. For example, the tenant may work sporadically or seasonally. In such cases, owners are expected to make a reasonable judgment as to how to the most reliable approach to estimating what the tenant will receive in the coming year.

Determining Annual Income

Household income is defined as the gross income (with no adjustments or deductions) the household anticipates it will receive in the 12-month period following the effective date of the household's certification of income.[17] If the household's income cannot be determined based on current information because the household reports little to zero income, or income fluctuates, income may be determined based on actual income received or earned within the last twelve months before the determination.[18]

Income includes, but is not limited to, earned and unearned income from all household members age 18 and older (adults, including foster adults[19]), unearned income of minor children and foster children[20] under the age of 18, and income from assets. Emancipated minors, persons under the age of 18 who have entered into a lease under state law, are treated as adults.

[14] Rev. Proc. 94-65, 1994-2 C.B. 798

[15] Treas. Reg. §§ 1.42-5(b)(vii) and 1.42-5(c)(1)(iii)

[16] Third party contacts are considered impossible if an employer does not respond, third party charges a fee, or no third party is available. Generally a third party contact is considered delayed if a response will not be received within two weeks, but can be less it is determined that the third party will not respond.

[17] As explained in Treas. Reg. §1.42-5(b)(vii), gross income for purposes IRC §42 is not gross income for purposes of determining a federal income tax liability.

[18] 74 FR 4841-4842, regulatory changes to 24 CFR 5.609

[19] Effective August 1, 2009.

[20] Effective August 1, 2009.

The treatment of a student's income is dependent on the age of the student, the type of income, and the status of the student within the household. It doesn't matter whether the student is living with the household or is away at school.

1. If the full-time student is 18 years of age or older and is the head of the family, spouse or co-head, all income is included.

2. If the full-time student is 18 years of age or older and a dependent, only the lesser of actual earned income or $480 is included, along with unearned income and income from assets.

3. If the full-time student is a minor (under the age of 18), then only unearned income and income from assets is included. No income from employment is counted.

The treatment of educational scholarships and grants is discussed later in this chapter.

As noted in Chapter 5 of HUD Handbook 4350.3, "In all instances, owners are expected to make a reasonable judgment as to the most reliable approach to estimating what the tenant will receive during the year."[21]

Common sources of income are discussed below. Refer to HUD Handbook 4350.3, Chapter 5, for additional information.

Employment Income

Employment income includes (but is not limited to) hourly wages, salaries, overtime pay, tips, bonuses, and commissions before any payroll deductions. Payments in lieu of employment income are also included; e.g., workers compensation, severance pay, unemployment and disability compensation. Earned income from employment of children (including foster children) is excluded.

Maximum benefits and annualized payments should not be used unless the source of funds is expected to continue throughout the certification period or for an indeterminable length of time. For example, if the third party does not indicate the length of time for which the tenant will be receiving a certain income, then the income should be annualized. In the event that the family cannot provide documentation that access to a specific source of income is for a limited and determinable time period, the benefits should be considered to be available for an indefinite time period and annualized.

Example 1: Benefits for Indefinite Time Period

> John works as a telemarketer for $9.00 an hour, 40 hours a week. He does not work overtime, has no other source of income, and is not planning to leave his job. His anticipated income is computed as:
>
> ($9.00/hour) x (40 hours/week) x (52 weeks/year) = $18,720/year

[21] The HUD Handbook 4350.3, Chapter 5, paragraph 5-5(C)

Example 2: Benefits for Definite Time Period

A teacher's assistant works nine months annually and receives $1,300 per month. During the summer recess, the teacher's assistant works for the Parks and Recreation Department for $600 a month. The teacher's assistant's anticipated income is computed as:

($1,300 x 9 months) + ($600 x 3 months) = $13,500

If information is available on changes in income expected to occur during the year, use that information to determine the total anticipated income from all know sources during the year. [22]

Example 3: Anticipated Changes in Income

In May 2004, an unemployed plumber applies for LIHC housing. At that time, the plumber is receiving unemployment benefits of $250.00 per month and will qualify for benefits for 4 more months.[23] Beginning in October, the plumber will be employed at $1,000 per month. The plumber's anticipated income is computed for the period from May to September, 2004 plus the income for October 2004 through May 2005.

($250.00 x 5 months) + ($1,000 x 7 months) = $8,250

Owners are expected to make reasonable judgments regarding the most reliable method for estimating the income a household will receive during the year. If the tenant's income cannot be determined using current information, the owner may include actual income received or earned within the 12-month period before the determination of annual income.

Example 4: Sporadic Employment

Justine is disabled and not always able to work full-time. She has income from disability insurance and a family trust, and also works as a typist with a temporary agency when she is well. Last year she worked nearly six months, but at the time she applies for an LIHC apartment, she has more medical problems and does not know when or how much she will be able to work.

Because Justine is not working at the time of the certification and actual income from her sporadic employment as a typist cannot be reasonably determined, the income earned during the six-month period in the prior year should be included in the income certification.

NOTE: An owner must make a reasonable judgment. The prior year's income should not be used to estimate Justine's future income if she can provide sufficient documentation that her earning capabilities have changed;

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[22] See Footnote #2.
[23] The HUD Handbook 4350.3, Chapter 5, paragraph 5-5(A)(1) refers to unemployment compensation as an example of income that *may* not last for a full 12 months.

e.g., her contract with the temporary agency has been terminated.

Payments received under the Domestic Volunteer Service Act of 1973 are excluded from income. This includes employment through VISTA, Retired Senior Volunteer Program, Foster Grandparents Program, youthful offender incarceration alternatives, and senior companions. Payment received under Title V of the Older Americans Act (Green Thumb, Senior Aides, Older American Community Service Employment Program) is also excluded.

Military Employment

Military employment may include (but is not limited to) base and longevity pay, proficiency pay, sea and foreign duty pay, hazardous duty pay, subsistence and clothing allowances. All these are includable in income. Hostile fire pay, however, is excluded from income. *Note*: a temporarily absent individual on active military duty must be removed from the family and his or her income must not be included in the computation of household income, unless (1) that person is the head of the family, spouse, or co-head or (2), the spouse or a dependent of the person on active military duty resides in the unit.

Military Basic Housing Allowance

Military basic housing allowances are also included in income. However, under IRC §142(d)(2(B)(ii),[24] military basic housing allowances are *not* included in household income if the low-income building is located in any county, or adjacent county, in which is located a qualified military installation. A qualified military installation is any military installation or facility to which:

1. not less than 1,000 members of the Armed Forces are assigned, and

2. the number of members of the Armed Forces assigned to units based out of such qualified military installation, as of June 1, 2008 has increased by not less than 20 percent, as compared to such number on December 31, 2005.

Qualifying military bases are identified in Notice 2008-79.[25] The list is not meant to be exclusive and any qualified military installation which satisfies the percentage requirements of IRC §142(d)(2)(B)(iii)(1) would be eligible to receive similar treatment regardless of its failure to be included in Notice 2008-79 or any subsequent updates.

1. Colorado – U.S. Air Force Academy
2. Hawaii – Fort Shafter
3. Kansas – Fort Riley
4. Maryland – Annapolis Naval Station (including U.S. Naval Academy)
5. South Carolina – Fort Jackson
6. Texas – Fort Jackson and Fort Hood
7. Virginia – Dam Neck Training Center Atlantic
8. Washington – Naval Station Bremerton

[24] IRC §142(d)(2)(B)(ii) was added under section 3005(a) of the Housing Assistance Tax Act of 2008.
[25] Notice 2008-79, 2008-40 I.R.B. 815. The IRS will update the list if it receives additional information indicating that other military installations should receive the same treatment. Owners may rely on this list for income determinations made after July 30, 2008 and before any successor list is published.

The exception under IRC §142(d)(2)(B)(ii) applies to:

1. determinations of income made after July 30, 2008 and before January 1, 2012, if (1) the IRC §42 credits were allocated[26] on or before July 30, 2008 or, (2) if financed with tax-exempt bonds, the building was placed in service before July 30, 2008, but only if the bonds were issued before July 30, 2008.

2. determinations of income made after July 30, 2008 if (1) the IRC §42 credits were allocated after July 30, 2008 and before January 1, 2012, or (2) if financed was tax-exempt bonds, the building is placed in service after July 30, 2008 and before January 1, 2012, but only if the bonds were issued after July 30, 2008 and before January 1, 2012.

The low-income building owner is responsible for documenting that the exception under IRC §142(d)(2)(B)(ii) is applicable.

Deployment of Military Personnel to Active Duty

Owners are encouraged to accommodate the unique circumstances of households where a member is called to active duty in the Armed Forces. Specific actions that owner can take and remain in compliance include, but are not limited to:

1. Allow a guardian to move into the low-income unit on a temporary basis to provide care for any dependents the military person leaves in the unit. The guardian's income is not included in the household's income.

2. Allow a tenant living in a low-income unit to provide care for any dependents of persons called to active duty in the Armed Forces on a temporary basis as long as the head and/or co-head of the household continues to service in active duty. Income of the dependent (e.g., SSI benefits, military benefits) is not included in the household's income.

3. Allow leases to remain in effect for a reasonable period of time without recertification (if required) depending on the length of deployment beyond that required by the Soldiers' and Sailors' Civil Relief Act of 1940, 50 U.S.C. §§501-591, even though the adult members of the military family are temporarily absent from the assisted unit.

Income from Training Programs

Compensation from state or local employment training programs or training of a family member as resident management staff is not included in income. Income from training programs not affiliated with a local government and income from the training of a family member resident to serve on the management staff are also excluded. Amounts excluded by this provision must be received under employment training programs with clearly defined goals and objectives, and are excluded only for a limited period as determined in advance under the program by the state or local government.

Amounts received under training programs funded by HUD are not included in income. Similarly, payments received under programs funded in whole or in part under the Workforce Investment Act (WIA – formerly the Job Training Partnership Act) are excluded from income. These are employment and training programs for Native

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[26] The date of allocation is the date the allocating document under IRC §42(h) is signed.

Americans and migrant and seasonal farm workers, Job Corps, veterans employment programs, state job training programs, career intern programs, and AmeriCorps. Amounts received by a person with a disability that are disregarded for a limited time for purposes of supplemental security income eligibility and benefits because they are set-aside for use under a Plan to Attain Self-Sufficiency (PASS) are excluded from income.

Excluded compensation includes stipends, wages, transportation or childcare payments received, or reimbursements of out-of-pocket costs and which are made solely to allow participation in a specific program. Income received as compensation for employment is excluded only if the employment is a component of a job-training program. Once training is completed, the employment income is included in the computation of annual income. Amounts received during the training period from unrelated sources (public assistance, social security payments, other employment) are not excluded from income.

Income from a Business

The net income from the operation of a business, profession, or sole proprietorship businesses is included in income. Net income is gross income less business expenses, interest on loans, and depreciation computed on a straight-line basis. Salaries paid to the applicant or other household members from the business must also be identified and included in income. In addition, cash and assets withdrawn by family members must be included in income except when the withdrawal is a reimbursement of cash or assets invested in the business.

Business expenses do *not* include principal payments on loans, interest on loans for business expansion or capital improvements, or other expenses for business expansion or outlays for capital improvements.

If the net income from a business is negative, it must be counted as zero income. A negative amount cannot be used to offset other family income.

Example 1: Negative Income from Sole Proprietorship

> John and Mary, a married couple, apply for LIHC housing. John operates a sole proprietorship business; the net income from the business after expenses last year was -$3,500. Mary earns $27,000 each year as an employee, as shown on the W-2 from her employer. The household's income is $27,000. The $3,500 loss generated by John's business cannot be used to offset Mary's wages.

Income from a sole proprietorship can be estimated by reviewing the individual's prior year tax returns and Schedules C. If necessary, the owner can ask the potential tenant to provide a signed Form 8821, which will allow the owner to verify the information with the IRS. Note: A tax return must be filed for all self-employed individuals who operate sole-proprietorship businesses or otherwise report income on Schedule C, regardless of whether the taxpayer is reporting a profit or a loss. If the person is not eligible to get an SSN, which is needed to file a tax return, an individual taxpayer identification number (ITIN) can be obtained using IRS Form W-7.

Example 2: Using the Prior Year Tax Return

> A potential LIHC tenant is self-employed and expects the business to continue indefinitely. The potential tenant submitted the tax return for the last year. The net income from the sole proprietorship was $13,000. The $13,000 figure can be used as income anticipated for the next 12 months.

Alternatively, the potential tenant can annualize income from self-employment for the current year business activity based on the number of full months in business. The formula is:

$$\frac{\text{(Net Income Year to Date) x 12 Months}}{\text{Number of Months in Business during the Current Year}}$$

Example 3: Annualized Current Year Self-Employment Income

> In September, a potential tenant prepared a Schedule C showing the income and expenses for the current year, from January 1 through August 31, using the tax form from the prior year. To date, the potential tenant has net income of $24,000. The anticipated income is determined by multiplying $24,000 by 12/8, which equals $36,000. This is an acceptable estimate of future earnings.

Office in the Home

A low-income tenant may use a portion of a low-income unit exclusively and on a regular basis as a principle place of business, and claim the associated expenses as tax deductions, as long as the unit is the tenant's primary residence. If the tenant is providing daycare services, the tenant must have applied for (and not have been rejected), be granted (and still have in effect), or be exempt from having a license, certification, registration, or approval as a daycare facility or home under state law. For more information, refer to Form 8829, Expenses for Business Use of Your Home, the form's instructions, and Publication 587, Business Use of Your Home (Including Use by Daycare Providers).

Example 4: Use of Residential Rental Unit as Home Office

> A self-employed bookkeeper wishes to rent a two bedroom unit and intends to use one bedroom as her principle place of business; i.e., to provide bookkeeping services. She provides her tax return for the last year, which includes a Schedule C, as verification of her income. The Schedule C includes an "office expense" for her home office in a prior residence. There's also a Form 8829 included with the return.

Income from Rental Property, Partnerships, S-Corporations, and Royalties

Rental property may be real estate or personal property such as equipment or vehicles. The tenant may have income from enterprises doing business as partnerships or s-corporations, or receive royalties for copyrights or patents.

Assets

There is no limit on the amount of assets a household may hold and a household is not required to convert an asset to cash.

Assets include bank accounts, trusts, stocks and bonds, the surrender value of life insurance policies, and cash kept in safety deposit boxes or at home. One time, lump sum distributions are considered assets; e.g., inheritances, capital gains, victim's restitution and settlements on insurance claims. Lottery winnings paid in one lump payment are treated as assets. Lottery winnings paid in periodic payments must be counted as income. Lump sum payments of deferred periodic payments of supplemental security income and social security benefits are also considered assets.

For non-cash assets held for investment, the cash value is the net amount the household would receive if the assets were converted to cash. The cash value is the market value, or the amount another person would pay to acquire the asset, less the cost to turn the asset into cash.

Assets do not include necessary personal items such as clothes, furniture, cars, wedding rings, or vehicles specially equipped for persons with disabilities. Assets used in a business are not assets included in the computation of the tenant's income. If an asset is held in the tenant's name, but the income generated by the asset accrues to someone who is not a member of the household and the other person is responsible for income taxes on the accrued income, then the asset is not included in the tenant's income.

Lump-sum additions to the household's assets, such as inheritances, insurance proceeds (including payments under health and accident insurance and worker's compensation), capital gains, and settlements for personal or property losses are excluded from income.

Example 1: Exhausting an Asset

> A tenant receives a lump sum inheritance of $12,000 and deposits the money in a savings account. The asset is disclosed and the income from the asset correctly accounted for at the time of the initial income certification. The tenant subsequently withdraws $1,000 each month to pay personal living expenses. A year later, when the annual income recertification is completed, the bank account balance is zero. The monthly withdraws retain their character of an asset; i.e., they are not considered income. There is no need to include the bank account as an asset in subsequent annual income recertifications since the balance is zero.

Assets disposed of for less than fair market value within two years of the effective date of a tenant's initial certification or recertification, including assets placed in irrevocable trusts, are included *as an asset in the determination of the tenant's income.* Assets are considered to be disposed of for less than fair market value if the cash value of the assets disposed of exceeds the gross amount the tenant received by more than $1,000.

Example 2: Tenant Disposed of Assets for Less Than Fair Market Value

> During April of 2009, Jackson Jones gave each of his three children $500. In September of 2009, he applied for low-income housing. Because the total ($1,500) exceeds the $1,000 limit, the gifts are treated as assets disposed of for less than fair market value and are included as income on his application.
>
> Note: The gifts should also be reported as income for the 2010 income recertification if the low-income unit is in a mixed-use building. See Chapter 14 for details.

Do not include assets disposed of for less than fair market value as the result of a foreclosure, bankruptcy, or divorce or separation agreement if the applicant or tenant receives valuable consideration not measurable in dollars.

Assets must be verified, the income generated from assets must be determined, and the income included in the computation of the household's income.

1. If the total cash value of a household's assets is more than $5,000, imputed income must be calculated using the current HUD passbook rate[27] and the greater of the actual income or imputed income must be included in the household's income. Refer to the HUD Handbook 4350.3, paragraph 5-7F, for the passbook rate, which is currently set at 2%.

2. If the total cash value of the household's assets is $5,000 or less, the actual income the tenant receives from assets is the amount included in annual income as income from assets. An owner may satisfy asset verification requirements by *annually* obtaining a signed, sworn statement from the tenant certifying that the tenant's net family assets are $5,000 or less and disclosing the tenant's annual income from net assets. Owners, however, may not rely on a low-income tenant's signed, sworn statement of income from assets if a *reasonable person*[28] *in the owner's position would conclude that the tenant's income is higher than the amount presented* by the tenant. In such cases, the owner must obtain other documentation of the low-income tenant's annual income from assets to satisfy documentation requirements.[29]

Income from Investments

Stocks, bonds, Treasury bills, certificates of deposit, mutual funds, and money market accounts are assets. Interest or dividends earned are included as income even when the earnings are reinvested.

Example 1: United States Savings Bonds

> A potential tenant buys a United States savings bond for $50 each month through a savings program offered by his employer. At the time of his application for housing, he is holding 18 bonds, which have a face value of $931; i.e., $900 investment and $31 accumulated interest. The savings bonds are included as assets and the anticipated interest that will be earned is included as income even though the interest is added to the value of the bond.

Contract Sales of Real Estate Assets

A tenant may sell real estate using an installment contract (or similar agreement) that provides a stream of payments over a period of time. A portion of the payment will be applied to the principal and a portion will be interest income. The interest should be included in income; the outstanding principal as the effective date of the certification is

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[27] Projects receiving a tax credit allocation for rehabilitation of USDA Rural Development properties typically use the USDA Rural Development passbook rate if imputed interest must be included in the income computation.

[28] The "reasonable person" concept is part of the definition of due diligence. Due diligence is defined *(Black's Law Dictionary [6th ed. 1990])* as: "Such measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances; not measured by any absolute standard, but depending upon the relative facts of the special case." In short, the due diligence standard is a judicially created test to determine the adequacy of the efforts exerted throughout all phases of any activity.

[29] See Rev. Proc. 94-65, 1994-2 C.B. 798.

considered an asset. The value of the asset will decrease over time as the loan is repaid.

Periodic Social Security Payments

The gross amount of periodic Social Security payments, before deductions, is included in income. Payments received by adults on behalf of individuals under the age of 18 or by individuals under the age of 18 for their own support are also included.

When social security or SSI benefit income is paid in a lump sum as a result of deferred periodic payments, that amount is excluded from income.

Periodic Payments, Retirement Accounts, Annuities, and Trusts

The full amount of periodic payments from annuities, insurance policies, retirement funds, pensions and disability or death benefits is included in income. Examples of periodic payments include Black Lung Sick benefits, Veterans Disability, Dependent Indemnity Compensation, and payments to the widow of a serviceman killed in action. Payments from long-term care insurance (in excess of $180 a day) are included in income.

Federal government/Uniformed Services, state, local government, social security or private pension funds are not included in income if paid directly to a former spouse according to the terms of a court decree of divorce, annulment or legal separation. However, if a tenant is the former spouse and is receiving any amounts pursuant to a court ordered settlement in connection with a divorce, annulment of marriage, or legal separation (reflected on a Form 1099), the amount is included in the tenant’s income.

<u>Retirement Accounts</u>

Balances in Individual Retirement Accounts (IRAs), 401K’s, Keogh plans and similar retirement savings accounts are considered assets if the money is accessible to the household.

1. For employed individuals, accessible amounts are considered assets even if withdrawal would result in a penalty; however, amount that are accessible only if the individual is retired are not included.

2. For employed individuals, include only the amount that can be withdrawn without retiring or terminating employment.

3. After retirement, the amount received as a lump sum is considered an asset.

Any retirement benefits received as periodic payments are included in annual income.

<u>Annuities</u>

If a member of the household is receiving annuity payments and is not able to withdraw the balance as a lump sum of cash, the payments are treated as income and no calculation of income from an asset is made. If the balance of the annuity can be withdrawn, the annuity is treated as an asset. In addition to the income earned from the annuity, the cash value of the annuity must also be determined.

The cash value is the full value of the annuity, minus any surrender (or withdrawal) penalty, minus any taxes and tax penalties that would be due, and is the value used to compute the imputed income of the household’s assets. The actual income is the balance in the annuity multiplied by the percentage at which the annuity is expected to grow over

the coming year.

Trusts

1. If any member of the household has the right to withdraw the funds in the account, the trust is considered an asset and treated as any other asset. The cash value of the trust is added to total net assets. The actual income received is added to actual income from assets.

2. If only the income, but none of the principal, is currently available to a member of the household, the income is counted in annual income, but the trust in not included in the calculation of income from assets.

3. If no member of the household has access to either the principal or income of a trust, the trust is not included in the calculation of income from assets or in annual income.

4. If a member of the household receives a portion of the trust's principal on a regular basis, the payments are included in annual income.[30]

If a member of the household creates a nonrevocable trust for the benefit of another person while residing assisted housing, the trust is considered an asset disposed of for less than fair market value.

1. If the trust's income is regularly reinvested in the trust, the value of the trust is calculated as any other asset disposed of for less than the fair market value for two years and not taken into consideration thereafter.

2. If the household member continues to receive income from the trust, the income is added to annual income and the trust is counted as an asset disposed of for less than the fair market value for two years. Thereafter, only the actual income distributed from the trust in included in income.

Documentation

Benefit letters or annual statements prepared by third parties are sufficient documentation. Verification may also include bank statements noting the transfers of funds.

Public Assistance

Amounts specified for shelter and utilities should be separately stated. They may be excluded from income. Special computations are needed; consult the HUD Handbook 4350.3 for details.

Example 1: Utility Allowance is Greater than Tenant's Portion of Rent

> Under HUD's section 8 program, the portion of the rent paid by the household is calculated as a percentage of the household's monthly income and subtracting a utility allowance if the household pays utilities, In some cases, the utility allowance will be greater than the household's portion of the rent and the households will receive a utility reimbursement to assist in meeting utility costs. The reimbursement is not included in income.

[30] See HUD Manual 4350.3, Chapter 5, section 5-6(G)(1)(b)(5).

Payments, rebates or credits received under the Federal Low-Income Home Energy Assistance Program are excluded from income. Also exclude any winter differentials given to the elderly.

Special calculations of public assistance income are required for as-paid state, county or local public assistance programs. Consult the HUD Handbook for detailed instructions.

Recurring Gifts, Grants and Contributions

Regular, recurring monetary and nonmonetary gifts or contributions to residents from persons not living in the unit must be included in income. This can include the payments of bills on behalf of a resident. For example, if a parent or family member will be paying a resident's utility bill each month directly to the utility company, those payments are still counted as income for the tenant. However, the value of groceries provided by someone outside the household, and the food portion of public assistance, even if provided routinely, is *not* included.

Example 1: Use of Vehicle

> A tenant uses her ex-husband's car to transport their son to medical examinations conducted on a regular basis. The title to the car is in the ex-husband's name, he makes the car payment, and he is responsible for maintenance.
>
> The use of the car should not be considered a regular non-cash contribution to the household unless the tenant has exclusive use of the vehicle.

Grants received specifically for medical expenses, set aside for use under a Plan to Attain Self Sufficiency (PASS) and excluded for purposes of Supplemental Social Security (SSI) eligibility, or for out-of pocket expenses for participation in publicly assisted programs (expenses include the costs for special equipment, clothing, transportation, child care, etc.) are excluded.

Generally, "amounts" paid directly to a childcare provider by persons not living in the unit for a tenant's childcare are not included in income. This exclusion is based on a handbook interpretation of reimbursed childcare expenses under the definition of Adjusted Income and it's bearing on Annual Income. See 24 CFR Parts 813.1, 215.1, and 236.1. In relevant part, the regulations define childcare expenses to include "amounts to be paid by the family for [child care]…to the extent [they are] not reimbursed." Handbook 4350.3 indicates that childcare expenses that are not reimbursed are not included as annual income. However, if such childcare is paid by a *non-custodial* parent in lieu of all, or part, of child support payments, then it should be included in income.

Educational Scholarships or Grants

The treatment of educational scholarships or grants is dependent on whether the student is receiving Section 8 assistance.

<u>Not Receiving Section 8 Assistance</u>

All forms of student financial assistance, no matter how it is used, are excluded from annual income. Financial assistance includes grants, scholarships, educational entitlements, work study programs, and financial aid packages. It doesn't matter whether the assistance is paid to the student or directly to the educational institution.

Receiving Section 8 Assistance

All financial assistance received from the following sources in excess of tuition is includable in income.

1. The Higher Education Act Assistance under the Higher Education Act of 1965[31], including Pell Grants, Federal Supplemental Educational Opportunity Grants, Academic Achievement Incentive Scholarships State assistance Partnership Program, the Robert G. Byrd Honors Scholarship Program, and the Federal Work Study programs.

2. Private sources (nongovernmental) of assistance, including assistance provided by a parent, guardian or other family member, whether residing within the family in the section 8 assisted unit or not, or from other persons not residing in the unit.

3. Institutions of higher education, when the specific institution and scholarship amount are referenced. An institution of higher learning provides education beyond high school (or equivalent), is accredited (or has reaccreditation status), is legally authorized to provide a program of education beyond the high school level, awards a bachelor's degree or provides a two-year program that is acceptable for full credit towards such a degree, The institution may be public or nonprofit.

   Institutions of higher education also includes any school providing education beyond high school (or equivalent),that is accredited (or has reaccreditation status), is legally authorized to provide a program of education beyond the high school level, which provides not less than a one year program of training to prepare students for gainful employment in a recognized occupation. The institution may be public or nonprofit.

   Finally, an institution of higher learning includes public and nonprofit private educational institutions in any state that, in lieu of providing education beyond high school, admits students who are beyond the age of compulsory school attendance in the state in which the institution is located.

Financial assistance received from one of the sources above, in excess of tuition, is not includable in income if either of the two following exceptions is applicable:

1. The student is over the age of 23 with dependent children, or

2. The student is living with his or her parents who are applying for, or receiving, Section 8 assistance.

Financial assistance does not include loan proceeds for the purpose of determining income.[32]

Temporary, Nonrecurring, or Sporadic Income

Irregular, nonrecurring monetary gifts or contribution to resident are not included in income.

[31] See 20 U.S.C. 10001 *et seq.*
[32] Page 18146, Federal Register Vol. 71

Alimony or Child Support

Alimony or child support that is court ordered or supported by a written agreement should be included in income unless the recipient certifies that the funds were not received and reasonable efforts have been made to collect the amount due, including filing with courts or agencies responsible for enforcing payments. When no documentation of child support, or alimony stipulated in a divorce decree or separation is available, the owner may require the family to sign a certification stating the amount received. The certification must be notarized. Documentation of the collection efforts made may be requested.

A signed, sworn self-certification by a tenant is sufficient documentation under Treas. Reg. §1.42-5(b)(1)(vii) to show that a tenant is not receiving child support payments and is consistent with the documentation requirements in Rev. Proc. 94-65.[33] In addition to specifying that a tenant is not receiving any child support payments, an annual signed, sworn self-certification should indicate whether the tenant will be seeking or expects to receive child support payments within the next 12 months. If the tenant possesses a child support agreement, but is not presently receiving any child support payments, the tenant should include an explanation of this and all supporting documentation; i.e., a divorce decree or court documents. Also, the self-certification should indicate that the tenant will notify the owner of any changes in the status of child support.[34]

A state agency monitoring procedure, however, may not permit an owner to rely on a low-income tenant's signed, sworn statement indicating that the tenant is not receiving child support payments if a reasonable person in the owner's position would conclude that the tenant's income is higher than the tenant's represented annual income. In this case, the owner must obtain other documentation of the low-income tenant's annual child support payments to satisfy the documentation requirement in Treas. Reg. §1.42-5(b)(1)(viii).

A state agency's monitoring procedure may require that an owner obtain documentation, other than the statement described above, to support a low-income tenant's annual certification of child support payments.

Unearned Income of Minor Children

Any unearned income of children under the age of 18 is included in income. This is any income other than employment income; e.g., interest income from bank accounts or dividends from mutual funds held in their name. Unearned income of minor children should be included even if the child is temporarily absent.

Resident Services Stipend

Resident service stipend is a modest amount received by a resident for performing a service for the owner, on a part-time basis, that enhances the quality of life in the LIHC housing. Such services include, but are not limited to, fire patrol, hall monitoring, lawn maintenance, and resident initiatives coordination. If the resident stipend exceeds $200 a month, the stipend is included in income. If the stipend is $200 or less, the stipend is excluded from income.

Items Excluded from Income (Miscellaneous)

This section includes a description of miscellaneous sources of funds and how they should be treated for purposes of determining the household's income. Refer to HUD Handbook 4350.3, Chapter 5, and Exhibit 5-1 for additional information.

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[33] The signed, sworn self certification under Rev. Proc. 94-65 is equivalent to the notarized certification under HUD Handbook 4350.3, Chapter 5, paragraph 5-6E. See also paragraph 5-13D.

[34] See Rev. Rul. 2004-82, Q&A #12, 2004-2 C.B. 350.

1. Lunches and food received through food programs such as Women, Infants and Children (WIC), amounts received under the School Lunch Act, Meals on Wheels, food stamps, are not included in income.

2. Amounts paid to a family to offset the costs of services or equipment needed to keep a developmentally disabled family member at home are excluded.

3. By Federal statute, the value of food stamps is not included in income.

4. Amounts received by the household that are specifically for, or in reimbursement of, the cost of medical expenses for any member of the household are not included in income.

5. Adoption assistance payments in excess of $480 per adopted child are not included in income.

6. Payments received for the care of foster children or foster adults are not included in income.

7. Personal loans, since they must be repaid, are not included in income.

8. Amounts received by the household in the form of refunds or rebates under state or local law for property taxes paid on the dwelling unit are not included in income.

9. Reparation payments paid by a foreign government pursuant to claims filed under the laws of that government by persons who were persecuted during the Nazi era are not included in income. Examples include payments by the German or Japanese governments for atrocities committed during the Nazi era.

10. Any amount of crime victim compensation (under the Victims of Crime Act) received through crime victim assistance (or payment or reimbursement of the cost of such assistance) as determined under the Victims of Crime Act because of the commission of crime against the applicant under the Victims of Crime Act (42 U.S.C. 10602) is not included in income.

11. Income from assets, and amounts received on behalf of, someone who does not reside in the household are not included in income, as long as (1) the amounts are not intermingled with the household's funds and (2) the amounts are used solely to benefit the person who does not reside within the household. For such amounts to be excluded from income, the individual must provide the owner with an affidavit stating that the amounts are received on behalf of someone who does not reside with the family and that the amounts meet the conditions stated above.

12. Interests of individual Native Americans in trust or restricted lands, and the first $2,000 per year of income received by individual Native American that is derived from a trust or restricted lands are not included in income. Amounts received under the Maine Indian Claims Settlement Act of 1980 are also excluded. In addition, all or a portion of the payments under the Alaska Native Claims Settlement Act, judgments of the Indian Claims Commission or U.S Court of Claims may be excluded from income. See HUD Handbook 4350.3 for details.

13. Payments received after January 1, 1989 from the Agent Orange Settlement Fund or any other fund established pursuant to the settlement in the Agent Orange product liability litigation are not included in income. M.D.L. No 236 (E.D.N.Y)

14. Any Earned Income Tax Credit to the extent it exceeds the tenant's income tax liability is not included in income. See IRC §32(j). For example, a tenant may have a tax liability of $400, and an Earned Income Credit of $700. The credit will not only eliminate that $400 tax liability, but the tenant will receive a $300 refund. The $300 is not included in income. Alternatively, the tenant may receive payments directly from his/her employer during the year. These periodic payments are not included in income.

15. The value of any childcare provided or arranged for under the Child Care and Development Block Grant Act of 1990 (CCDBGA) (42 U.S.C. 9858q) is not included in income. Participating families may either pay a reduced amount based on a sliding fee scale or they may receive a certificate for child care services. Note that funds received through CCDBGA for providing childcare services are included in income.

Tenant Income Certification Effective Date

Once all sources of income and assets have been properly verified, owners or managers perform an income calculation using the applicant's tenant income certification to determine whether the applicant qualifies for IRC §42 housing.

The effective date of the tenant's income certification is the date the tenant actually moves into the unit. All adult members of the household should sign the certification. HUD Handbook 4350.3, 5-17B. If the certification is more than 120 days old, the tenant must provide a new certification. The income recertifications, if required, must be completed annually based on the anniversary of the effective date.[35]

Example 1: Determining the Tenant Income Certification Effective Date

> A potential household consisting of John and Jane Doe and their two children completed a rental application and income certification on April 12, 2004. The property manager completed the third party verifications and determined that the household was income eligible on April 21, 2004. John and Jane signed the rental lease on April 25th, and took possession of the unit on May 1, 2004.
>
> The effective date of the tenant income certification is May 1, 2004. All subsequent tenant income recertifications must be performed within 120 days before May 1st of each subsequent year of the 15-year compliance period.

When additional adult individuals join the household, the effective day will remain the same until the unit is completely vacated.

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[35] Tenants may be subject to income certifications for other programs which define the effective date differently. The notation or use of alternative "effective dates" for purposes of triggering an annual income recertification will not disqualify an annual income recertification for IRC §42 purposes. The IRS will rely on the source documents; i.e., the signature dates on the initial income certification and subsequent income recertifications (as needed for mixed-use projects).

Example 2: Effective Date After Move In of Additional Adult Member

> Jane and her daughter were income qualified and moved into an LIHC unit on September 5, 2003. On March 15, 2004, Jane's widowed mother joined the household.
>
> The tenant income certification continues to be based on the original certification date. All subsequent annual income recertifications will be completed within 120 days before September 5th each year until the household vacates the unit.

Signatures

Generally, all adult members of the household should sign the income certification before, or when, the household moves into the rental unit. However, there will be circumstances where obtaining the signatures is impractical. In these situations, the owner should document the reason for the delay in the tenant's file and secure the signature as soon as possible.

Example 1: Household Member is Serving in the Military

> Mary, with her two children, applies for an LIHC unit and completes a tenant income certification. She discloses and includes the income her husband earns for military service in the Marines. He is currently on active duty and stationed overseas. The owner determines that Mary's household is income qualified for low-income housing
>
> Mary signs the income certification two days before moving in. Because her husband is not available to sign the certification, the owner included documentation in the tenant file that he is in the military and stationed overseas. Mary's husband returns stateside five months later and signs the income certification as soon as he joins his family.
>
> The owner is in compliance. The household's income is properly accounted for and the file sufficiently documents the reason why the husband could not timely sign the income certification. In this case, the file will also indicate that the signature was obtains within a reasonable time after his return.

Tenant Moves to Another Low-Income Unit

A household may move to another unit within a low-income project.

In the Same Building

When a household moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit.[36] Thus, if a current household, whose income exceeds the applicable income limitation moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit. The vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident.

[36] See Treas. Reg. §1.42-15(d).

Example 1: Household in Over-Income Unit Transfers Within Building

An initially income-qualified household occupying a low-income unit in a mixed-use project was determined to have income in excess of 140 percent of the current AMGI at the time of the last annual income recertification. The household subsequently moved from Unit A, a 2-bedroom over-income unit to Unit B, a vacant 3-bedroom low-income unit.

Even though the units are not comparably sized, Unit A is now a low-income unit and Unit B is an over-income unit.

In a Different Building

As noted in Rev. Rul. 2004-82, Q&A #8, a similar rule applies when a household whose income is no greater than 140% of the income limit (or 170% for deep rent skewed projects) moves to a low-income unit in a different building within the project during any year of the 15-year credit period.[37] The vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident.

Example 1: Household is First Occupant of Low-Income Unit

On May 31, 2004, of the first year of the credit period, an income qualified household moved into a new, never-occupied, low-income unit in Building A. On October 19, 2004, the household moved, and the lease was transferred, to a similar rent- restricted unit in Building B, which had never been occupied, and continued to occupy the unit until the end of the first credit year. The unit in Building A was not rented again until February 2005.

Only the unit the household actually occupies qualifies as a low-income unit.

- The unit in Building A would qualify for May, June, July, August and September. The unit would not qualify as a low-income unit in October, November, or December for purposes of computing the Applicable Fraction for the first year under IRC §42(f)(2). The unit will continue to be treated as a never occupied unit until a qualified household moves in.

- The unit in Building B is a qualified low-income unit for October, November, and December.

Households residing in 100% LIHC projects, where a household's current income is not known, can also transfer between buildings within the project.

Example 2: Household in 100% LIHC Project Transfers Between Buildings

On August 15, 2008, an income-qualified household moved into a low-income unit. The unit was part of a 100% LIHC multi-building project as identified by the owner on Form 8609, line 8b. The household was not required to complete annual income recertifications and, therefore, the household's current income was not known when, on January 15, 2010, the

[37] See IRC §42(g)(1) and IRC §142(d)(4)(B).

household requested a transfer to a low-income unit in another building within the project.

The household may transfer to a low-income unit in another building within the project even though the household's income is not known.

Income Certifications Where Owner Acquires or Rehabilitates Existing Building

Income Qualifying Households Before the Beginning of the 10-Year Credit Period

Under Rev. Proc. 2003-82, a unit occupied before the beginning of the credit period will be considered a low-income unit at the beginning of the credit period, even if the household's income exceeds the income limit at the beginning of the first year of the credit period, if two conditions related to income qualifications are met, and the unit must is rent restricted.[38]

For households occupying a unit at the time of acquisition[39] by the owner, the initial tenant income certification is completed within 120 days after[40] the date of acquisition using the income limits in effect on the day of acquisition. The effective date of the tenant income certification is the date of acquisition since there is no move-in date.

In the event that the household occupies a unit at the time of acquisition, but the tenant income certification is completed more than 120 after the date of acquisition, the household is treated as a new move-in. Owners use the income limits in effect at the time of the tenant income certification and the effective date is the date the last adult member of the household signed the certification, (this is an exception to the general rule for effective dates because there is no move-in date).

When the household moves into a unit after the building is acquired but before the beginning of the first year of the compliance period, the tenant income certification is completed using the income limits in effect at the time of the certification and the effective date is the date the household moves into the unit.

Testing for Purposes of the Next Available Unit Rule

For purposes of Rev. Proc. 2003-82, the incomes of the individuals occupying a unit occupied before the beginning to the first credit year are first tested for purposes of the Next Available Unit Rule under IRC §42(g)(2)(D)(ii) and Treas. Reg. §1.42-15 at the beginning of the first year of the building's credit period.[41]

1. The test must be completed within 120 days before the beginning of the first year of the credit period.

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[38] Rev. Proc. 2003-82, 2003-2 C.B. 1097, provides a safe harbor under which, if certain conditions are met, a residential rental unit in an existing building acquired by a new owner or in rehabilitated building will be treated as a low-income unit even though the occupants' incomes exceed the income limit at the beginning of the building's 10-year credit period. In order to qualify, the household must have been income-qualified at the time the owner acquired the building or the date the household started occupying the unit, whichever is later. The owner must maintain documentation of the income qualification and the unit must be rent restricted. See Chapter 10 for further discussion of the requirement for units to be rent-restricted.

[39] The date of acquisition is the date the building is acquired by purchase under IRC §179(d)(2).

[40] Alternatively, if the new owner has access to the property before the acquisition date, tenant income certifications may be completed before the acquisition using the current income limits. The effective date is the date of acquisition.

[41] See Chapter 14 for detailed discussion of the Next Available Unit Rule.

2. The “test” consists of confirming with the household that sources and amounts of anticipated income included on the tenant income certification are still current. If additional sources or amounts of income are identified, the tenant income certification will be updated based on the household’s documentation. It is not necessary to complete third party verifications.

3. If the household is over-income based on current income limits, the Next Available Unit Rule is applied.

If the effective date of the initial tenant income certification is 120 days or less before the required “test”, it is not necessary to “test” for purposes of the Next Available Unit Rule because the time period for completing the initial tenant income certification and the time period for completing the “test” is the same. The annual tenant income recertification will be completed each year on the anniversary of the original tenant income certification’s effective date.

Example 1: The Effective Date of Initial Tenant Income Certification is 120 Days or Less Before the Test Date

An owner purchased an existing building on September 1, 2004 and anticipated beginning the credit period on January 1, 2005. Household A occupied a unit at the time of the purchase and was determined to be income qualified on September 22, 2004. Because the household was determined to be income-qualified within 120 days of January 1, 2005, it is not necessary to “test” for purposes of the Next Available Unit Rule.

If the effective date of the original tenant income certification is more than 120 days before the required “test,” the household’s income must be tested within 120 days before the beginning of the first year of the credit period.

Example 2: The Effective Date of Original Tenant Income Certification is More Than 120 Days Before the Beginning of the First Year of the Credit Period

An owner purchased an existing building on March 1, 2004 and anticipated beginning the credit period on January 1, 2005. Household A, an income qualified household, moved into a rent-restricted unit on April 1, 2004. Because the household was determined to be income-qualified more than 120 days before the beginning of the credit period on January 1, 2005, the household’s income must be tested no earlier than 120 days before January 1, 2005 to determine whether the Next Applicable Unit Rule should be applied.

Previously Income-Qualified Households

Beginning with allocations of credit after 1989, owners of LIHC buildings are required to enter into extended use agreements with the state agency allocating the credit. Owners make a long-term commitment to maintain the buildings as low-income housing for at least 30 years beginning with the first day of the 15-year compliance period.[42] The owner must maintain the specified number of low-income units (Applicable Fraction) based on the income limit elected under IRC §42(g)(1).

[42] See IRC §42(h)(6) and Chapter 16 for complete discussion.

Households determined to be income-qualified for purposes of the IRC §42 credit during the 15-year compliance period are concurrently income-qualified households for purposes of the +30-year extended use agreement. As a result, any household determined to be income qualified at the time of move-in for purpose of the extended use agreement is a qualified low-income household for any subsequent allocation of IRC §42 credit.

Example 1: Owner Receives Additional Credit for Rehabilitation

An owner received IRC §42 credits to construct new low-income housing. The owner placed the buildings in service in 1991 and started claiming credits the same year. The 15-year compliance period ended December 31, 2005. In 2007, the owner applied for and received an allocation of credit to rehabilitate the existing low-income buildings. The rehabilitation is completed and the owner starts claiming the credit in 2009.

On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit project. John and Mary timely complete their income recertification each year 2005 through 2008. The unit has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period.

The unit is a low-income unit on January 1, 2009, when the owner (a calendar year taxpayer) begins claiming the credit. If the unit was determined to be an over-income unit under IRC §42(g)(2)(D) at the time of the household's last income recertification in January of 2008, then the owner is subject to the Available Unit Rule. (See Chapter 14.)

NOTE: Similarly, vacant units previously occupied by income-qualified households continue to qualify as low-income units if the units are suitable for occupancy. However, the owner is subject to the Vacant Unit Rule. (See Chapter 15.)

Example 2: New Owner Receives Credit for Acquisition and Rehabilitation

Owner ABC received IRC §42 credits to construct new low-income housing. ABC placed the buildings in service in 1991 and started claiming credits the same year. The 15-year compliance period ended December 31, 2005. In 2006, ABC sold the project to XYZ, who simultaneously received an allocation of acquisition and rehabilitation credit. The rehabilitation was completed and XYZ started claiming the credit in 2008. From the time of acquisition until a new extended use agreement is recorded, XYZ is subject to the extended use agreement between ABC and the state agency.[43]

On February 1, 2004, John and Mary are determined to be income-qualified and move into a low-income unit project. John and Mary timely complete their income recertification each year 2005 through 2007. The unit has always qualified as a low-income unit, except when the unit was not suitable for occupancy during the rehabilitation period.

[43] See IRC §42(h)(6)(B)(v).

Based on the 2007 annual income recertification, the unit is a low-income unit at the beginning of XYZ's credit period on January 1, 2008, when XYZ (a calendar year taxpayer) begins claiming the credit. XYZ should follow the procedures under Rev. Proc. 2003-82 to test income at the beginning of the credit period as described above.

NOTE: Vacant units previously occupied by income-qualified households are not low-income units on January 1, 2008. The owner must apply IRC §42(f)(2).

Income Qualifying Households During First Year of the 10-Year Credit Period

Under IRC §42(f)(2), the applicable fraction for the first year of the credit period is computed based on a month-by-month accounting of units or floor space occupied by income-qualified households. In the case of buildings that were acquired and then rehabilitated, there are two separate allocations of credit documented on two Forms 8609; one for the acquisition credit and a separate allocation for the rehabilitation credit. However, the owner is not required to determine two applicable fractions. Under IRC §42(e)(4)(B), the applicable fraction for the substantial rehabilitation credit will be the same as the applicable fraction for the acquisition credit. Therefore, for purposes of computing the applicable fraction under IRC §42(f)(2), the following units are considered low-income units:

1. Units occupied before the beginning of the credit period, which are determined to be low-income unit at the beginning of the credit period under Rev. Proc. 2003-82.

2. Units initially occupied after the beginning of the credit period by newly certified income-qualified households (regardless of whether rehabilitation costs have been incurred for the unit).

3. Units occupied by income-qualified households that moved from other units within the project. The household's lease and tenant income certification (with effective date) move with the household. See the section above titled "Tenant Moves to Another Low-Income Unit" for complete discussion.

Units are *not* included in the numerator of computation of the applicable fraction if:

1. The unit is occupied by a nonqualified household;

2. The unit is vacant and was last occupied by a nonqualified household;

3. The unit is not suitable for occupancy under IRC §42(i)(3)(B)(ii). These units, including units being rehabilitated, are considered "out of compliance."[44] The noncompliance is corrected when the unit is again suitable for occupancy. The unit's character will be determined based on the household that occupied the unit immediately preceding the rehabilitation during the first year of the credit period.

[44] The state agency is not required to file Form 8823 to report noncompliance during the rehabilitation period.

Example 1: Units Rehabilitated During the First Year of the Credit Period

An owner acquired a building with 10 units and determined that 6 of the units (1-6) were occupied by nonqualifying households at the beginning of the first year of the credit period on January 1, 2005. Four units (7-10) were occupied by income-qualified households. The nonqualifying households moved out and the owner rehabilitated the six vacant units. Five of the rehabilitated units (1-5) were rented to new households that moved into the units in August of 2005. The sixth rehabilitated unit (6) was rented in August to an existing tenant who transferred from unit 7, one of the four units qualifying on January 1, 2005

1. The owner may include units 1-5, the rehabilitated units occupied by new low-income tenants in the applicable fraction computation under IRC §42(f)(2) for August, September, October, November, and December of 2005

2. For the tenant who transferred between units within the building, the owner may include the unrehabilitated unit 7 that the tenant occupied from January through July in the computation of the applicable fractions for those months, but the unit is no longer a low-income unit when the household moves to the rehabilitated unit 6 in August; Unit 6 is a low-income unit for August through December.

Therefore, for purposes of computing the applicable fraction for August, 2005, there are three low-income units that have not been rehabilitated (units 8, 9, and 10) and six low-income units that have been rehabilitated (units 1-6). Unit 7 is not a low-income unit.

During September, unit 7 was rehabilitated and the tenant from unit 8 moved in; therefore, unit 8 is now considered a vacant market-rate unit. To expedite completion of the rehabilitation of the remaining units, the owner also temporarily located the households in 9 and 10 in off-site quarters (and paid all expenses) and started rehabilitation of units 8, 9, and 10. For purposes of determining the applicable fraction for September, units 1-7 are low-income units and units 9, and 10 are out of compliance low-income unit. Unit 8 is a market-rate unit that is being rehabilitated in September.

The owner completed the rehabilitation of the final three units (8, 9, and 10) in October and moved the two temporarily displaced households back into units 9 and 10 during October 2005. Unit 8 remains an unoccupied market rate unit through December.[45] For purposes of computing the applicable fraction for October, units 1-7, 9, and 10 are all low-income units. The same is true for November and December.

The following chart summarized the status of each unit for each month during 2005. The columns (left to right) represent the individual months and the rows (top to bottom) represent Units 1 through 10. The field where a row

[45] In the January 2007 revision of the Guide, Unit 8 was considered a low-income unit. The IRS will not challenge a taxpayer's reliance on the January 2007 explanation for determining the status of a unit before January 1, 2010.

and column intersect indicates the unit's status as either "LIHC" for a low-income unit or is left blank if the unit is not a low-income unit.

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1								LIHC	LIHC	LIHC	LIHC	LIHC
2								LIHC	LIHC	LIHC	LIHC	LIHC
3								LIHC	LIHC	LIHC	LIHC	LIHC
4								LIHC	LIHC	LIHC	LIHC	LIHC
5								LIHC	LIHC	LIHC	LIHC	LIHC
6								LIHC	LIHC	LIHC	LIHC	LIHC
7	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC		LIHC	LIHC	LIHC	LIHC
8	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC				
9	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC		LIHC	LIHC	LIHC
10	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC	LIHC		LIHC	LIHC	LIHC

Documentation Requirements

For a unit to be included as a low-income unit, documentation of the household's initial eligibility must be on file with the owner. Under IRC §6001, every taxpayer is required to maintain records sufficiently detailed to prepare a proper tax return. This requires the maintenance of such permanent books and records sufficient to establish the amounts of gross income, deductions, *credits*, or other matters to be shown on the taxpayer's return. This requirement extends to the preparation and maintenance of tenant files sufficiently documented to support household eligibility for purposes of claiming the low-income housing credit under IRC §42.

A tenant income certification and supporting documentation are not sufficient unless, at a minimum, the following documents are included:

1. Application/Income and Asset Questionnaire - A document completed by the household that the owner uses to gather information relevant to establishing all aspects of eligibility including, but not limited to, household composition, income, income from assets, and student status.

2. Verification of Income and Assets - All sources of income and assets must be verified to establish move-in eligibility.[46] Each tenant file must contain an annual statement of income, household composition, and student status.

[46] Rev. Proc. 94-65, 1994-2 C.B. 798, allows building managers to obtain a tenant's signed, sworn statement if the total combined cash value of household assets is less than $5,000. Some states have not implemented this procedure and will require third party verification. The states that allow this have an appropriate form.

The preferred verification method is through third parties, and such verifications must be no older than 120 days before the effective date of the Tenant Income Certification. Verification may be written documentation (mail), oral (telephone), or electronic (facsimile, e-mail, or Internet). Where applicable, there should be further evidence to support the third party verifications; e.g., a copy of a divorce decree showing award of maintenance or child support, a realtor's statement of market value for a home, a self-employed tenant's tax return, etc. When third party verification has been delayed or attempted, but is not possible, documentation may be by check stubs, W-2's, bank statements, etc. Self-certification (notarized statement or signed affidavit) may be accepted if third party verification or other documentation cannot be obtained. Documentation of attempts to obtain verification, however, must be kept on file.

3. Student Status - Depending upon the student status of each household member, student verification may be required. (See Chapter 17 for more information.)

4. Tenant Income Certification – Documents must be signed by all the adult members of a household prior to move-in and at the time of the annual recertification, and must state the anticipated annual gross income of the household.

Sufficient But Imperfect Documentation

If eligibility documentation is imperfect, yet sufficient for the monitoring agency to make a reasonable determination that a household is eligible, the owner should be advised of the imperfections and the need to implement procedures ensuring that similar imperfections do not occur in the future. Imperfections are not of a nature that would cause the unit to be considered out of compliance and will not result in reportable noncompliance.

Use of Standardized Forms

The compliance monitoring regulations under Treas. Reg. §1.42-5 establish the minimum monitoring requirements. State agencies can determine how documents are maintained and may mandate the use of standardized forms to document an owner's compliance with the requirements under Treas. Reg. §1.42-5.

In Compliance

In order to establish a unit as a qualified housing tax credit unit, the household's Gross Annual Household Income must be at or below the elected area median income (AMGI) limit or national nonmetropolitan median gross income (NNMGI) limit when applicable, adjusted for family size. Household income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937. Therefore, the definitions of income of individuals and AMGI for purposes of IRC §42(g)(1) include items of income that are not included in a taxpayer's gross income for purposes of computing a federal tax liability.

Documentation of the household's initial eligibility must be on file with the owner. The initial tenant income certification must be completed and signed by all the tenants on or before the move-in date.

Example 1: Unrelated Parties Sharing an Apartment

Sally and Jane are unrelated individuals who want to rent a two-bedroom apartment in an LIHC building. Sally and Jane's combined income does not exceed 60% of the AMGI for a two-individual family.

In this case, Sally and Jane are qualified tenants for low-income credit housing. For purposes of computing the Gross Annual Household Income, the combined income of all the occupants of an apartment, whether or not legally related, is compared to the median family income for a household with the same number of members.

State agencies may determine that, even though the documentation at the time a certification was performed was insufficient, sufficient documentation was subsequently obtained by the owner *before* the state agency's notification of a compliance review, which allowed the monitoring agency to make a reasonable determination that the unit was in compliance. Such self-corrected documentation should not be reported to the IRS as noncompliance. The owner has demonstrated due diligence and reasonable attempts to maintain sufficient documentation of tenant eligibility.

Example 2: Failure to Obtain Third Party Verification

An owner initially failed to verify or include documentation of court-ordered child support when the household moved in. The oversight was identified nine months later when the owner's management company conducted a quality review of the file. The management company immediately corrected the deficiency by obtaining a copy of the court order for the child support. When the amount of child support was added to the move-in income, the annual income did not exceed move-in eligibility. The unit is in compliance with IRC §42 requirements.

Example 3: Correction After Notification of Upcoming Compliance Review

Unit A in an LIHC building went out of compliance on January 15, 2004, when a household with income exceeding the limit moved in. The owner was notified on March 15, 2004, that the state agency would be conducting a tenant file review on May 1, 2004. The owner realized the problem while preparing for the review and paid the moving costs for the over-income household to move out immediately. A new income-qualified household moved into Unit A on April 13, 2004.

The state agency selected Unit A as part of the 20% sample and reviewed the new tenant's income certification. Because the effective date of this certification was after the date of the notification of the upcoming review, the state agency requested the file for the previous tenant and determined that Unit A was out of compliance from January 15 to April 13, 2004.

Example 4: Tenant Income Increases After Move In

> John and Mary are newly married, in their early 20's, and have moved to a new city where John has accepted a job. The couple is income-qualified based on John's anticipated salary for the next 12 months. Three weeks after they move in, Mary starts working. If her wages are added to the tenant income certification, the couple's income exceeds the limit.
>
> There is no noncompliance if the state agency determines that the owner used due diligence in accepting John and Mary as a qualified low-income household based on their initial tenant income certification. For example, the owner can demonstrate that due diligence was exercised by asking whether Mary intended to seek employment or was sporadically employed during the prior year. However, the next available unit rule may apply. See Chapter 14.

By itself, the fact that a tenant's actual income exceeds the anticipated income identified during the income certification is not a reportable noncompliance event (hindsight is always perfect). However, the state agency should consider expanding the sample size if multiple instances are identified. Collectively, multiple errors are indicative of poor internal control and increased risk of noncompliance.

The tenant income certification should be based on the best information available at the time of the certification. It represents the income the household anticipates it will receive in the 12-month period *following* the effective date of certification of income. If information is available on changes expected to occur during the year, that information should be used to most accurately determine the anticipated income from all known sources during the year. If the household reports little or zero income, or sporadic income, owners may use estimates based on actual income earned or received during the twelve month period immediately preceding the certification. Owners should use due diligence by asking follow-up questions when the income certification process reveals unusual circumstances suggesting additional sources of income.

Out of Compliance

Units are considered out of compliance as of the date an ineligible household moves into a unit. A unit will also be considered out of compliance if the initial tenant income certification is inaccurate, documentation of initial eligibility is insufficient, or no initial tenant file is on record.[47]

Example 1: Specific Source of Income Omitted

> Annual Income was not properly calculated. The manager/owner did not include a source of income, such as a raise, overtime, or bonus. When reviewed, a correct calculation indicates that the household was not income eligible at move-in.

[47] A determination by the IRS (during an examination) that the taxpayer has not maintained adequate books and records may result in the issuance of an Inadequate Records Notice. The notice informs taxpayers that their recordkeeping practices are insufficient and must be improved to meet the requirements of the law. The issuance of an Inadequate Records Notice may result in a follow-up examination.

Example 2: Household Incorrectly Determined to be Eligible

The owner calculated annual household income correctly, but the household is over the appropriate income limit at move-in. For example, the owner may have used the income limit for the 40/60 minimum set-aside when the income limit for the 20/50 minimum set-aside income limit was required, or the wrong county AMGI, or the income limits used were not in effect as of the date of the tenant income certification.

Example 3: Unrelated Parties Sharing an Apartment

Tom and Jack are unrelated individuals who want to rent a two-bedroom apartment in an LIHC building. Tom and Jack individually have incomes that do not exceed 60% of AMGI for one individual. However, Tom's and Jack's combined income exceeds 60% of the AMGI for a two-individual family.

In this case, Tom and Jack do not qualify for LIHC housing. For purposes of computing the Gross Annual Household Income, the combined income of all the occupants of an apartment, whether or not legally related, is compared to the median family income for a household with the same number of members.

Example 4: No Initial Tenant Income Certification on File

A household moves into a unit that the owner wishes to include as an LIHC unit. However, the owner does not provide documentation of initial eligibility at the time the state agency reviews the tenant's file. The owner cannot substantiate that the unit qualifies for the LIHC.

Example 5: No Initial Tenant Income Certification on File for New Member of Household

An income qualified household moved into an LIHC unit. Six month later, an adult friend moved into the unit with the household, but no initial tenant income certification was completed for the additional member of the household.

Example 6: Initial Tenant Income Certification Performed After Move-In (Late Certification)

A household moved into a unit that the owner wanted to include as a low-income unit. However, the certification of income eligibility, including the third party verification, was not performed until after the household moved in.

Example 7: Insufficient Documentation of Initial Eligibility

A household moves into a unit that the owner wishes to include as a low-income unit. Income eligibility was not properly documented. The state agency could not reasonably determine that the household was income

qualified. The following are possible documentation noncompliance issues:

a. Application/questionnaire is not sufficiently detailed to disclose all sources of income and/or assets,
b. Not all sources of income are verified,
c. Not all sources of assets are verified,
d. Verifications are insufficient,
e. Not all adult household members' income and/or assets are disclosed and included;
f. Tenant income certification form is not prepared, signed and/or dated; and
g. Other state-required forms designed to document compliance with IRC §42 are not in file.

Back in Compliance

Units are back in compliance when it is determined that an income-qualified household occupies the unit. Evidence of corrected noncompliance includes copies of certification paperwork such as the tenant's application, income and asset questionnaire, third party verifications, and tenant income certification.

Insufficient Documentation

In the event that income eligibility was not properly documented and the state agency cannot reasonably determine that the household is eligible, the noncompliance can be corrected in either of two ways:

1. A new certification can be performed using current income and asset sources and current income limits. Assuming the household is eligible, the unit would be out of compliance on the date of move in and back in compliance on the date the new certification signed (Form 8823 should be filed); or

2. A retroactive certification can be performed which completely and clearly documents the sources of income and assets that were in place at the time the *initial certification* should have been effective, and applies income limits that were in effect on that date. Assuming the owner can document that the household was income eligible at the time of move in, the unit should not be considered out of compliance. The owner has clarified the noncompliance; Form 8823 should not be filed.

Evidence of corrected noncompliance may include a copy of the full certification, including application, third party verifications, and/or the tenant income certification.

Income Ineligible Households

The household may be income certified as if it were a new move-in. If the household is eligible under the applicable move-in income limit in place on the date of the new certification, then the unit would be considered back in compliance.

Example 1: Ineligible Household Occupies LIHC Unit

> The household was over the appropriate income limit at move-in on June 1, 2002. The error was discovered during the state agency's review on April 3, 2003.

The owner may treat the household as a new tenant and complete a new income certification using the income limits in effect on April 3, 2003. If the household is qualified, the noncompliance is corrected. The unit is out of compliance from June 1, 2002 until April 3, 2003. If, upon certification, the household is not income-eligible, the unit is considered back in compliance when a new income- qualified household moves into the unit. In either scenario, a Form 8823 noting the noncompliance must be filed.

Initial Tenant Income Certification is Late

If the initial certification is late, the unit is considered out of compliance as of the date the tenant moved into the LIHC unit and back in compliance on the date the completed income certification, indicating the household is income qualified, is signed by all the tenants.

Example 1: Initial Tenant Income Certification Performed After Move-In (Late Certification)

A household moved into an LIHC unit on August 4, 2003. However, certification of eligibility, including the third party verification, was not completed until September 15, 2004. If the tenant income certification meets all the requirements, the unit is considered in compliance beginning on September 15, 2004.

Note: Noncompliance with the initial income certification requirements that is identified and corrected by the owner retroactive to move-in and *prior to notification* of the compliance review by the state agency need not be reported; i.e., the owner has demonstrated due diligence by addressing noncompliance issues independently. See Chapter 3.

References

1. IRC §42(g)(1)
2. Treas. Reg. §1.42-5(b)(1)(vii) states that "[t]enant income is calculated in a manner consistent with the determination of annual income under Section 8 of the U.S. Housing Act of 1937."
3. HUD Handbook 4350.3 as revised June 2009 is the authority for further information on calculation of annual income. HUD publishes updated 50% Median Family Income limits annually. Other income limit schedules such as the 60% limits are based on an extrapolation of the 50% limits.
4. Rev. Rul. 89-24, 1989-1 C.B. 24
5. Rev. Rul. 90-89, 1990-2 C.B. 8
6. Rev. Rul. 91-38, 1991-2 C.B. 3
7. Rev. Rul. 2004-82, 2004-2 C.B. 350
8. Rev. Proc. 94-65, 1994-2 CB 798
9. Rev. Proc. 2004-38, 2004-2 C.B. 10, which supersedes Rev. Proc. 94-64, 1994-2 C.B. 797
10. Rev. Proc 2003-82, 2003-2 C.B. 1097
11. Notice 88-80, 1988-2 C.B. 396
12. Notice 2008-79, 2008-40, I.R.B. 815

Exhibit 4-1
CCA 2009090416224806

ID: CCA_2009090416224806

Office: CC:PSI:5

UILC: 42.00-00

From: [...]
Sent: Friday, September 04, 2009 4:22:51 PM
To: [...]
Cc: [...]; [...]
Subject: Increases in Family Size under §42(g)(2)(D)(ii)

This e-mail responds to your request for assistance regarding increases in family size under §42(g)(2)(D). You have asked on behalf of revenue agents and state housing agencies whether addition of a new member to an existing low-income household requires the household to be treated as a new household for purposes of §42(g).

Chapter 4 of the Guide for Completing Form 8823 (revised January 2007) on pages 4-3 & 4-4 provides that the addition of new member(s) to an existing low-income household requires the income certification for the new member of the household. The new member's income is added to the income disclosed on the existing household's tenant-income certification. A household may continue to add members as long as at least one member of the original low-income household continues to live in the unit. Once all the original tenants have moved out of the unit, the remaining tenants must be certified as a new income-qualified household unless the remaining tenants were income qualified at the time they moved into the unit. The household continues to be income qualified and the income of the new member is taken into consideration for purposes of the available-unit rule under §42(g)(2)(D). If a state agency determines that the tenants manipulated the income limitation requirements, then the unit should not be treated as a low-income unit as of the date the household initially occupied the unit.

Section 42(g)(2)(D)(i) states that, except as provided in §42(g)(2)(D)(ii), notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation, 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.

Section 42(g)(2)(D)(ii) provides that if the income of the occupants of the unit increases above 140% of the income limitation under §42(g)(1), §42(g)(2)(D)(i) shall cease to apply to any such unit if any residential rental unit in the building (of a size comparable to, or smaller than, such unit) is occupied by a new resident whose income exceeds such income limitation.

The legislative history of §42 provides that, for purposes of the available unit rule, if the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant) that tenant is no longer counted in determining whether the project satisfies the set-aside requirement. No penalty is assessed in such an event, however, provided that each residential rental unit that becomes vacant (of comparable or smaller size to the units no longer satisfying the applicable income requirement) is rented to tenants satisfying the qualifying income until the project is again in compliance. Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 162 (1987).

The above cited legislative history demonstrates that decreases in family size are subject to the available-unit rule in §42(g)(2)(D)(ii). We see no reason why increases in family size should not be subject to the same rule. For example, if an existing low-income household's income increases above 140% of the applicable income limitation, then the unit continues to be treated as a low-income unit if the available-unit rule under §42(g)(2)(D)(ii) is met. Yet, if the addition of a new member to an existing low-income household results in the household being treated as a new household, then any increases in income above the applicable income limitation, no matter how small, would result in the unit not being a low-income unit. Provided the household is not manipulating the income limitation requirements, we see no difference between increased household income and increased household income resulting from the addition of a new member to the low-income household.

Accordingly, we continue to believe that rule for increases in family size in the Guide for Completing Form 8823 is correct. The new member of the existing low-income household must complete an initial income certification and provide third party verification regardless of whether §142(d)(3)(A), as amended by section 3010(a) of the Housing Assistance Tax Act of 2008, applies to the project.

Chapter 5
Category 11b
Owner Failed to Correctly Complete or Document Tenant's Annual Income Recertification

Definition

Under Treas. Reg. §1.42-5(b)(1)(vi), owners are required to complete an annual income certification for each low-income household. The recertification process is identical to the initial certification in terms of documenting household composition, income, and income from assets. State agencies are required to review the tenant income recertifications and the supporting documentation for the tenants in the units.[1] Therefore, the state agency should be reviewing the most recent income recertification.

Exception for Certain Buildings

Under Treas. Reg. §1.42-5(c)(4), a state agency may except buildings financed by the Rural Housing Service (RHS) under the section 515 program and buildings financed with tax-exempt bonds (50% or more of the aggregate basis of the building and land) from the annual income recertification as part of its certification and review provisions. To qualify for this exception, the state agency must enter into an agreement with the RHS or tax-exempt bond issuer. Under the agreement, RHS or the bond issuer must agree to provide information concerning the income and rent of the tenants in the building to the state agency. The state agency may assume the accuracy of the information provided without further verification.

Under this exception, owners are not required to perform annual income recertifications specific to IRC §42, and the state agencies are not required to review, tenant income recertifications, supporting documentation, and rent records. Instead, the state agency must review the information provided by RHS or the bond issuer and determine whether the owner is in compliance with the income limitations and rent restrictions in IRC §42(g)(1) and (2). If the information provided by RHS or the bond issuer is not sufficient for the state agency to make a determination, the state agency must request the necessary additional income or rent information from the owner of the buildings.

NOTE: RHS determines tenant eligibility based on its definition of "adjusted annual income," rather than "annual income" as defined under the Section 8 program. Therefore, the state agency may be required to calculate the tenant's income for IRC §42 purposes and may need to request additional income information from the owner.

Noncompliance Corrected by Owner Prior to Notification of State Agency's Compliance Review

Noncompliance with the annual income recertification requirements that is identified and corrected by the owner *prior to notification* of the compliance review by the state agency need not be reported; i.e., the owner has demonstrated due diligence by addressing noncompliance issues independently. See Chapter 3.

Example 1: Noncompliance Corrected Before Notification of Compliance Review

> On January 15, 2004, the owner of a LIHC building incorrectly completed a household's income recertification. The owner identified the problem and corrected the documentation deficiency on March 30, 2004. The owner was notified on April 20, 2004, that the state agency would be

[1] See Treas. Reg. §1.42-5(c)(2)(ii)(B).

conducting a tenant file review on May 1, 2004.

The state agency selected Unit A as part of the 20% sample and reviewed the household's income certification and noted the corrections. Because the owner corrected the noncompliance before the April 20, 2004 notification date, the owner is in compliance.

100% LIHC Projects

Tax Years Ending Before July 31, 2008

An owner may have received a waiver of the annual income recertification requirements under Rev. Proc. 2004-38, 2004-2 C.B. 10 or Rev. Proc. 94-64, 1994-2 C.B. 797, which applied to owners of qualified low-income housing projects that consist entirely of 100 percent low-income buildings. If noncompliance with the tenant income certification requirements was sufficiently serious, consideration was given to revoking the waiver. Revocation was not required, but the Service would revoke the waiver at the state agency's request.

Tax Years Ending After July 30, 2008

Under IRC §142(d)(3)(A), if all the low-income buildings in the *project* are 100% low-income buildings, owners are not required to complete annual tenant income recertifications.[2] "Projects" are identified based on the owner's election as documented on Form 8609, line 8b.[3] Previously approved Income recertification waivers are subsumed by the new law and are no longer in force.

Mixed-Use Buildings

Note: For buildings with both LIHC units and market rate units, the state agencies must also determine whether the owner appropriately applied the Available Unit Rule when a household's income exceeds 140 percent of the income limit at the time of recertification. See Chapter 14.

In Compliance

Owners of mixed-use LIHC properties are in compliance if the recertification is completed within 120 days before the anniversary of the effective date of the original tenant income certification.

Household Vacates Unit

If an owner has sent a timely notice informing the household that the annual recertification is due, but the household does not provide the certification and supporting documentation prior to vacating the unit, the vacated unit will not be considered out of compliance with the recertification requirements. Owners should document attempts to obtain the recertification and the date the tenant actually moved out.

[2] IRC §142(d)(3)(A) was amended by section 3010 of the Housing Assistance Tax Act of 2008 and is effective for taxable years ending after July 30, 2008. IRC §142(d)(3)(A) is made applicable to IRC §42 low-income projects in IRC §42(g)(4).

[3] Each building is considered a separate building unless each building that is (or will be) part of the multiple-building project is identified by check "yes" on Form 8609, line 8b, and attaching a statement identifying the (1) name and address of the project and aggregate credit associated with the project, and (2) the address and building identification number (BIN) and credit associated with every building in the project.

Example 1: Household Gives Notice of Departure Before Recertification is Due

> The owner provided timely notice to a household on July 15th, 2009, that the annual income recertification was due on October 1, 2009. The household informed the owner on September 13, 2009 that they would be vacating the unit on October 15, 2009.
>
> Since the household gave notice in advance and will not occupy the unit in the coming year, there is no reason to complete the income recertification and the unit remains in compliance. Should the household later decide to stay in the unit, a late recertification must be completed.

Owner Takes Action to Remove Noncompliant Household

If the owner initiates an eviction proceeding and the household vacates the unit, no recertification is necessary. If, for any reason, it is determined that the household will not vacate the unit as anticipated, a recertification will be necessary within 120 days of the determination.

Example 1: Court Failed to Sustain Request for Eviction

> Income recertification was due on July 1, 2009. The owner initiated the recertification process on April 15, 2009, and documented attempts to obtain recertification information. The household did not complete the recertification and the owner initiated eviction proceedings on July 29, 2009. The court did not sustain the owner's filing for eviction on September 15, 2009. The owner must secure the tenant income recertification.

Households Determined to be Over the Income Limit at Recertification

In the event that a household's income exceeds the income limit at the time of recertification, state agencies must determine whether the household was income qualified at the time of move in. The initial tenant income certification should be reviewed.

Example 1: Household Qualified at Move In

> An income qualified household moved into a rent restricted unit on June 23, 2004 and timely completed their tenant income recertifications each year. In 2009, for the first time, the recertification indicates that that same household's income exceeds the income limit.
>
> The state agency must review the initial tenant income certification. If the household qualified at move in, no further action is necessary and the unit is in compliance with the annual income recertification requirements. If the household's income is 140% or more of the income limit, compliance with the Available Unit Rule must also be evaluated. See Chapter 14.

If the state agency identifies an issue of noncompliance on the initial tenant income certification, the state agency must review the intervening tenant income recertifications to determine whether the noncompliance was corrected at some intervening point.

Out of Compliance

A unit will be considered out of compliance if the annual recertification was not performed, or the annual recertification was performed late *and after notification* of a state agency compliance review.

Example 1: Annual Recertification Was Not Performed

Household was initially qualified and properly certified at move-in. However, it has been more than 12 months from the previous recertification and there is no recertification on file. This unit is out of compliance as of the date the recertification is due.

Example 2: Insufficient Documentation of Eligibility at Recertification

Household was initially qualified and properly certified at move-in; however, recertification was not properly documented and the state agency cannot reasonably determine the household's continuing eligibility. The following are possible documentation noncompliance issues:

a. Application/questionnaire is not sufficiently detailed to disclose all sources of income and/or assets;
b. Not all sources of income are verified;
c. Not all sources of assets are verified;
d. Verifications are insufficient;
e. Not all adult household members' incomes and/or assets are disclosed and/or included;
f. Tenant income certification form is not prepared, signed and/or dated; and
g. Other state-required forms designed to document compliance with IRC §42 are not in file.

Back in Compliance

Owners may use the following methods to self-correct noncompliance. Evidence of corrected noncompliance may include a copy of the full recertification, including application, verifications, and/or tenant income recertification. Owners must submit copies of the documents required by the monitoring agency.

1. A recertification can be performed using current income and asset sources and current income limits. If there is no resulting noncompliance (e.g., violation of the Available Unit Rule), the unit would be out of compliance on the date the recertification was due and back in compliance on the date the tenant signs the recertification.

2. A retroactive recertification can be performed which completely and clearly documents the sources of income and assets *that were in place at the time the recertification should have been completed* and applies income limits that were in effect on that date. If there is no resulting noncompliance (e.g., violation of the Available Unit Rule), the unit would be out of compliance on the date the recertification was due, and back in compliance on the date the tenant signs the recertification.

While the recertification has been performed retroactively, the recertification documents should be dated with the current date. All the adult members of the household should sign the recertification using the current date. In other words, the recertification documents should not be backdated.

The advantage of the retroactive recertification is that the owner may avoid violating the Available Unit Rule.

In either case, the effective date for recertification continues to be the anniversary of the actual date of move in.

Example 1: New Recertification is Performed After Notification

An owner failed to complete a tenant's annual income recertification, which was due February 10, 2009. The mistake was identified during a state agency compliance review conducted November 1, 2009. The management company completed the recertification on November 12, 2009 using the income limits available on that date. The recertification was completed based on the tenant's anticipated future income for the period November 12, 2009 through November 12, 2010.

The unit is out of compliance from February 10th to November 12th, 2009. Since the late income recertification was completed within 120 days of the annual income recertification due February 10, 2010, and is based on current income limits and the tenant's anticipated income for the next year, the income recertification satisfies the annual income recertification requirement for 2010. Since the noncompliance was corrected after notification of a state agency review, the noncompliance must be reported on Form 8823.

Example 2: Household Determined to be Over-Income

An owner failed to complete a tenant's annual income recertification, which was due February 10, 2009. The mistake was identified during a state agency compliance review conducted November 1, 2009. The management company completed the recertification on November 12, 2009 using the income limits available on that date. The recertification was completed based on the tenant's anticipated future income for the period November 12, 2009 through November 12, 2010. The household's income was determined to be more than 140% of the income limit.

Since the recertification was corrected after notification of a state agency review, the noncompliance must be reported on Form 8823. The unit is out of compliance with the recertification requirements from February 10th to November 12th, 2009. Since the late income recertification was completed within 120 days of the annual income recertification due February 10, 2010, and is based on current income limits and the tenant's anticipated income for the next year, the income recertification satisfies the annual income recertification requirement for 2010. Further, the Available Unit Rule may have been violated if any comparable (or smaller) unit was rented to a nonqualified household or as a market rate unit after February10, 2009, and before November 12, 2009.

References

1. Notice 88-80, 1988-2 CB 396
2. HUD Handbook 4350.3
3. Under IRC §6001, taxpayers are required to keep records and comply with regulations as prescribed. To claim the low-income housing credit, taxpayers must substantiate that the tenants were income qualified.
4. Rev. Proc. 94-65, 1994-2 C.B. 798
5. Rev. Proc. 2004-38, 2004-2 C.B. 10, which supersedes Rev. Proc. 94-64, 1994-2 C.B. 797

Chapter 6
Category 11c
Violation(s) of the UPCS or Local Inspection Standards

Definition

This category is used to report noncompliance when rental units, building exteriors and systems, common areas, or the property site in a project are not suitable for occupancy. State agencies should assess whether low-income housing tax credit projects are in safe, decent, sanitary condition and in good repair, according to either the Uniform Physical Conditions Standards[1] (UPCS) established by HUD[2], or local inspection standards. The standards to be used should be identified in the Qualified Allocation Plan[3] (QAP).

1. State agencies are not required to use the Real Estate Assessment Center (REAC) protocol in using the UPCS.

2. State agencies cannot combine selected portions of the UPCS with portions of local standards; only one inspection standard can be selected and used.

Identifying Noncompliance

Certification Reviews

Noncompliance may be identified when the agency reviews an owner's annual certification that the buildings and units in an LIHC project were suitable for occupancy. (See Treas. Reg. §1.42-5(c)(1)(vi).) The owner must also certify that state or local authorities responsible for making inspections did not issue a violation report for any building or low-income unit in the project. If a violation notice or report was issued, the owner must attach a statement summarizing the violation report/notice (or a copy) to the annual certification submitted to the state agency. The owner must also state whether the violation was corrected.

Physical Inspections

State agencies must inspect LIHC properties to ensure that LIHC buildings and units are suitable for occupancy.[4] Under Treas. Reg. §1.42-5(C)(2)(ii)(B), on-site inspections must be made at least once every three years.

HUD's Uniform Physical Condition Standards (UPCS)

The UPCS requires housing to be decent, safe, sanitary and in good repair. The major areas of consideration include:

1. Site: The site components such as fencing and retaining walls, grounds, lighting, mailboxes/project signs, parking lots and driveways, play areas and equipment, refuse disposal, roads, storm drainage, and walkways must be free of health and safety hazards and in good repair. The site must not be subject to material

[1] The Uniform Physical Conditions are available at www.gpoaccess.gov. On the main page, select the "Code of Federal Regulations" option and then enter "24CFR5.703" into the search feature using the quotes ("…").
[2] Department of Housing and Urban Development
[3] See IRC §42(m)(1)(B)(iii).
[4] See Treas. Reg. §1.42-5(d)(2)

adverse conditions, such as abandoned vehicles, dangerous walks or steps, poor drainage, septic tank back-ups, sewer hazards, excess accumulations of trash, vermin or rodent infestation, or fire hazards.

2. Building Exterior: Each building on the site must be structurally sound, secure, habitable, and in good repair. Each building's doors, fire escapes, foundations, lighting, roofs, walls, and windows, where applicable, must be free of health and safety hazards, operable, and in good repair.

3. Building Systems: Each building's domestic water, electrical systems, elevators, emergency power, fire protection, HVAC, and sanitary system must be free from health and safety hazards, functionally adequate, operable and in good repair.

4. Dwelling Units: Each dwelling unit within a building must be structurally sound, habitable, and in good repair. The dwelling unit must be free from health and safety hazards, functionally adequate, operable and in good repair. This includes all areas and aspects of the dwelling unit; i.e., bathroom, call-for-aid (if applicable), ceiling, doors, electrical systems, floors, hot water heater, HVAC, kitchen, lighting, outlets/switches, patio/porch/balcony, smoke detectors, stairs, walls and windows.

   Where applicable, the dwelling unit must have hot and cold running water, including an adequate source of potable water. If the unit includes its own sanitary facility, it must be in proper operating condition, usable in privacy and adequate for personal hygiene and the disposal of human waste. The unit must include at least one battery-operated or hard-wired smoke detector in proper working condition on each level of the unit.

5. Common Areas: The common areas must be structurally sound, secure, and functionally adequate for the purposes intended. The basement/garage/carport, restrooms, closets, utility, mechanical, community rooms, day care, halls and corridors, stairs, kitchens, laundry rooms, office, porch, patio, balcony and trash collection areas, if applicable, must be free from health and safety hazards, operable, and in good repair. All common area ceilings, doors, floors, HVAC, lighting, outlets/switches, smoke detectors, stairs, walls, and windows, to the extent applicable, must be free of health and safety hazards, operable, and in good repair.

6. Health and Safety Concerns: All areas and components of the housing must be free of health and safety hazards. These areas include, but are not limited to, air quality, electrical hazards, elevators, emergency/fire exits, flammable materials, garbage and debris, handrail hazards, infestation and lead based paint.

   For example, buildings must have fire exits that are not blocked and have hand rails that are not damaged, loose, missing portions, or otherwise unusable. The housing must have no evidence of infestation by rats, mice, vermin, or garbage and debris. The housing must have no evidence of electrical hazards, natural hazards, or fire hazards. The dwelling units and common areas must have proper ventilation and be free of mold as well as odor (e.g., propane, natural, sewer or

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[5] As defined in Subpart J of 24 CFR part 35.

methane gas) or other observable deficiencies. The housing must comply with all requirements related to the evaluation and reduction of lead-based paint hazards and have available proper certifications of such.[5]

Local Standards

Although there is considerable variability among local codes, inspection of the LIHC property using local codes should entail an inspection of the project site, building exteriors, building systems, common areas, dwelling units, and health and safety concerns.

Differences between Local Codes and the Uniform Physical Condition Standards (UPCS)

The UPCS do not supersede or preempt[6] local health, safety and building codes; i.e., a low-income housing project under IRC §42 must satisfy the local standards and the state agency must report known violations to the IRS. However, if the state agency uses the UPCS to conduct inspections and determines that they are met, the state agency is not required to determine *by inspection* whether the project meets local standards.

There will be situations when using the UPCS for the state agency's inspection standard may result in a conflict with the local standards. For example, the local code may require bars on windows to prevent children from falling out whereas the bars may be viewed under the uniform physical condition standards as blocking access/exists in case of emergencies. The conflict should be brought to the attention of the state agency by a governmental entity or individual such as a fire marshal's office or municipal building inspector who must provide a written submission explaining the nature of the conflict. When conflicts are presented in this manner, the local code will be evaluated by the state agency in determining whether the project or unit is in compliance.

In Compliance

A building is in compliance if, during an inspection of the building, it meets the requirements of the UPCS or local code. Exhibit 6-1 is a sample checksheet that may be useful (it is not required) in helping document physical inspections of LIHC properties. Owners should be notified of the state agency's findings. Exhibit 6-2 is a sample letter that may be used.

Out of Compliance

An LIHC unit, building and/or entire project is out of compliance if:

1. The owner discloses violations of local standards or incorrectly certifies that the buildings and units in an LIHC project were suitable for occupancy, taking into account local standards (or other habitability standards). See Treas. Reg. §1.42-5(c)(1)(vi).

2. During a physical inspection by the state agency, the property had elements that failed to meet the requirements.

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[6] In other words, the UPCS do not replace or preempt local health, safety, and building codes.

3. Otherwise fails to comply with the requirements of the UPCS or local codes at any time.

To ensure consistent evaluation of the project's physical condition, the definitions of physical deficiencies used for the REAC system, by the Department of Housing and Urban Development (HUD) will be used to determine whether noncompliance has occurred.[7] The dictionary is divided into six sections:

1. Site Inspection
2. Building Exterior Inspectable Items
3. Building Systems Inspectable Items
4. Common Areas Inspectable Items
5. Unit Inspectable Items
6. Health and Safety Inspectable Items

Each section identifies specific components, which are then defined in ascending levels of severity (level 1, level 2 or level 3), and a fourth category is health and safety hazards and fire safety hazards. All levels of deficiencies must be reported. State agencies using local codes as their inspection standard may find the UPCS levels of violation helpful in categorizing reported violations.

Level 1 Violations of UPCS

Examples of Level 1 violations include:

1. At least one screen door or storm door is damaged or is missing screens or glass. The noncompliance would be evidenced by an empty frame or frames.

2. The roofs of a project where up to one square (100 square feet) of surface material or shingles is missing from roof areas.

3. In one room in a dwelling unit, a permanent lighting fixture is missing or not functioning, and no other switched light source is functioning in the room.

Level 2 Violations of UPCS

Examples of Level 2 violations include:

1. Evidence of water stain, mold, or mildew, such as darkened areas, over a small area of floor (1-4 square feet). Water may or may not be visible. The affected area is estimated to be less than 10% of the floors.

2. In two rooms in a dwelling unit, a permanent lighting fixture is missing or not functioning, and no other switched light source is functioning in the rooms.

Level 3 Violations of UPCS

Example of Level 3 violations include:

1. A common area where a large portion of one or more floors –more than 4 square feet- has been substantially saturated or damaged by water, mold, or mildew. Cracks mold, and flaking are visible and the floor surface may have failed.

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[7] 66 FR, 59102-59124, Public Housing Assessment System Physical Condition Scoring Process Interim Scoring, Corrections and Republication

2. A sink or other related hardware in a kitchen may be missing, which creates unsanitary living conditions.

3. A permanent light fixture in more than two rooms is missing or not functioning, and no other switched light sources are functioning in the rooms.

Health and Safety Violations and Fire Hazard Violations of UPCS

Health and safety violations can be divided into non-life threatening and exigent, life threatening conditions.

Non-life threatening events include items such as pavement and walkway problems that create the potential for tripping and falling; missing or non-functioning sinks and bathroom components in individual units that impair human sanitation; missing exterior doors; and floor covering damage.

Exigent health and safety and fire hazards require immediate attention because of their life-threatening potential. Exigent health and safety violations include exposed electrical wires or water leaks on or near electrical equipment; propane /natural gas/methane gas detected; emergency/fire exits that are blocked; unusable fire escapes; gas or oil fired hot water heaters with missing or misaligned chimneys that pose carbon monoxide hazards. Fire safety hazards include missing or inoperative smoke detectors; fire extinguishers expired or window security bars preventing egress from a building.

Casualty Losses

A casualty loss is defined as the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and unintended. An unusual event is one that is not a day-to-day occurrence and that is not typical for low income housing credit properties. Casualty losses may result from a number of different sources: e.g., car accidents, fires, government-ordered demolitions, hurricanes, mine cave-ins, sonic booms, storms, tornadoes, vandalism, etc. Property damage is not considered a casualty loss if the damage occurred during normal use, the owner willfully caused the damage or was willfully negligent, or was progressive deterioration such as damage caused by termites.

Physical damage to LIHC projects caused by casualty events and which render LIHC residential rental units or buildings, or common areas associated with the property, unsuitable for occupancy is reported as noncompliance with the UPCS or local standards.

Vacant Units

Vacant low-income units must also be suitable for occupancy; i.e., prepared for immediate occupancy. Depending on the facts, state agencies should allow a reasonable period to clean a vacated unit or repair damages caused by a prior tenant.

Example 1: Vacant Units not Suitable For Occupancy

> The state agency determined that some vacant LIHC residential units were not suitable for occupancy by new tenants when they conducted a physical inspection of the property. The owner explained that because of the high vacancy rate, there were a sufficient number of empty units suitable for occupancy. All vacant LIHC units that are not suitable for

occupancy are out of compliance. The out of compliance date is determined for each unit based on the date that particular unit was vacated.

Date of Noncompliance

The reportable "out of compliance" date is the date the project failed to meet the inspection standard, if known; otherwise, at the earliest documented date that the standard was not met.

Example 1: Factual Determination

A frozen pipe burst and flooded two vacant units in a low-income building. The owner timely repaired the pipe but did not adequately clean the damaged floors, rugs and walls in the two affected units. Upon inspection, the state agency discovered mold damage resulting from the flooding in both units. The date of noncompliance is the date the frozen pipe burst.

Example 2: Noncompliance Date Identified by Inspection

The state agency inspected the property site and determined that a dilapidated wooden fence on the exterior of the property represented a UPCS violation because it was about to fall down and nails were protruding out of the boards. The date of noncompliance is the date of the inspection.

Example 3: Noncompliance Date Identified by Documentation

HUD performed an inspection and determined that there were significant safety hazards on an LIHC project site. The owner was notified, but when HUD revisited the property six months later, the hazards had not been corrected. HUD provided the state agency with a copy of their report. The state agency conducted an inspection and confirmed HUD's information. The date of noncompliance is the date of HUD's initial inspection.

Notice to Owner

The state agency is required to provide prompt *written* notice to the *owner* of a low-income housing project if the state agency discovers that the project is not in compliance with the state agency's inspection standard, or the annual certification is inaccurate. Notification letters establish and document the beginning of the correction period for any "out of compliance" issues. See Exhibit 6-3.

When state agencies determine that the violations involve life-threatening problems, a critical notification letter requiring immediate corrective action should be sent to the owner. *To ensure prompt correction of exigent, life threatening health and safety deficiencies*, the project representative should be provided a list of every observed life threatening violation and fire safety hazard that needs immediate attention or remedy, before the inspector leaves the project site. See Exhibit 6-4. To document receipt, the project representative should sign the state agency's copy of the list of deficiencies.

Back in Compliance

Property is back in compliance when noted violations are corrected. The correction date is the date of the repair, the date of the inspection at which the repair was observed, or the date of the certification that the repair had occurred; whichever evidenced the correction to the agency's satisfaction.

Acceptable evidence of the corrected violations includes items such as a certification from an appropriate licensed professional that the item now complies with the inspection standard, or other documentation demonstrating that the violation has been corrected. Alternatively, the state agency may determine that the owner is back in compliance by visual inspection.

Reporting Noncompliance

Under Treas. Reg. §1.42-5(a), state agencies are required to report any noncompliance of which the agency becomes aware. [8] State agencies must file Form 8823 no later than 45 days after the end of the correction period (including permissible extensions), whether or not the identified noncompliance is corrected. See Chapter 2.

Example 1: Extenuating Circumstances

> A state agency conducted a physical inspection of an LIHC building on October 3, 2004. When inspecting the laundry room located in the basement, the state agency noted that water pipes to three of the six washing machines had frozen and burst during a recent snow storm. The correction period started on October 6, 2004, the date on which the notice of noncompliance was sent to the owner. The correction period ends 90 days later on January 5, 2005.
>
> The damage was extensive and could not be repaired immediately because the ground was frozen, so the owner requested an extension of time. The state granted the maximum extension of an additional 90 days (180 days total), so that the correction period ended April 5, 2005. At that time, the ground was still frozen and the repair had not been completed.
>
> The state agency must file form 8823 within 45 days of the end of the correction period, or May 17, 2005, noting the noncompliance. A second Form 8823 should be filed when the noncompliance is corrected.

Submitting Documentation to the IRS

Documenting noncompliance with the physical inspection standards with sufficient detail to support IRS audit adjustments is particularly important because, at the time of a subsequent IRS audit, there may be no visible indication that the noncompliance ever occurred. Narratives describing the cause, nature and extent of the violations are helpful and should also clarify if the issue is a unit, common area, building exterior or system, or site problem.

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[8] In additional to information submitted as part of the owner's annual certification and the physical inspection of the property, information may be received from other sources such as (but not limited to) governmental agencies, tenants affected by the noncompliance, or public documents such as newspaper articles.

Copies of reports summarizing unit-by-unit noncompliance originally given to the owner and electronic pictures are adequate when documenting noncompliance even though the violations may have been corrected after the filing of the report of noncompliance. Note: do not include photocopies of photographs; they are not useful.

References

1. 24 CFR 5.703, HUD's Uniform Physical Condition Standards
2. IRC §42(i)(3)(B)(i)
3. Treas. Reg. §1.42-5
4. Dictionary of Deficiency Definitions
5. *CCA 201042025*

Exhibit 6-1
Checksheet for the Physical Inspection of LIHC Properties

Physical Inspection Review Summary			
Development Name and Address: Name: Address: City/State/Zip Code Owner Contact Phone: Fax #:		Project #: Inspection Date: Asset Manager Conducting Inspection: Total # Bldgs/Units Inspected: # / # Lead Risk: (Yes / No)	
	Finding		**Finding**
SITE:		**BUILDING EXTERIOR:**	
Fencing & Gates		Doors	
Grounds		Fire Escapes	
Mailboxes/Project Signs		Foundation	
Parking Lots/Driveways/Roads		Lighting	
Play Areas & Equipment		Roof	
Refuse Disposal		Walls	
Retaining Walls		Windows	
Storm Drainage		**UNITS:**	
Walkways/Stairs		Bathroom	
BUILDING SYSTEMS:		Call-For-Aid	
Domestic Water		Ceiling	
Electrical System		Doors	
Elevators		Electrical Systems	
Emergency Power		Floors	
Exhaust System		Heating/Ventilation/Air Conditioning	
Fire Protection		Hot water Heater	
Heating/Ventilation/Air Conditioning		Kitchen	
Sanitary System		Laundry Area (Room)	
COMMON AREAS:		Lighting	
Basement/Garage/Carport		Outlets/Switches	
Closet/Utility/Mechanical		Patio/Porch/Balcony	
Community Room		Smoke Detectors	
Day Care		Walls	
Halls/Corridors/Stairs		Windows	
Kitchen		**HEALTH & SAFETY:**	
Laundry Room		Air Quality	
Lobby		Electrical Hazards	
Office		Elevator	
Other Community Spaces		Emergency/Fire Exits	
Patio/Porch/Balcony		Flammable Material	
Pools & Related Structures		Garbage and Debris	
Restrooms		Hazards	
Storage		Infestation	
Trash Collection Area		Mold	
		Lead-based Paint	

Severity of Violation

Items should be marked "1", "2" or "3" to identify the severity level of the violation that reflects the extent of damage associated with the deficiency.

Summary of Findings

Violation Code	Bldg/Unit	Description	Date Completed & Description of Repair

Exhibit 6-2
Notification Letter – No Violations Noted

Date

Owner
Address
City State ZIP

RE:
Project:
BIN Numbers:

Dear Owner:

On __[date]__, a physical inspection of the project listed above was conducted.

The review included a walk-through of the building, common areas, mechanical rooms, and grounds, as well as 20% of the qualified units. This review considered whether the building and its units were suitable for occupancy, taking into account ___[local health, building and safety codes] or [the Uniform Physical Condition Standards as specified in Treas. Reg. § 1.42-5(d)].

The buildings and units inspected were all found to be in good condition. Based on this finding, no response is necessary.

Thank you for the cooperation and courtesies extended by members of your staff.

Please call me at __[telephone number]__ if you have any questions. Or you may reach me by e-mail at __[e-mail address]__. Thank you for your commitment to providing quality affordable housing in the state of _[state]__.

Sincerely,

Name-Signature
Title

CC: Management Contact

Exhibit 6-3
Notification Letter – Noncompliance

Date

Owner
Address
City State ZIP

RE:
Project:
BIN Numbers:

Dear Owner:

On __[date]__, a physical inspection of the project listed above was conducted. The units inspected and property were, in general, in good condition with my findings noted on the following pages.

Enclosed you will find a copy of the Physical Inspection Report and a document titled "Addressing the Physical Inspection Report", which will explain the violation categories, set forth required correction periods and provide additional information for responding to the inspection results.

Thank you for the cooperation and courtesies extended by members of your staff.

Please call me at __[telephone number]__ if you have any questions. Or you may reach me by e-mail at __[e-mail address]__. Thank you for your commitment to providing quality affordable housing in the state of _[state]__.

Sincerely,

Name-Signature
Title

CC: Management Contact

Exhibit 6-4
Notification Letter – Critical Violations

Notice of Critical Violations

72 Hour Correction Period

Inspection Date: ________________________ Tax Credit Project Number: _____________________

Property Name: ____

Property Location: ____

Based on the physical inspection completed on the date referenced above, one or more **critical violations have been identified and need to be corrected immediately.**

Within _[time]__ hours of the inspection, the cited item(s) must be repaired and __[state agency]__ must be provided with written notification of the action taken to complete the correction. Refer to the "Addressing the Physical Inspection Report" for further information.

Critical Violations

Buildings:

Units:

Inspections by: ________________________________ Telephone: ____________________________

E-Mail: ______________________________________ FAX: _______________________________

Received By: _________________________________ Signature: ___________________________

Chapter 7
Category 11d
Owner Failed to Provide Annual Certifications or Provided Incomplete or Inaccurate Certification

Definition

This category is used to report owners of low-income housing projects who fail to submit annual certifications, or any other required reports and documentation, to the state agency as described in Treas. Reg. §1.42-5(c). Monitoring procedures require certifications (and state agency reviews of the certifications) at least annually for each year of the 15-year compliance period. Monitoring procedures may require certifications (and state agency reviews) more frequently than annually, provided that all months within each 12-month period are subject to certification.

Owners are responsible for reporting to the state agency annually that their projects were in compliance with IRC §42 for the preceding 12-month period. They must report in the form and manner the state agency specifies and must certify, under the penalty of perjury, that the information provided is true, accurate, and in compliance with the requirements of IRC §42. The owner must certify that:

1. The project met the requirements of the minimum set-aside test applicable to the project; i.e., the 20-50 test, the 40-60 test, or the 25-60 test for New York City.[1] See Chapter 10.

2. If applicable, the 15-40 test under IRC §§42(g)(4) and 142(d)(4)(B) for deep rent skewed projects was met.

3. There has been no change in the applicable fraction (as defined in IRC §42(c)(1)(B)) of any building in the project, or that there was a change and a description of the change is included with the certification.

4. The owner has an annual income certification from each low-income tenant (Tenant Income Certification) and documentation to support that certification at initial occupancy and subsequent years during the compliance period. Tenants receiving Section 8 housing assistance payments may satisfy the documentation requirement by submitting a statement provided by a public housing authority (see Treas. Reg. §1.42-5(b)(1)(vii)). For an exception to this requirement, see IRC §42(g)(8)(B) and Rev. Proc. 94-64,[2] or Rev. Proc. 2004-38,[3] which provide rules for 100 percent low-income buildings when the owner has received a waiver from the annual recertification requirements. *Note: For tax years ending after July 30, 2008, if all the low-income buildings in the *project* are 100% low-income buildings, owners are not required to complete annual tenant income recertifications. See Chapter 5 for additional explanation.*

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[1] See IRC §§42(g)(1)(A) and (B), 42(g)(4), 42(g)(4) and 142(d)(6).
[2] Rev. Proc. 94-64, 1994-2 C.B. 797
[3] Rev. Proc. 2004-38, 2004-2 C.B. 10

5. Each low-income unit in the project was rent restricted.

6. All units in the project were for use by the general public,[4] including the requirement that no finding of discrimination under the Fair Housing Act, 42 U.S.C. 3601-3619, has occurred for the project. A finding of discrimination includes an adverse final decision by the Secretary of the Department of Housing and Urban Development, 24 CFR 180.680, an adverse final decision by a substantially equivalent state or local fair housing agency, 42 U.S.C. 3616a(a)(1), or an adverse judgment from a federal court.

7. The buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety and building codes (or other habitation standards), and the state or local government unit responsible for making local health, safety, or building code inspections did not issue a violation report for any building or low-income unit in the project. If a violation report or notice was issued by the governmental unit, the owner must attach a statement *summarizing* the violation report or notice or attach a *copy* of the violation notice or notice to the annual certification submitted to the state agency. In addition, the owner must state whether the violation has been corrected.

8. There has been no change in the eligible basis (as defined in IRC §42(d)) of any building in the project (determined at the end of the first credit year), or if there was a change, the nature of the change (e.g., a common area has become commercial space, or a fee is now charged for a tenant facility formerly provided without charge).

9. All tenant facilities included in the eligible basis of any building in the project (such as swimming pools, other recreational facilities, or parking areas, etc.) were provided on a comparable basis without charge to all tenants in the buildings.

10. If a low-income unit in the project became vacant during the year, reasonable attempts[5] were or are being made to rent that unit (or the next available unit of comparable or smaller size) to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income.

11. If the income of tenants of a low-income building in the project increased above 140% of the applicable income limit (or 170% for deep rent skewed projects), the next available unit of comparable or smaller size in the building was or will be rented to tenants having a qualifying income. See IRC §42(g)(2)(D)(ii), Treas. Reg. §1.42-15, and Chapter 14 for guidance on the Available Unit Rule.

12. An extended low-income housing commitment is in effect including the requirement[6] that an owner cannot refuse to lease a unit in the project to an applicant because the applicant holds a voucher or certificate of eligibility under Section 8 of the United States Housing Act of 1937. This requirement is not

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[4] As defined in Treas. Reg. §1.42-9.
[5] See Rev. Rul. 2004-82, 2004-2 C.B. 350, Q&A #9.
[6] See IRC §42(h)(6)(B)(iv), effective August 10, 1993.

applicable to buildings receiving allocations before 1990 or bond-financed buildings placed in service before 1990.

13. All low-income units in the project were used on a non-transient basis, except for transitional housing for the homeless[7] or single-room occupancy units rented on a month-by-month basis.[8]

The state agency may also require additional reporting items. However, unless noncompliance with these reporting requirements constitutes noncompliance with IRC §42, noncompliance with these state agency reporting requirements should not be reported to the IRS.

In Compliance

Owners are in compliance, for federal tax purposes, when annual certifications have been submitted timely,[9] accurately, and completely.

Disclosure of Noncompliance

If the owner's certification discloses noncompliance with the requirements under IRC §42, the noncompliance must be reported to the IRS using Form 8823 and identifying the appropriate category of noncompliance.

Example 1: Owner Discloses Decrease in Eligible Basis

> The owner of an LIHC building correctly submitted the annual certification and reported that the swimming pool had been closed and would no longer be available for use by the tenants. The owner is in compliance with the annual certification requirements, but the reduction in eligible basis should be reported to the IRS on Form 8823, line 11e, Changes in Eligible Basis or the Applicable Percentage.

Example 2: Compliance With Extended Use Agreement Requirements

> As documented in the extended use agreement, the owner of an LIHC building agreed to dedicate 25 percent of the units in a 100 unit building to households with incomes less the 30 percent of the Area Median Gross Income. For purposes of IRC §42, the owner elected the 40/60 minimum set-aside on Form 8609. On the 2006 annual certification, the owner noted that the minimum set-aside had been met, but that only 20 of the units were occupied by households with incomes less than 30% of AMGI.
>
> The nonperformance of the terms of the extended use agreement should not be reported to the IRS.

---

[7] See IRC §42(i)(3)(B)(iii).
[8] See IRC §42(i)(3)(B)(iv).
[9] The state agencies should establish timeframes for submission of annual certifications.

Documentation Requirements

State agencies may require the use of standardized forms or submission of additional documentation to ensure compliance with the certification requirements. The state agencies may establish administrative policies and procedures such as requiring the original signature of the managing general partner or allowing facsimiles, the manner in which certifications are perfected if errors are identified, submission of additional information to clarify issues, etc.

Example 1: Change in Eligible Basis

> To help evaluate the owner's compliance with the eligible basis certification, the state agency requires owners to provide information on any modification to the building that may result in changes to eligible basis. The owner failed to provide the information.
>
> The state agency should report the owner's failure to provide a complete annual certification. The owner has not certified to the state agency's satisfaction that there has been non change in the eligible basis under IRC §42(d) of any building in the project as required under Treas. Reg. §1.42-5(c)(1)(vii).

Out of Compliance

If the owner fails to certify as required under Treas. Reg. §1.42-5(c)(1), submits inaccurate or incomplete certifications, or the certifications and documentation discloses noncompliance with the requirements under IRC §42, the state agency must report the owner using Form 8823. Similarly, an owner must be reported if the state agency does not receive or is not permitted to inspect the tenant income certifications, supporting documentation, and rent records described in Treas. Reg. §1.42-5(c)(2)(ii), or if the state agency learns that the project is not in compliance with the provisions of IRC §42.

To the extent that inadequate documentation from the owner prevents a state agency from determining whether a project is in compliance with IRC §42, the state agency can treat the project as out of compliance.

Out of Compliance Date

If an owner fails to complete or submit any of the certification items listed above, the date each building ceased to comply would be the first day of the reporting year for which such information was due. For example, if an owner does not submit the annual certification package for the 2006 calendar year, the first day of the reporting year date of noncompliance is January 1, 2006.

Back In Compliance

The owner is considered back in compliance when a perfected annual certification (and any other required documentation) is received by the state agency. Corrections may include submission of the required documentation or answering all the questions.

References

1. IRC §42(m)(1)(B)(iii)
2. Treas. Reg. §1.42-5(c)

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:

Eligible Basis x Applicable Fraction = Qualified Basis

Qualified Basis x Applicable Percentage = 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 year[2]. 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 program[3] of rental assistance administered under section 9 of the Unit State 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.

<u>Buildings Placed in Service On or Before July 30, 2008</u>

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 2008[5] 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 following[6] 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,

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[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 x .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 x 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

Chapter 9
Category 11e
Changes in the Applicable Percentage

Definition

This category is used to report violations associated with the Eligible Basis of a building (discussed in Chapter 8) or any occurrence that result in a decrease in the Applicable Percentage of a building. This chapter addresses noncompliance affecting the Applicable Percentage of a building.

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:

Eligible Basis x Applicable Fraction = Qualified Basis

Qualified Basis x *Applicable Percentage* = 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 year[2]. 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.

IRC §42(b)(1)(B) provides that a new building that is not federally subsidized is eligible for an Applicable Percentage equal to a 70 percent present value credit while a new building that is federally subsidized and an existing building are eligible for a 30 percent present value credit.

Monthly credit tables published in the Internal Revenue Bulletin provide the actual Applicable Percentages to be used in calculating the credit. These tables effectively adjust the rates on a monthly basis so that the present value over the ten-year credit period will continue to yield the 70 percent and 30 percent figures.

A special rule under IRC §42(b)(2)(B) for non-federally subsidized building placed in service after July 30, 2008, and before December 31, 2013, provides that the applicable percentage shall not be less the 9 percent.

[1] IRC §42(b)(2)(B)
[2] IRC §42(f)(1)(B)

Federal Subsidies for Buildings Placed in Service Before July 31, 2008

For buildings placed in service before July 31, 2008, former IRC §42(b)(2)(B)(ii) (now IRC §42(b)(1)(B)(ii)) provides that the Applicable Percentage for new buildings that are federally subsidized is the 30 percent present value. Former IRC §42(i)(2)(A) provides that a new building is federally subsidized for any tax year if, at any time during such tax year or any prior tax year, there is or was outstanding any obligation the interest on which is exempt from tax under §103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation. However, the building will become eligible for the 70 percent present value credit if (1) by the close of the first year of the credit period the taxpayer elects (on Part II of Form 8609) to reduce the Eligible Basis of the building by the principal amount of the loan or by the proceeds of the tax-exempt bond, or (2) before the building is placed in service, the taxpayer repays the loan or redeems the tax-exempt bond.

IRC §1400N, Tax Benefits for Gulf Opportunity Zone

Under IRC §1400N)(c)(6), loans from Community Development Block Grant[3] funds are not considered a federal subsidy if the low-income buildings are located in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone and the low-income buildings were placed in service during the period beginning on January 1, 2006 and ending on December 31, 2010.

Assistance Provided Under the HOME Investment Partnership Act

For buildings placed in service before July 31, 2008, former IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnership Act (HOME) or the Native American Housing Assistance and Self-Determination Act of 1986 (NAHASDA) 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 Area Median Gross Income (AMGI). This Code section is commonly referred to as the 40-50 rule.

Example 1[4]: Qualifying for the 70 Percent Present Value Credit Under IRC §42(b)

> A new qualified low-income housing project consists of Building 1 and Building 2, each containing 100 residential rental units. Forty percent of the units in each building are low-income units. The owner elected the 40/60 minimum set-aside under IRC §42(g)(1)(B). Also, the owner elected, on Form 8609, Low-Income Housing Credit Allocation Certification, to treat the buildings as part of a multiple building project. The owner obtained a HOME loan at less than the AFR for the project.
>
> The rule under IRC §42(i)(2)(E)(i) applies on a building-by-building basis. To qualify for the 70 percent present value credit, the taxpayer must rent at least 40 units in both Building 1 and Building 2 to tenants whose income is 50 percent of less of AMGI throughout the 15-year compliance period.

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[3] IRC §1400Nc)(6) reads. "…a loan shall not be treated as a below market Federal loan solely by reason of any assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 by reason of section 122 of such Act or any provision of the Department of Defense Appropriations Act, 2006, or the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006.

[4] This example is based on Rev. Rul. 2004-82, Q&A #6.

In addition:

a. The units used to satisfy the rules under IRC §42(i)(2)(E)(i) are also counted toward the project's minimum set-aside under IRC §42(g)(1).

b. 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). In this example, the imputed income limitation applicable to the units in the project is 60 percent of AMGI and the rent may not exceed 30 percent of that amount.

See reference #1 at the end of the chapter for IRC §42(i)(2) as applicable to buildings placed in service prior to July 31, 2008.

Federal Subsidies for Buildings Placed in Service After July 30, 2008

For buildings placed in service after July 30, 2008, below market federal loans are no longer considered federal subsidies. Therefore, below market loans under HOME or NAHASDA are not federal subsidies. Under section 3002(b) of the Housing Assistance Tax Act of 2008, IRC §42(i)(2)(D) and (E) were removed.

See reference #2 at the end of the chapter for IRC §42(i)(2) as applicable to buildings placed in service prior to July 31, 2008.

In Compliance

A new building receiving the 70 percent present value credit is in compliance if no federal subsidy is used (directly or indirectly) for the building or for its operation.

Buildings Placed in Service Before July 31, 2008

If a federal subsidy is used (directly or indirectly) for the building or for its operation, a building receiving the 70 percent present value credit is in compliance if (1) the taxpayer elected (on Part II, Form 8609) to reduce the Eligible Basis of the building by the amount of the subsidy and this reduction is properly reflected in the Eligible Basis determined at the close of the first year of the credit period, or (2) the federal subsidy is redeemed or paid before the building is placed in service. A building using (directly or indirectly) the proceeds of a below market federal loan provided under the HOME or NAHASDA programs will not be considered a federally subsidized building as long as 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of AMGI.

Buildings Placed in Service after July 30, 2008

New buildings placed in service after July 30, 2008, may use the proceeds of a below market federal loan without being characterized as federally subsidized. However, the proceeds of tax-exempt bonds used (directly or indirectly) at any time for the building or its operation continue to characterize the building as federally subsidized.

If tax-exempt bonds are used (directly or indirectly) for the building or its operation, a building receiving the 70 percent present value credit is in compliance if the taxpayer

elected (on Part II, Form 8609) to exclude from Eligible Basis of the building the proceeds of the tax-exempt bond.

Out of Compliance

A new building receiving a 70 percent present value credit is out of compliance if a federal subsidy is used (directly or indirectly) for the building or for its operation and:

1. The taxpayer fails to elect (on Part II, Form 8609) to reduce the Eligible Basis of the building,

2. The taxpayer elects (on Part II, Form 8609) to reduce the Eligible Basis of the building but the reduction is not properly reflected in the Eligible Basis of the building determined at the close of the first year of the credit period, or

3. The federal subsidy is not redeemed or paid before the building is placed in service and the taxpayer did not elect to reduce the Eligible Basis as described above.

A new building receiving the 70 percent present value credit is also out of compliance if it otherwise meets the "In Compliance" requirements above, but a federal subsidy is subsequently used with respect to the building or its operation during years 2 through 15 of the compliance period.

A building placed in service before July 31, 2008, receiving assistance under the HOME or NAHASDA programs and subject to the 40-50 rule, is out of compliance if the number of residential units in the building occupied by individuals whose income is 50 percent or less of area median gross income is less than 40 percent.

A building is out of compliance as of the date the federal subsidy rule (or exception) is violated.

Example 1: Assistance under HOME

> An owner received an allocation of 70 percent credit for a building constructed using HOME assistance and placed in service on January 1, 2007. The state identified, on line 6f of Form 8609, that the building was not federally subsidized by reason of the 40-50 rule under IRC §42(i)(2)(E).
>
> The owner complied with the 40-50 rule, and therefore was able to claim the 70 percent credit, for tax years 2004, 2005 and 2006. In 2007, however, the number of units rented to households with income of 50% or less than AMGI fell below the minimum required 40%.
>
> The taxpayer is out of compliance. Therefore, the Applicable Percentage for the year of noncompliance and all subsequent years is limited to the 30% present value credit.

Back in Compliance

In general, a violation of the federal subsidy rules is a noncompliance event that cannot be corrected. For example, a federal subsidy used (directly or indirectly) with respect to a new building receiving the 70 percent present value credit during years 2 through 15 of the compliance period results in a decrease in the Applicable Percentage of the building from the 70 percent to the 30 percent present value credit, beginning with the year the subsidy is used and for all remaining years in the compliance period. Following the close of the first year of the credit period, a taxpayer cannot elect to reduce the Eligible Basis of the building in an attempt to qualify for the 70 percent present value credit.

If a state agency identifies the receipt of a federal subsidy during years 2 through 15 of the compliance period for the operation of a building or project where the Applicable Percentage is the 70 percent present value credit rate, noncompliance should be reported under category 11e. No attempt should be made to determine whether the taxpayer correctly lowered the Applicable Percentage.

Under unusual circumstance, it might be possible to correct a noncompliance event occurring during the first year of the credit period. For example, the owner receives a favorable private letter ruling from the IRS allowing the taxpayer to make a late election on Part II, Form 8609, to reduce Eligible Basis to the extent of a federal subsidy. The owner should not be considered back in compliance unless documented by a favorable determination by the IRS.

References

1. IRC §42(i)(2), as applicable to buildings placed in service before July 31, 2008.

   (2) Determination of whether building is federally subsidized.

   (A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b)(1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

   (B) Election to reduce eligible basis by balance of loan or proceeds of obligations. A loan or tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d)--

   (i) in the case of a loan, the principal amount of such loan, and

   (ii) in the case of a tax-exempt obligation, the proceeds of such obligation.

   (C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if--

   (i) such obligation or loan (when issued or made) identified the building for which the proceeds of such obligation or loan would be used, and

   (ii) such obligation is redeemed, and such loan is repaid, before such building is placed in service.

(D) Below market Federal loan. For purposes of this paragraph, the term "below market Federal loan" means any loan funded in whole or in part with Federal funds if the interest rate payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date on which the loan was made). Such term shall not include any loan which would be a below market Federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (as in effect on the date of the enactment of this sentence [enacted Dec. 19, 1989]).

(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, 1983]) 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), clause (i) shall be applied by substituting "25 percent" for "40 percent".

2. IRC §42(i)(2), as applicable to buildings placed in service after July 30, 2008.

(2) Determination of whether building is federally subsidized.
(A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b)(1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

(B) Election to reduce eligible basis by proceeds of obligations. A tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d) the proceeds of such obligation.

(C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation used to provide construction financing for any building if--
(i) such obligation (when issued) identified the building for which the proceeds of such obligation or loan would be used, and
(ii) such obligation is redeemed before such building is placed in service.

3. Rev. Rul. 2004-82, 2004-35 I.R.B. 350

Chapter 10
Category 11f
Project Failed to Meet
Minimum Set-Aside Requirement

Definition

This category is used to report projects that have violated the minimum set-aside rule; i.e., the number of qualifying units falls below the minimum requirement.

Under IRC §42(g)(1), a "qualified low-income housing project" means any *project* for residential rental property if the project meets one of the two requirements below, whichever is elected by the owner on Form 8609, line 10c.

1. At least 20% of the available rental units in the development are rented to households with incomes not exceeding 50% of Area Median Gross Income (AMGI) adjusted for family size.

2. At least 40%[1] of the available rental units in the development are rented to households with incomes not exceeding 60% of AMGI adjusted for family size.

The choice of minimum set-aside also establishes the income limit and rent limit applicable to low-income units in the project.

Project Defined

Each building is considered a separate project under IRC §42(g)(3)(D) unless, before the close of the first calendar year in the project period,[2] each building that is, or will be, part of a multiple-building project is identified as such by checking the "yes" box on line 8b of Form 8609 and attaching the statement described in the instructions for line 8b. The minimum set-aside documented on Form 8609, line 10c, must be the same for all buildings in a multiple-building project.

Two or more qualified low-income buildings may be included in a multiple-building project only if they:

1. are located on the same tract of land (unless all of the dwelling units in all of the buildings being aggregated in the multiple-building project are low-income units (see IRC §42(g)(7));

2. are owned by the same person for Federal tax purposes;

3. are financed under a common plan of financing; and

4. have similarly constructed residential units.

Deep Rent Skewing Under IRC §142(d)(4)

In addition to the election of a minimum set-aside, the owner may elect on Form 8609, line 10d, to provide housing to households with incomes of 40 percent or less of the AMGI under IRC §142(d)(4)(B). Under this "deep-rent skewing" set-aside, at least 15% of the low-income units in the project must be occupied by individuals with incomes at 40% or less of the AMGI (adjusted for family size) applicable to the units.

[1] For the boroughs of New York City, 25% is substituted for 40%. See IRC §42(g)(4) and IRC §142(d)(6).
[2] Defined in IRC §42(h)(1)(F)(ii).

Also, gross rent for each low-income unit cannot exceed (1) 30% of the AMGI applicable to the unit, and (2) 50% of the average gross rent for market rate units of comparable size in the project.

Irrevocable Elections

Once made, the minimum set-aside and deep-rent skewing elections are irrevocable.[3] Thus, the applicable minimum set-aside, deep-rent skewing, and the corresponding rent restrictions apply for the duration of the 15-year compliance period.

Assistance Provided Under HOME and NAHASDA[4]

For buildings placed in service before July 31, 2008, former IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnership 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 Area Median Gross Income (AMGI).[5] The units used to satisfy the rules under IRC §42(i)(2)(E)(i) also count toward the project's minimum set-aside under IRC §42(g)(1).

NOTE: IRC §42(i)(2)(E) was removed from the Code under section 3002(b)(2)(C) of the Housing Assistance Tax Act of 2008 and is not applicable to buildings placed in service after July 30, 2008.

Suitability for Occupancy

For purposes of computing the minimum set-aside, the low-income units must be physically maintained in a manner suitable for occupancy under IRC §42(i)((3)(B)(ii). See Chapter 6 for complete discussion.

Example 1: Vacant LIHC Rental Unit Suitable for Occupancy at the End of the Taxable Year Within the Compliance Period

The owner of a 100% LIHC building elected the 40/60 minimum set-aside and placed the building in service in July of 2003; 2003 is the first year of the credit (and compliance) period. An income-qualified tenant moved into a unit in October 2003 and moved out in November of 2004. The unit was cleaned and ready for occupancy on December 1, 2004. The unit is in compliance as of the end of the of the owner's 2004 taxable year and is, therefore, included in the count of qualified low-income units to determine whether the minimum set-aside requirement is satisfied.

Vacant Units

A rental unit is considered an LIHC unit beginning on the date that the first qualified tenant moved in and continues to be eligible for the LIHC even though it is vacant if the character of the last household to inhabit the unit qualified as a low-income household. Unless a specific noncompliance issue is identified for the unit, qualifying units that are vacant at the end of the owner's taxable year of the credit (and compliance) period are included in determining that the minimum set-aside has been met.

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[3] In rare circumstances the IRS has granted an owner an extension of time to make the correct election. The owner must request a private letter ruling and receive express permission to do this.
[4] See Rev. Rul. 2004-82, Q&A #6.
[5] The designation is shown on Form 8609 (beginning with the Nov. 2003 revision). Line 6f is completed by the state agency.

Example 1: Qualified LIHC Rental Unit Vacant at End of the Taxable Year of the Compliance Period

An income-qualified tenant moved into a unit on April 15, 2003, but the owner did not reduce the rent to account for a utility allowance, resulting in the unit not being rent restricted. The tenant moved out on November 15, 2003. The unit was not rented again until February 2004. At that time, the owner correctly accounted for the utility allowance.

The unit was out of compliance beginning on April 15, 2003 and remains out of compliance until February 2004, when the utility allowance is correctly accounted for. Assume that the close of the first year of the credit (and compliance period) is December 31, 2003. Since the unit is out of compliance on December 31, 2003, the unit is not included in the count of qualified low-income units to determine whether the minimum set-aside requirement is satisfied for the 2003 taxable year.

In Compliance

A property is in compliance if the elected minimum set aside requirement (20/50 or 40/60) and the elected deep-rent skewing requirement (15/40) is met by the end of the first year of the owner's credit (and compliance) period and continues to be met each year throughout the compliance period. The LIHC residential units must also be rent-restricted.

Out of Compliance

The initial analysis of compliance with the minimum set-aside requirement is generally based on a sample of tenant files. In the event that the sample does not meet the minimum set-aside, the owner must be given the opportunity to demonstrate that the minimum set-aside is met in the project. Noncompliance should be reported only if the owner cannot demonstrate compliance for the minimum number of units. The burden is on the owner to show that the minimum set-aside was met.

Noncompliance with the minimum set-aside should also be reported if systemic errors affecting all the LIHC units are identified; e.g., using incorrect income or rent limits for all the units.

Example 1: Single Building Project

20 units in a 100 unit building with a 40/60 minimum set-aside were reviewed. To satisfy the minimum set-aside test, 8 of the selected units must be in compliance.

If there are multiple buildings, and the owner elects to treat them collectively as one project, then combine the samples for each building to determine whether the minimum set-aside has been met.

Example 2: Multi-Building Project

> A project consists of three buildings with 75 units in each building. The owner elected a 40/60 minimum set-aside. In total, there are 225 units and at least 90 must be qualified LIHC units to meet the minimum set-aside. The state agency must review 45 files. To satisfy the minimum set-aside test, 18 of the selected units must be in compliance.

Date of Noncompliance

In the event that noncompliance results in the failure to meet the minimum set-aside for the first year of the credit period, the taxpayer is prohibited from ever claiming the LIHC; the date of noncompliance is the last day of the taxable year of the first year of the credit period.

Example 1: First Year Lease Up

> The owner did not lease the minimum number of units to income eligible tenants by the end of the first year of the credit period.
>
> The date of noncompliance is the last day of the first year of the credit period. The state agency should issue Form 8823 indicating Category 11f, Project failed to meet minimum set-aside requirements, and Category 11p, Project is no longer in compliance nor participating in the program, if Form 8609 has been filed with the IRS.

If the project meets the minimum set-aside by the end of the first year, but fails to meet the minimum set-aside at the close of a subsequent taxable year in the compliance period, the entire credit is lost for that year. The date of noncompliance is the last day of the taxable year for which the minimum set-aside was not met.

Back in Compliance

First Year of the Credit Period

If a project failed the first year minimum set-aside requirement at the close of the first taxable year of the credit period, the noncompliance cannot be corrected and the owner is prohibited from ever claiming the LIHC. The date of noncompliance is the last day of the first taxable year of the credit period for that project. The state agency should issue Form 8823 indicating Category 11f, Project failed to meet minimum set-aside requirements and Category 11p, Project is no longer in compliance and is no longer participating in the program.

Years Subsequent to the First Year of the Credit Period

If the minimum set-aside violation occurs *after* the first taxable year of the compliance period, the project is back in compliance for the taxable year in the compliance period in which the minimum set-aside is met, determined as of the close of that taxable year.

Example 1: Fees for Assisted Living Services

> The first taxable year of the credit period ended December 31, 1998 for a 100 percent LIHC building. The units were all rented to income qualified households. Subsequently, in 2003, the owner charged all households a fee for mandatory assisted-living services. This fee, when

added to the rent, exceeded the gross rent limitation for all the units and resulted in a violation of the minimum set-aside requirement for year 2003. The state agency conducted a review on February 2004 and noted the violation of the rent rules. The owner stopped charging the fee on March 1, 2004.

The owner did not meet the minimum set-aside as of the close of 2003 and should not claim any credit for 2003. The date of noncompliance with the minimum set-aside requirement is December 31, 2003. The owner will be back in compliance at the end of the taxable year in the compliance period in which the minimum set-aside is again met.

The submission of a Form 8823 identifying noncompliance with the minimum set-aside should not be delayed even if the taxpayer demonstrates that the minimum set-aside will be restored by the end of the taxable year in the compliance period. State agencies should file Form 8823 within 45 days after the end of the correction period. A second Form 8823 should be filed after the end of the first taxable tax year in which the minimum set-aside is restored.

Documentation of Corrected Noncompliance

Documentation of corrected noncompliance with the minimum set-aside requirement will be specific to the noncompliance issue resulting in failure to satisfy the set-aside.

Example 1: Rental to Ineligible Tenants Violates Minimum Set-Aside Requirement

Upon inspection, it is determined that the number of units qualifying as LIHC units did not satisfy the minimum set-aside requirement during a year following the first year of the credit period because the owner rented to ineligible tenants. To correct the minimum set-aside violation, the owner must rent units to IRC §42 eligible income-qualified households until the minimum set-aside is restored.

At a minimum, documentation should include the tenant's application/eligibility questionnaire, income verifications, tenant income certification, and student verification, if necessary.

References

1. IRC §42(g)
2. Rev. Rul. 90-89, 1990-2 C.B. 8
3. Rev. Rul. 2004-82, 2004-35 I.R.B. 350

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 x $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 x $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 ÷ 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 terminated[2] 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 responsible[3] 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 HUD[4] 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 elects[5] (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 election[6] 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.

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[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, 1989[7] 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-restricted[8]. 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 Service[9] 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

Chapter 12
Category 11h
Project not Available to the General Public

Note

As part of the Housing Assistance Act of 2008, IRC §42(g) was amended to add a clarification of the General Public Use requirement. Until further guidance is provided through administrative ruling or regulation, IRS will evaluate an owner's compliance with the General Public Use Rule as explained here.

Definition

This category is used to report properties that are not available to the general public. A residential rental unit is for use by the general public if the property conforms to the requirements of Treas. Reg. §1.42-9. The general public use rules are violated any time the general public is denied access to LIHC housings.[1]

Under Treas. Reg. §1.42-9(b), if a residential unit is provided only for a member of a social organization or provided by an employer for its employees, the unit is not for use by the general public and is not eligible for credit under IRC §42. However, as clarified in IRC §42(g)(9),[2] a qualified low-income project does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants (1) with special needs, (2) who are members of a specified group under a Federal program or state program or policy that supports housing for such a specified group, or (3) who are involved in artistic or literary activities.

In addition, any residential rental unit that is part of a hospital, nursing home, sanitarium, life care facility, retirement home providing significant services other than housing, dormitory, trailer park, or intermediate care facility for the mentally and physically disabled is not for use by the general public.

Fair Housing Act

LIHC properties are also subject to Title VIII of the Civil Rights Act of 1968, which makes it unlawful to discriminate in any aspect relating to the sale, rental, or financing of dwellings because of race, color, religion, sex, or national origin. The Fair Housing Act of 1988 expanded coverage of Title VIII to include familial status and disabilities. Notifications of administrative and legal actions in regards to the Fair Housing Act are also reported to the IRS using Form 8823. See Chapter 13 for complete discussion.

In Compliance

Owners must rent their units in a manner consistent with the general public use requirements to be in compliance with IRC §42. Residential rental units must be for use by the general public and all of the units in a project must be used on a nontransient basis. In addition, the owner must not evict, nonrenew the lease for, or otherwise terminate the tenancy of, an

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[1] General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Congress; Public Law 99-514.

[2] IRC §42(g)(9) was added by section 3004(g) of the Housing Assistance Act of 2008 and is applicable to buildings placed in service before, on, or after July 30, 2008, the date of enactment.

existing tenant of any low-income unit for other than good cause. (See Chapter 26.) Residential rental units are not for use by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees.

Example 1: Proximity to Supportive Services[3]

> A LIHC project composed entire of single room occupancy (SRO) units is located adjacent to, but is separate from, a clinic providing supportive services for homeless individuals. In addition to the street entrances to the project, the owner has provided covered walkways from the housing to the clinic facility. Although the owner anticipates that a large number of the SRO units will be rented to homeless individuals participating in the clinic's programs, participation is not a requirement for leasing a unit.
>
> The owner has not violated the General Public Use Rule. The SRO units are available to all homeless individuals regardless of whether the tenant participates in the clinic's programs.

Marketing

Owners must make reasonable attempts to make vacant low-income units available to the public for rent. Owners should advertise the availability of vacant units using advertising methods designed to be accessible to all prospective tenants.

"Reasonable attempts" will vary depending on factors such as size and location of the project, tenant turnover rates, and market conditions. Advertising can include printed and electronic media. Common examples include banners and "For Rent" signs at the entrance to the project, classified ads in local newspapers and accessing the local public housing authority's list of section 8 voucher holders. Consider the appropriateness of the advertising for the location of the property. See Rev. Rul. 2004-82, Q&A #9.

Out of Compliance

The failure of LIHC buildings to comply with the general public use requirements will result in the denial of low-income housing credits on a per-unit basis. A unit is out of compliance starting on the date of the event triggering the noncompliance. State agencies will also need to consider whether the problem is systemic and whether owner has met the minimum set-aside under IRC §42(g)(1). See Chapter 10.

Example 1: LIHC Units Restricted to Members of a Social Organization

> The owner of an LIHC building started renting only to members of a local fraternal organization in the third year of the compliance period. By the fifth year, all the tenants in the building were members of the organization.
>
> This building is in violation of the general public use requirements under Treas. Reg. §1.42-9(b), which provides that a residential unit rented only to a member of a social organization is not for use by the general public and is not eligible

[3] For an example, see PLR 9814006

for the credit under IRC §42. The noncompliance started on the date the first nonqualified tenant moved into a unit in the third year of the credit period and each unit is in violation when that unit was rented to a member of the organization.

Example 2: LIHC Units Rented Exclusively to Student Households

The owner of an LIHC building starts rent low-income units only to households where at least one adult member of the household is a student attending a nearby university. If all the household members were full-time students, the household met one of the exceptions under IRC §42(i)(3)(D). The student households are not a qualified group under IRC §42(g)(9).

Although the units are in compliance with the rules for full-time student households, the owner has violated the General Public Use Rule by renting units exclusively to student households. The date of noncompliance for each unit is the date that unit is rented to a household with at least one member attending the university.

Back in Compliance

Generally, an owner is back in compliance with the general public use requirements when two conditions are met:

1. The owner demonstrates that marketing and rental practices are no longer in violation of the general public use rules.

2. All the units are made available to the general public.

Example 1: Units Rented to Members of an Occupational Group

An owner placed a 100% LIHC building in service, began claiming the credit in 2000, and elected the 40/60 minimum set-aside. In 2002, when all 25 units were in compliance with qualifying households, the owner decided to rent units solely to teachers. Assume the teachers are not part of a qualifying group under IRC §42(g)(9). The first unit was rented to a teacher on January 21, 2002 and by December 31, 2002, five vacated units were rented to teachers. During 2003, the owner rented an additional 6 units to teachers. The last of the 6 units was rented on November 1, 2003, and the character of all the units remained unchanged through the close of 2003. The issue was identified during the state agency's inspection in 2004.

Although each unit fell out of compliance on the date it was rented to a teacher, the building is as out of compliance as of January 21, 2002, when the first unit is rented to a teacher. The applicable fraction for 2002 is 20/25 or 80%. The applicable fraction for 2003 is 9/25 or 36%. Since the minimum set-aside was violated at that time and continued to be so as of the close of 2003, no credit is allowable for 2003.

The building is back in compliance when:

1. The owner demonstrates that marketing and rental practices are no longer in violation of the general public use rules, and

2. All the units are made available to the general public.

References

1. IRC §42(g)(9)
2. Treas. Reg. §1.42-9

Chapter 13
Category 11h
Project not Available to the General Public
(Notifications of Fair Housing Act Administrative and Legal Actions)

Definition

State agencies must report the receipt of notices of Fair Housing Act (FHA) administrative and legal action issued by HUD or the Department of Justice to the Internal Revenue Service.

The Fair Housing Act

LIHC properties are subject to Title VIII of the Civil Rights Act of 1968,[1] which makes it unlawful to discriminate in any aspect relating to the sale or rental of dwellings, in the availability of transactions related to residential real estate, or in the provision of services and facilities in connection therewith because of race, color, religion, sex, disability, familial status, or national origin.

Reasonable Modification and Accommodation

The FHA specifically makes it unlawful to refuse to permit, at the expense of the person with a disability, reasonable modifications to existing premises if the modifications are necessary to accommodate a person with a disability to occupy the premises. A landlord may, where reasonable, condition permission for a modification on the renter's agreeing to restore the interior of the premises to the condition that existed before the modification.

The FHA also makes it unlawful to refuse to make reasonable accommodations in rules, policies, practices or services to afford a person with a disability equal opportunity to use and enjoy a dwelling.

Accessibility

The FHA makes it unlawful to design and construct certain multifamily dwellings for first occupancy after March 13, 1991, in a manner that makes them inaccessible to persons with disabilities. The Fair Housing Act defines multifamily dwellings as buildings consisting of four or more units if such buildings have one or more elevators; and ground floor units in other buildings consisting of four or more units.

All premises within such dwellings are also specifically required to contain features of adaptive design so that the dwelling is readily accessible to and useable by persons with disabilities.[2] The FHA provides a list of the accessibility features necessary for compliance with the design and construction requirements[3]:

1. the public and common use portions of such dwellings are readily accessible to and usable by disabled persons;

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[1] 42 USC 3601 et.seq., as amended
[2] 42 USC §3604(f)(3)(c)(iii)
[3] Refer to the Fair Housing Act Design Manual: A Manual to Assist Designers and Buildings in Meeting the Accessibility Requirements of the Fair Housing Act for more specific information about these requirements. The manual is available through HUD USER 1-800-245-2691.

2. all the doors designed to allow passage into and within all premises within such dwellings are sufficiently wide to allow passage by disabled persons in wheelchairs;

3. all premises within such dwelling contain the following features of adaptive design:

   (a) an accessible route into and through the dwelling;

   (b) light switches, electrical outlet, thermostats, and other environmental controls in accessible locations;

   (c) reinforcements in bathroom walls to allow later installation of grab bars;

   (d) usable kitchens and bathrooms such that an individual in a wheelchair can maneuver about the space.

Citizenship Status

The FHA does not prohibit discrimination based solely on a person's citizenship status. Therefore, asking housing applicants to provide documentation of their citizenship or immigration status during the screening process would not violate the FHA. Owners implementing citizenship or immigration status screening measures must make sure they are carried out in a uniform, nondiscriminatory fashion.

Example 1: Visa Expiration

> A person applying for an LIHC apartment mentions in the interview that he left his native country to study in the United States. The landlord, concerned that the student's visa may expire during tenancy, asks the student for documentation to determine how long he is legally allowed to be in the United States.
>
> If the landlord requests this information, regardless of the applicant's race or specific national origin, the landlord has not violated the Fair Housing Act.

Questions concerning the Fair Housing Act should be referred to the state's HUD regional office. HUD's regional offices are listed in Exhibit 13-1.

Role of the U.S. Department of Housing and Urban Development (HUD)

HUD is responsible for enforcing the Fair Housing Act. In so doing, HUD investigates allegations of housing discrimination, attempts to resolve the complaint, and determines whether there is reasonable cause to pursue civil action. If reasonable cause is present, HUD must bring the case before an administrative law judge. In the alternative, if either party elects to have claims or complaints decided in a civil action, HUD must refer the complaint to the U.S. Department of Justice for prosecution in the United States District Court.

Role of the U.S. Department of Justice

The Department of Justice (DOJ) may file a lawsuit whenever the Attorney General has reasonable cause to believe that any person or group of persons is engaged in a pattern or practice of discrimination or denial of rights to a group of persons where such denial raises an issue of general public importance. DOJ may also file a lawsuit based upon HUD referrals involving the legality of any state or local zoning, or other land use law or ordinance if the parties agree to a civil action. DOJ may also enter into settlement/consent agreements with property owners to obtain compliance with the Fair Housing Act. DOJ may also seek a court judgment to enforce the terms of a settlement/consent agreement.

Role of Substantially Equivalent State or Local Fair Housing Agency

Where HUD has determined that state or local laws are substantially equivalent to the federal Fair Housing Act, a state or local fair housing agency investigates fair housing allegations, attempts conciliation, and determines whether reasonable cause exists to believe a discriminatory housing practice has occurred. If the fair housing agency makes a determination of reasonable cause, then a charge is filed with representation of the complainant provided by a state or local representative.

Memorandum of Understanding (MOU) Among Treasury , HUD and DOJ

Treasury, HUD, and DOJ entered into an MOU in a cooperative effort to promote enhanced compliance with the Fair Housing Act for the benefit of residents of LIHC properties and the general public. Key points of the MOU include coordinated procedures for notifying the state agencies and IRS of charges, lawsuits, or other actions under the Fair Housing Act involving an LIHC property. The MOU also calls for interagency assistance and training, training for the state agencies and industry stakeholders, and training for architects on the accessibility requirements. See Exhibit 13-2 for the full text of the MOU.

Reporting of Fair Housing Act Administrative and Legal Actions

HUD or DOJ will notify a state agency of:

1. a charge by the Secretary of HUD for a violation of the Fair Housing Act,
2. a probable cause finding under a substantially equivalent fair housing state law or local ordinance by a substantially equivalent state or local agency,
3. a lawsuit under the Fair Housing Act filed by the DOJ, or
4. a settlement agreement or consent decree entered into between HUD or DOJ and the owner of an LIHC property.

Other non-FHA civil rights actions and lawsuits, such as section 504 Rehabilitation Act lawsuits or administrative actions, are not covered under the terms of the MOU and should not be reported to the IRS.

On receipt of such a notification, a state agency should immediately file a Form 8823 with the IRS noting the potential violation using the “out of compliance” box and notify the owner in writing. A sample letter that a state agency should send to the owner is included as Exhibit 13-3.

When a Form 8823 pertaining to the above is received, the IRS will send a letter to the owner notifying the owner that a finding of discrimination, including an adverse final decision by the Secretary of HUD, an adverse final decision by a substantially equivalent state or local fair housing agency, or an adverse judgment by a federal court, will result in the loss of low-income housing credits. Similarly, the IRS will also send a letter to owners notifying them that a judgment enforcing the terms of a settlement agreement or consent decree will result in the loss of low-income housing credits.

Potential Violations Discovered by State Agencies

State agencies should report potential Fair Housing Act violations discovered during their compliance monitoring activities to their HUD Regional offices, or other fair housing enforcement agencies, as appropriate. HUD's Regional offices are listed in Exhibit 13-1. Do not submit this information to the IRS via Form 8823.

State Agency Notified by HUD or DOJ that the Terms of Settlement Agreement, Consent Decree, or Judgment are Satisfied

Form 8823 should be filed with the IRS when the civil action is completed. HUD or DOJ will notify the state agency of the resolution of an alleged violation of the Fair Housing Act. Documentation that the owner has complied with the court order and/or HUD's requirements and that the violation has been corrected is needed.

IRS Determinations

The state agencies are responsible for reporting their receipt of notifications of administrative and legal action by HUD and the Department of Justice as outlined in the MOU. The IRS is responsible for determining whether the owner is out of compliance for purposes of IRC §42, and the associated out of compliance and back in compliance dates, based on the findings of the court proceeding. The determination will be based on the facts of the individual case.

Example 1: Violation of Fair Housing Act

> A LIHC project discriminated against single women in its rental practices. The U.S. Department of Justice initiated a lawsuit and obtained a judgment covering all units in the project. The property violates the Fair Housing Act and is in violation of Treas. Reg. §1.42-9.

Depending on the nature of the violation, noncompliance may be determined at the unit, building, or project level. The costs attributable to a residential rental unit that is not for use by the general public are not excludable from eligible basis by reason of the unit's ineligibility for the credit under this section. However, in calculating the applicable fraction, the unit is treated as a residential rental unit that is not a low-income unit.

Reference

Treas. Reg. §1.42-9(a)

Exhibit 13-1
HUD's Regional Offices

HUD AREA	DIRECTOR	PHONE NUMBER	REGIONAL STATES
REGION I BOSTON Fair Housing Hub U.S. Department of Housing and Urban Development Thomas P. O'Neill, Jr. Federal Building 10 Causeway Street, Room 321 Boston, MA 02222-1092	Marcella Brown	617 994-8320	Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont
REGION II NEW YORK Fair Housing Hub U.S. Department of Housing and Urban Development 26 Federal Plaza - Suite 3532 New York, New York 10278-0068	Stanley Seidenfeld	212 264-1290 Ext. 3501	New Jersey, New York
REGION III PHILADELPHIA Fair Housing Hub U.S. Department of Housing and Urban Development The Wanamaker Building 100 Penn Square East, 12th Floor Philadelphia, PA 19107-3380	Wanda S. Nieves	215-656-0661 Ext. 3265	Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, and West Virginia
REGION IV ATLANTA Fair Housing Hub U.S. Department of Housing and Urban Development Five Points Plaza 40 Marietta Street, 16th Floor Atlanta, Georgia 30303-2806	Gregory King	404 331-5001 Ext. 3660	Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, Puerto Rico, South Carolina, and Tennessee
REGION V CHICAGO Fair Housing Hub U.S. Department of Housing and Urban Development Ralph H. Metcalfe Federal Building 77 West Jackson Boulevard, Rm. 2101 Chicago, Illinois 60604-3507	Barbara Knox	312 353-7776 Ext. 2400	Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin
REGION VI FORT WORTH Fair Housing Hub U.S. Department of Housing and Urban Development 801 Cherry Street, 27th Floor P.O. Box 2905 Fort Worth, Texas 76113-2905	Garry Sweeney	817 978-5868	Arkansas, Louisiana, New Mexico, Oklahoma, and Texas

Exhibit 13-1
HUD's Regional Offices

REGION VII KANSAS CITY Fair Housing Hub U.S. Department of Housing and Urban Development Gateway Tower II 400 State Avenue, Room 200 Kansas City, Kansas 66101-2406	Robbie Herndon	913 551-6889	Iowa, Kansas, Missouri, and Nebraska
REGION VIII DENVER Fair Housing Hub U.S. Department of Housing and Urban Development 633 17th Street, 13th Floor Denver, Colorado 80202-3690	Evelyn Meininger	303 672-5434 Ext. 1364	Colorado, Montana, North Dakota, South Dakota, Utah, and Wyoming
REGION IX SAN FRANCISCO Fair Housing Hub U.S. Department of Housing and Urban Development Philip Burton Federal Building & U.S. Courthouse 450 Golden Gate Avenue, 9th Floor P.O. Box 36003 San Francisco, CA 94102-3448	Chuck Hauptman	415 436-8420	Arizona, California, Hawaii, and Nevada
REGION X SEATTLE Fair Housing Hub U.S. Department of Housing and Urban Development Seattle Federal Office Building 909 First Avenue, Rm. 205 Seattle, Washington 98104-1000	Judith Keeler	206 220-5170 Ext. 3415	Alaska, Idaho, Oregon, and Washington

Exhibit 13-2

MEMORANDUM OF UNDERSTANDING AMONG

THE DEPARTMENT OF THE TREASURY,

THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, AND

THE DEPARTMENT OF JUSTICE

Preamble

The United States Departments of the Treasury, Housing and Urban Development, and Justice enter into this memorandum of understanding (MOU) in a cooperative effort to promote enhanced compliance with the Fair Housing Act (Act), 42 U.S.C. §§ 3601 et seq., for the benefit of residents of low-income housing tax credit properties and the general public.

It is recognized that the Department of the Treasury's (Treasury) Internal Revenue Service (IRS) is responsible for administering and enforcing the tax laws in the low-income housing tax credit program under § 42 of the Internal Revenue Code, 26 U.S.C. § 42. In accordance with § 1.42-9 of the Income Tax Regulations, 26 C.F.R. § 1.42-9, low-income housing tax credit properties are to be rented in a manner consistent with the Act. Noncompliance of these properties with the low-income housing tax credit provisions is required to be reported to the IRS by state housing finance agencies under 26 U.S.C. § 42(m)(1)(B)(iii).

It is recognized that the Department of Housing and Urban Development (HUD) is responsible for enforcing the Act, 42 U.S.C. §§ 3601 et seq. In doing so, HUD is required to investigate allegations of housing discrimination, attempt conciliation of the complaint, and determine whether there is reasonable cause to believe discrimination has occurred under the Act. Upon finding reasonable cause, HUD must bring the case before an administrative law judge, or if either party elects to have claims or complaints decided in a civil action, HUD must refer the complaint to the Department of Justice for prosecution in the United States District Court.

It is recognized that the Department of Justice (Justice) is responsible for enforcing the Act, 42 U.S.C. §§ 3601 et seq. Pursuant to section 3614 of the Act, Justice may file a lawsuit whenever the Attorney General has reasonable cause to believe that any person or group of persons is engaged in a pattern or practice of discrimination or denial of rights to a group of persons where such denial raises an issue of general public importance. Justice also may file a lawsuit upon referral of matters from HUD involving the legality of any state or local zoning or other land use law or ordinance and after receiving a referral from HUD following an election by a party to a HUD complaint to have the matter decided in a civil action. Justice may enter into

settlement agreements and consent decrees with property owners to obtain compliance with the Act. In the event a property owner fails to comply with the terms of the settlement agreement or consent decree, Justice may seek a court judgment to enforce the terms of the settlement agreement or consent decree.

The parties to this MOU agree to the following:

1) Coordination on Notifying Low-Income Housing Tax Credit Property Owners about Charges, Lawsuits, and Other Actions

HUD and Justice will identify low-income housing tax credit properties for which there is: 1) a charge by the Secretary of HUD for a violation of the Act; 2) a probable cause finding under a substantially equivalent fair housing state law or local ordinance by a substantially equivalent state or local agency; 3) a lawsuit under the Act filed by Justice; or 4) a settlement agreement or consent decree entered into between HUD or Justice and the owner of a low-income housing tax credit property. HUD or Justice will then transmit the address of the property and a summary of these actions to the appropriate state housing finance agency, using a current list of contacts and addresses of state housing finance agencies provided by the IRS.

Upon the state housing finance agencies reporting this information to the IRS (using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance), the IRS will send a letter to involved property owners notifying them that a finding of discrimination, including an adverse final decision by the Secretary of HUD, an adverse final decision by a substantially equivalent state or local fair housing agency, or an adverse judgment by a federal court, could result in the loss of low-income housing tax credits. Similarly, the IRS will also send notification to property owners that a judgment enforcing the terms of a settlement agreement or consent decree could result in the loss of low-income housing tax credits. The IRS, HUD, and Justice will collaboratively develop the model letters addressed to property owners and other entities. HUD and Justice will also send to the IRS and the appropriate state housing finance agency a summary of the above-referenced actions, describing relevant information such as the precise nature of the violation, the dates of the violation, and proposed corrective actions.

2) Designating Contacts and Interagency Technical Assistance and Training

HUD and Justice will designate personnel to provide the IRS upon request with technical assistance and problem resolution concerning emerging civil rights and discrimination matters involving the administration of the low-income housing tax credit program (e.g., accessibility issues, section 8 vouchers, civil rights interpretative issues, and published guidance). In addition, HUD and Justice will provide training upon request to a few designated IRS personnel about the Act. The IRS will designate personnel to provide technical assistance and training upon request to HUD and Justice personnel on general tax administration issues under the low-income housing tax credit program, in a manner consistent with the IRS's disclosure limitations contained in section 6103 of the Internal Revenue Code.

3) Training for State Housing Finance Agencies and Others

HUD and Justice will make training available upon request to state housing finance agencies and other entities (e.g., developers, property management companies, syndicators) on the Act, including training on inspecting for Act accessibility criteria referenced in the uniform physical condition standards in 24 CFR 5.703. HUD will also encourage substantially equivalent state and local fair housing agencies to invite state housing finance agencies and other entities to participate in civil rights training developed by the substantially equivalent agencies.

4) HUD's Pilot Program to Train Architects on the Act's Accessibility Requirements

HUD has begun the process of developing a pilot program in one region of the country to provide training and technical assistance to architects and others on the accessible design and construction requirements of the Act. HUD has also proposed expanding this program to four regions in FY 2001. HUD will promote participation in the program by members of the American Institute of Architects, including those involved with the design and construction of low-income housing tax credit properties.

5) Cooperation in Research Concerning Low-Income Housing Tax Credit Properties

HUD and Treasury will cooperate in research sponsored by either Department concerning low-income housing tax credit properties.

6) Cooperation to Identify and Remove Unlawful Barriers to Section 8 Tenants

In consultation with the state housing finance agencies, HUD, Justice, and the IRS will cooperate in identifying and removing unlawful barriers to occupancy of low-income housing tax credit properties by individuals holding section 8 vouchers.

7) Cooperation in Assisting Syndicators of Low-Income Housing Tax Credits

HUD, Justice, and the IRS will cooperate in helping the national associations of investment syndicators of low-income housing tax credit properties to enhance practices by syndicators in monitoring and promoting compliance with the Act and the low-income housing tax credit program.

8) Annual Civil Rights Meeting Among Federal Agencies and Participation in National Conference of State Housing Finance Agencies

HUD, Justice, Treasury, and other interested federal agencies will meet annually to discuss emerging civil rights issues and new methods and programs to increase civil rights compliance in the low-income housing tax credit program. IRS will encourage the state housing finance agencies to invite HUD and Justice to the annual national conference of state housing finance agencies. HUD and Justice agree to designate personnel to conduct training and discuss emerging civil rights issues at the national

conference.

Implementation

This MOU will become effective 30 days from the date of the last signature on this document.

The parties agree to confer on the interpretation and application of the memorandum as necessary and to conduct a mutual annual review of its operation.

Nothing in this MOU shall be construed to impair or affect i) HUD's or Justice's authority to enforce the Act, ii) the IRS's authority to administer the low-income housing tax credit program, including complete administrative discretion to deny low-income housing tax credits in the event of a violation of the Act, or iii) the IRS's disclosure limitations under section 6103 of the Internal Revenue Code.

/signed/ *Lawrence H. Summers*	/signed/ *Andrew Cuomo*	/signed/ *Janet Reno*
LAWRENCE H. SUMMERS Secretary of the Treasury	ANDREW CUOMO Secretary, U.S. Department of Housing and Urban Development	JANET RENO Attorney General
August 9, 2000 DATE	August 9, 2000 DATE	August 10, 2000 DATE

Exhibit 13-3
Sample Letter to Notify Building Owner of Potential Fair Housing Act Violations

Date

Owner
Address
City State ZIP

RE:
Project:
BIN Numbers:

Dear Owner:

Enclosed are Forms 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, concerning certain Fair Housing Act [administrative/legal actions] reported by [the U.S. Department of Housing and Urban Development (HUD)/U.S. Department of Justice] to this agency. Our agency has submitted these Forms 8823 to the Internal Revenue Service.

Low-income housing tax credit properties are subject to Title VIII of the Civil Rights Act of 1968, also known as the Fair Housing Act ("Act"). The Act prohibits discrimination in housing and housing related transactions, including the sale, rental and financing of dwellings, based on race, color, religion, sex, national origin, familial status, and disability. See 42 U.S.C. sections 3601 through 3619. The Act also mandates specific design and construction requirements for multifamily housing built for first occupancy after March 13, 1991, in order to provide accessible housing for individuals with disabilities.

Section 1.42-9 of the Income Tax Regulations provides that the failure of low-income housing tax credit properties to comply with the requirements of the Act results in the denial of credits on a per-unit basis. Thus, an adverse final decision by the Secretary of HUD, an adverse final decision by a substantially equivalent state or local fair housing agency, or an adverse final judgment by a federal court, including a judgment enforcing compliance with the terms of a settlement agreement or consent decree, could result in the disallowance of credits, recapture of credits, and preclusion of future credits on the effected units. If the reduction in the number of the low-income units in the building(s) brings the project below the minimum set-aside requirement defined in section 42(g)(1) of the Internal Revenue Code, the entire amount of the credit for the project could be disallowed.

Your ability to enter into a settlement agreement concerning the particular Fair Housing Act problem with HUD, the Department of Justice, or the state or local fair housing agency may preclude the necessity of loss of low-income housing tax credits. It is incumbent upon you to work with the appropriate agency to resolve the problem.

Sincerely,

Name-Signature
Title

CC: Management Contact

Chapter 14
Category 11i
Violations of the Available Unit Rule
Under Section 42(g)(2)(D)(ii)

Note

Effective July 31, 2008, owners of 100% low-income project are no longer required to complete the annual tenant income recertifications referenced in Treas. Reg. §1.42-5(b)(1)(vi). Until further guidance is provided through administrative ruling or regulation, the IRS will evaluate an owner's compliance with the Available Unit Rule as explained here.

Definition

This category is used to report violations of the Available Unit Rule (AUR)[1]; i.e., situations where an *initially* qualified household's income subsequently rises above 140 percent (170 percent in deep rent skewed developments) of the current income limit and a household that is not income qualified moves into a unit of comparable or smaller size in the low-income building.

The Available Unit Rule under IRC §42(g)(2)(D) states that if the income of the occupants of a low-income unit increases above 140 percent of the income limit (or 170 percent in deep rent skewed developments), the unit will continue to be treated as a low-income unit if the occupants initially met the income limitation and the unit continues to be rent restricted. If the income of the occupants of the unit increases above 140 percent of the applicable income limitation, the unit will cease to qualify as a low-income unit if any residential rental unit in the building (of a size comparable to, or small than, such unit) is occupied by a *new* resident whose income exceeds the income limitation.

Under IRC §142(d)(3)(A), as amended by the Housing Assistance Tax Act of 2008, owners are not required to complete annual income recertifications if the building is part of a 100% low-income project. For purposes of applying the Available Unit Rule *only*, all households documented as initially income-qualified households are treated as initially income-qualified as long as the owner *demonstrates due diligence*[2] when completing the initial income certification.

Compliance on a Continuing Basis

The determination of whether a tenant qualifies for purposes of the low-income set-aside is made on a continuing basis, both with respect to the tenant's income and the qualifying income for the location, rather than only on the date the tenant initially occupies the unit.[3]

[1] The terms Next Available Unit Rule (NAUR) and Available Unit Rule (AUR) are synonymous and can be used interchangeably.
[2] Due diligence is discussed in Chapter 3.
[3] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89

Changes in Area Median Gross Income

The determination of an over-income unit is not limited to instances where the household's income increases. A unit may also become over-income if, subsequent to the initial income qualification, there is a decrease in the Area Median Gross Income (AMGI). Likewise, an increase in AMGI increases the income limitation used to calculate whether an owner must rent any available residential unit of comparable or smaller size to a new low-income tenant. See Rev. Rul. 94-57 for additional information.

Treatment of Vacated Over-Income Units

If an over-income unit is vacated, it will be treated as an over-income unit subject to the Available Unit Rule until the effective date of the tenant income certification for the new income-qualified household that moves into the unit or the unit is rented to a nonqualifying tenant.

Next Available Unit Defined

The "next available unit" is any vacant unit, or any unit that is subsequently vacated in the same building, of a comparable or smaller size. Treas. Reg. §1.42-15(c) states that a unit is not available when the unit is no longer available for rent due to contractual arrangements that are binding under local law.

Comparable or Smaller Unit

A comparable or smaller unit is defined in §1.42-15 as "a residential unit in a low-income building that is comparably sized or smaller than an over-income unit or, for deep rent skewed projects described in IRC §142(d)(4)(B), any low-income unit. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available." Since a comparable unit may need to be identified before the end of the year when the qualified basis is determined, an owner may consider a residential unit with the same number of bedrooms (or fewer) and comparable amenities to be a comparable unit.

Summary

Key concepts of the Available Unit Rule include:

1. The Available Unit Rule is used to replace over-income units with new low-income units as available units are rented. Alternatively, over-income units may be returned to low-income status if the household's income decreases or the AMGI increases.

2. In a project containing more than one low-income building, the Available Unit Rule applies separately to each building.

3. Low-income units containing households whose income rises above 140% (or 170% for deep rent skewed projects) of the *current* income limit are still considered low-income units as long as the rent remains restricted and available units of comparable or smaller size are rented to qualified low-income households with restricted rents.

4. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available. For example, an owner may consider a residential unit with the same number of bedrooms (or fewer) and comparable amenities to be a comparable unit.

5. The owner of a low-income building must rent all comparable units that are available or that subsequently become available in the same building as low-income units in order to continue treating the over-income unit as a low-income unit. Once the percentage of low-income units in a building (excluding the over-income units)

equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance; i.e., the over-income units can be converted to market-rate units.

6. If any comparable or smaller unit that is available or that subsequently becomes available is rented to a nonqualified resident, all over-income units within the same building for which the available unit is comparable or *larger* lose their status as low-income units. See Treas. Reg. §1.42-15(f).

7. The Available Unit Rule should not be confused with the Vacant Unit Rule, which applies without regard to the income of existing tenants.

In Compliance

A building is in compliance when the current applicable fraction is at the applicable fraction on which credit is based. Units containing households whose incomes originally qualified, but currently exceed 140 percent (170 percent for deep rent skewed projects) of the current income limit are included in the applicable fraction as long as the rents for the units continue to be restricted.

Example 1: Change in Over-Income Units

A project consists of one building with 10 units of equal size. Units 1 through 8 are low-income units. Unit 9 is a market rate unit. Unit 10 is a vacant market rate unit. The applicable fraction for the credit is 80%. The current percentage of income-qualified tenants is 80% and the building is in compliance.

On July 1, 2000, the income of the tenants in units 6, 7 and 8 were determined to be over 140 percent of the income limit. The rents for these 3 units remained restricted. The current applicable fraction remains at 80% and the building continues to be in compliance.

To determine whether a noncompliance event could potentially occur, the owner calculated the applicable fraction without the over-income units as part of the numerator. This fraction is 50 percent (5/10). To remain in compliance, Unit 10 must be rented as a low-income unit to replace one of the over-income units. In addition, if the tenant in Unit 9 (the other market rate unit) vacates, that unit must also be rented as a low-income unit.

An income-qualified household moved into Unit 10, at a restricted rent, on August 1, 2000. At the time of the move in, the current applicable fraction (excluding all of the over-income units) has increased to 60 percent.

On August 31, 2000, Unit 9, a market-rate unit, was vacated and an income-qualified household moved into Unit 9 at a rent restricted rate on January 1, 2001. The applicable fraction (excluding all of the over-income units) increased to 70 percent.

On December 31, 2000, Unit 6, an over-income unit, was vacated and an income-qualified household moved on February 1, 2001, at a rent-restricted

rate. The current fraction (excluding all of the over-income units) increased to 80%.

Because the current fraction excluding the over-income units meets the 80% applicable fraction for the building, the remaining over-income units, Units 7 and 8, may be rented at market rate (depending on the terms of the leases). Once the percentage of low-income units in the building (excluding the over-income units) equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance.

Example 2: Lease Reservation Signed Prior to the Effective Date of a Unit Becoming an Over-Income Unit

A project consists of one building with 10 units of equal size. The project is currently "in compliance" with respect to the qualified basis. Unit 10 is a vacant market rate unit. A household with income exceeding the limit signs a lease on June 25, 2000, for unit 10 and intends to move in on July 5, 2000. The lease term is from July 5, 2000 to June 30, 2001. Unit 6 was an over-income unit on July 1, 2000. Under local law, no other person may rent Unit 10 between June 25, 2000 and July 5, 2000.

The building remains "in compliance" even though the next available unit was *occupied* after the *effective* date of the over-income unit because a unit is not available for purposes of the Available Unit Rule if the unit is unavailable due to contractual arrangements that are binding under local law. See Treas. Reg. §1.42-15(c).

Out of Compliance

Under Treas. Reg. §1.42-15(c), noncompliance occurs when a comparable or smaller unit than the over-income unit is rented to a nonqualified household when the current applicable fraction (excluding all over-income units from the numerator, but not the denominator) is less than the applicable fraction for which the credit is based. The date of a noncompliance event is the date the market rate unit is occupied or the reservation date, if earlier.

Example 1: Moving In Nonqualified Household When Over-Income Units Have Not Been Replaced

A project consists of one building with ten units of equal size. Units 1 through 8 are low-income units. Unit 9 is a market rate unit. Unit 10 is a vacant market rate unit. The applicable fraction for the credit is 80 percent. The current applicable fraction is 80 percent and the building is presently in compliance.

Units 6 and 7 were determined to be over-income. The rents for these two units remain rent restricted. The current applicable fraction remains at 80%.

To determine whether a noncompliance event could potentially occur, the owner calculated the applicable fraction without the over-income units as

part of the numerator. The applicable fraction is now 60 percent (6/10). To remain in compliance, Unit 10 must be rented to an income-qualified household and the rents restricted to replace one of the over-income units.

An income-qualified household moved into Unit 10 on August 1, 2000 and paid market rate rents. At the time of the move in, the current applicable fraction (excluding all of the over-income units) was 60 percent. The event triggered a violation of the Available Unit Rule. All the over-income units cease to be treated as low-income units. The date of noncompliance is August 1, 2000.

Example 2: Comparable Units

A mixed-use building, with an applicable fraction of 85 percent, contains 85 low-income units and 15 market rate units. Eleven of the low-income units are occupied by households with incomes that have increased above 140 percent of the income limit. The eleven over-income units consist of 4 three-bedroom, 5 two-bedroom, and 2 one-bedroom units. The next unit to be vacated is #99, a two-bedroom unit (not one of the eleven over-income units). The vacated unit is leased to a nonqualified household at market rate rent.

The building is out of compliance. To comply with the Available Unit Rule, the unit should have been leased to an income-qualified household and the rents should have been restricted. Because the unit was leased to a nonqualifying tenant, all over-income units, for which #99 was a comparable or *larger*-sized unit, lose their status as low-income units. Thus, all 4 of the three-bedroom and all 5 of the two-bedroom units of the over-income units are out of compliance. The 2 one-bedroom units (which are smaller than the rented unit) are not out of compliance (See Treas. Reg. §1.42-15(f).)

100% LIHC Projects: Owner Fails to Demonstrate Due Diligence

The Available Unit Rule is also violated when an owner of a 100% LIHC project fails to rent a unit to an income-qualified household *and* cannot demonstrate due diligence when completing the initial income certification. The rule is also violated if the owner deliberately rents a unit as a market-rate unit.[4]

Example 1: Owner of 100% LIHC Project Fails to Demonstrate Due Diligence

A state agency conducts a tenant file review for a 100% low-income project and determines that numerous errors were made when identifying source of income and completing third party verification as part of the initial income certifications after July 30, 2008. In some cases, certifications were not completed for months after the households moved in. The state agency reviewed the owner's due diligence and determined that the owner did not provide sufficient oversight or due diligence.

[4] To avoid noncompliance, the owner must first determine which units are over-income units and apply the Available Unit Rule accordingly. Reducing the number of low-income units in a building will reduce the allowable credit and is a credit recapture event under IRC §42(j).

Failure to provide sufficient due diligence results in disregard of the Available Unit Rule. (See Chapter 21.) The noncompliance date is the date of the earliest unacceptable initial income certification.

Other Non-Compliance Issues

Violations of the Available Unit Rule can also result in noncompliance with other IRC §42 requirements. Specifically, consideration should be given to the following:

1. Minimum Set-Aside Requirement – as a violation of the Available Unit Rule may result in multiple over-income units losing the low-income status, the minimum set-aside requirement may not be met; i.e., the number of qualifying units falls below the minimum requirement. See Chapter 10.

2. Annual Income Recertifications after July 30, 2008 - if the building is part of a 100% qualified low-income project, where the owner is not completing annual tenant income certifications under IRC §142(d)(3)(A),[5] the IRS accepts, for purposes of the Available Unit Rule only, that households documented as initially income-qualified households are income-qualified. Failure to rent the next available unit as a rent-restricted unit reduces the low-income building's qualified basis to zero unless the owner can document which units are not over-income units. If the owner intends to convert from a 100% low-income project to a mixed-use project, the owner must first determine which units are over-income units and apply the Available Unit Rule as needed. Reducing the number of low-income units in a building is a credit recapture event under IRC §42(j).

3. Annual Income Recertification Waivers before July 31, 2008 - if the *building* was a100% low-income building and the owner has a waiver of the annual income recertification under IRC §42(g)(8)(B), qualified low-income units in the building continued to be treated as qualified low-income units even if the owner was not completing annual tenant income certification or otherwise documenting that the units are not over-income. However if the building owner rented an available unit in the building to a nonqualified household, the owner was required to determine if any of the units in the building were over-income, despite having a recertification waiver in effect. Further, under Rev. Proc. 94-64 or Rev. Proc. 2004-38, renting a unit to a nonqualified household in a 100% LIHC building resulted in the revocation of the waiver. The Annual Income Recertification Waiver was subsumed by the new exception under IRC §142(d)(3)(A) for 100% qualified low-income projects and are, therefore, no longer enforced.

4. Annual Certification – the owner may have incorrectly reported compliance with the Available Unit Rule as part of the annual certification as described in Treas. Reg. §1.42-5(c). See Chapter 7.

Back in Compliance

Once the Available Unit Rule has been triggered, the noncompliance can be corrected by renting any combination of market rate units, over-income units, and out of compliance low-income units as rent restricted units to income-qualified households until the

[5] IRC §142(d)(3)(A) was amended by section 3010 of the Housing Assistance Act of 2008 and is effective for taxable years ending after July 30, 2008. IRC §142(d)(3)(A) is made applicable to IRC §42 low-income projects in IRC §42(g)(4).

applicable fraction upon which the credit amount is based is restored. The applicable fraction can also be restored if:

1. The tenant's income decreases to an amount below 140 percent of the income limit in place, or
2. The AMGI increases to an amount, such that 140 percent of the income limit is more than the tenant's income.

The date of correction is the date the last household, which restores the applicable fraction, moves into the building or the income of an existing household falls below the current income limit.

References

1. IRC §42(g)(2)(D)(ii)
2. Treas. Reg. §1.42-5(c)(1)(x)
3. IRC §42(d)(3)(B)
4. Treas. Reg. §1.42-15
5. Rev. Rul. 94-57, 1994-2 C.B. 5
6. Rev. Rul. 2004-82, 2004-2 C.B. 350

Chapter 15
Category 11j
Violation(s) of the Vacant Unit Rule
Under Reg. 1.42-5(c)(1)(ix)

Definition

This category is used to report violations of the Vacant Unit Rule (VUR); i.e., situations where an owner failed to make reasonable attempts to rent that unit, or the next available unit of comparable or smaller size, before renting units to tenants not having a qualifying income.

As part of the requirements for the annual certification, Treas. Reg. §1.42-5(c)(1)(ix) states, "If a low-income unit in the project became vacant during the year, that reasonable attempts were or are being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income."

Reasonable Attempts

As long as reasonable attempts are being made to rent to qualified low-income households before renting units to nonqualifying tenants, vacant LIHC units will continue to be included as qualified low-income units for purposes of determining the minimum set-aside (IRC §42(g)(1)) and calculating the applicable fraction (IRC §42(c)(1)(B)). What constitutes reasonable attempts to rent a vacant unit is based on facts and circumstances, and may differ from project to project depending on factors such as the size and location of the project, tenant turnover rates, and market conditions. Also, the different advertising methods that are accessible to owners and prospective tenants would affect what would be considered reasonable. [1]

Available Low-Income Unit Defined

The definition of an available low-income unit for purposes of the Vacant Unit Rule is the same as used for the Available Unit Rule. Treas. Reg. §1.42-15(c) states that a unit is not available when the unit is no longer available for rent due to contractual arrangements that are binding under local law. See Rev. Rul. 2004-82, Q&A #10.

Comparable Units

The definition of a comparable or smaller unit for purposes of the Vacant Unit Rule is the same as used for the Available Unit Rule; i.e., a residential unit that is comparably sized or smaller than the vacated unit. For deep rent skewed projects described in IRC §142(d)(4)(B), any low-income unit is considered a comparable unit. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available. See Treas. Reg. §1.42-15(a). Since a comparable unit may need to be identified before the end of the year when the qualified basis is determined, an owner may consider a residential unit with the same number of bedrooms (or fewer) and comparable amenities to be a comparable unit.

[1] Rev. Rul. 2004-82, Q&A #9, 2004-2 C.B. 350

In Compliance

A project is in compliance when reasonable attempts are made to rent vacant low-income units (comparably sized or smaller than the vacated units) to tenants having a qualifying income before any units are rented to nonqualifying tenants. A state agency's responsibility for reviewing the owner's compliance with the Vacant Unit Rule must include a review of the owner's advertising practices; i.e., a project will be considered in compliance when the owner makes reasonable efforts to rent vacant units to qualified low income households before renting any vacant units to nonqualifying tenants.

Example 1: Renting Market Rate Unit Before Low-Income Units[2]

> Twenty market rate units and ten low-income units previously occupied by income-qualified tenants in a 200-unit mixed-use housing project are vacant. None of the low-income units are over-income units. The owner displayed a banner and for rent signs at the entrance to the project, placed classified advertisements in two local newspapers, and contacted prospective low-income tenants on a waiting list for the project and on a local public housing authority's list of section 8 voucher holders. These are customary advertising methods for apartment vacancies in the area where the project is located. Subsequent to the low-income unit vacancies, a market rate unit of comparable size to the low-income units became vacant. The owner rents five market rate units before any of the ten vacant low-income units.
>
> The owner is in compliance with the Vacant Unit Rule. The owner has used reasonable methods of advertising an apartment vacancy in the area of the project before renting a market rate unit. In addition, the Available Unit Rule is not violated be renting the market rate unit because there are no over-income units in the building.

A unit is not available for purposes of the vacant unit rule when the unit is no longer available to rent due to contractual arrangements that are binding under local law, such as a reservation entered into between a building owner and a prospective tenant.

Example 2: Low-Income Unit Not Available[3]

> A building has 10 units, consisting of 7 low-income units (none was an over-income unit) and 3 market rate units. All units in the building were occupied except for one market rate unit.
>
> A low-income unit became vacant on March 15, 2004, so the owner started advertising to rent the unit to an income-qualified tenant. On March 29, 2004 the owner agreed to rent the unit to an income-qualified household and the parties signed a reservation binding on both parties. The owner ceased advertising efforts for the low-income unit. The vacant market rate unit was rented on April 15, 2004. The low-income household signed their lease on April 30, 2004 and

[2] Rev. Rul. 2004-82, Q&A #9
[3] Rev. Rul. 2004-82, Q&A #10

moved in on May 1, 2004.

Since a reservation had been signed for the vacant low-income unit at the time the market unit was rented, the low-income unit was not available for rent and, therefore, the owner no longer needed to make reasonable efforts to rent the low-income unit.

Out of Compliance

Noncompliance occurs when the owner does not make reasonable attempts to rent vacant low-income units and rents units to nonqualifying tenants. If the Vacant Unit Rule is violated, all vacant units previously occupied by qualified households lose their low-income status and are not considered qualified units. The date of noncompliance is the date the first low-income tenant moved out of the now vacant units.

Example 1: Owner Stopped Making Reasonable Efforts to Rent Low-Income Housing Units

The owner of a mixed-use LIHC project with 100 units stopped advertising efforts to attract low-income tenants on January 15, 2004. 15 of the 25 market rate units are vacant and 25 of the 75 low-income units are vacant at the time the state agency conducts a tenant file review. The LIHC units were vacated between September 25, 2003 and March 31, 2004.

The project is out of compliance on September 25, 2003, when the first currently vacant low-income unit was vacated.

Note 1: Vacant units that are not available for rent because the units are not prepared for immediate occupancy are reported as unsuitable for occupancy under Category 11c. See Chapter 6.

Note 2: If the owner fails to market vacant low-income units, the owner has violated the General Public Use Rule, which should be reported as noncompliance under Category 11h. See Chapter 12.

Failure to Provide Information

If it is determine that an owner is not making reasonable attempts to rent vacant low-income units, the owner will need to provide the state agency a list of all vacant low-income units in the project. Under Treas. Reg. §1.42-5(b)(1)(v), owners are required to maintain records identifying vacant low-income units and information that shows, when, and to whom, the next available unit was rented. Failure to provide the needed information will result in a finding of noncompliance under 11f, Project failed to meet minimum set-aside requirement, because the owner has failed to establish that the minimum set-aside has been met.[4] Under IRC §6001, every taxpayer is required to maintain records sufficiently detailed to prepare a proper tax return. This requires the

[4] The legislative history explains that vacant units formerly occupied by low-income individuals may continue to be treated as occupied by a qualified low-income individual for *purposes of the set-aside* requirement provided that the owner has not violated the vacant unit rule.

maintenance of such permanent books and records sufficient to establish the amounts of gross income, deductions, *credits*, or other matters to be shown on the taxpayer's return. This requirement extends to the preparation and maintenance of records sufficient for demonstrating compliance with the Vacant Unit Rule.

Back in Compliance

The noncompliance is corrected when if a sufficient number of vacant units in the project are rented to qualified low-income households.

Example 1: Owner Restored Applicable Fraction

The owner of a mixed-use LIHC project with 100 units stopped advertising efforts to attract low-income tenants on January 15, 2004. 15 of the 25 market rate units are vacant and 25 of the 75 low-income units are vacant. The LIHC units were vacated between September 25, 2003 and March 31, 2004.

The project violated the Vacant Unit Rule on September 25, 2003, when the first currently vacant low-income unit was vacated. The owner resumes advertising efforts on June 18, 2004, and rented 13 former market rate units and 12 out of compliance low-income units between June 30, 2004 and November 18, 2004 to income-qualified tenants. The building is restored to its pre-violation status when the last household, which restores the applicable fraction, moves into the building; i.e., November 18, 2004, when 75% of the units were restored to the status of low-income units.

References

1. Treas. Reg. §1.42-5(c)(1)(ix)
2. Rev. Rul. 2004-82, 2004-2 C.B. 350

Chapter 16
Category 11k
Owner Failed to Execute
and Record Extended Use Agreement
Within Time Prescribed by Section 42(h)(6)(J)

Definition

This category is used to report buildings for which an extended low-income housing commitment (extended use agreement) is not in effect; i.e., the extended use agreement is not executed, is not recorded, or fails to meet the requirements of IRC §42(h)(6). No credit is allowable for a building in a year unless an extended use agreement is in effect at the end of the year. See IRC §42(h)(6)(A). If it is determined that an extended use agreement was not in effect at the beginning of the year, IRC §42(h)(6)(J) permits the owner to correct the problem within one year from the date of the determination.

For all buildings allocated tax credits after 1989, IRC §42(h)(6) requires owners of tax credit properties to enter into an extended use agreement with the state agency that allocated the credits to the project. Building owners must agree to a long-term commitment beginning on the first day of the 15-year compliance period and ending on the later of (1) the date specified by the state agency in the agreement or (2) the date which is 15 years after the close of the 15-year compliance period. In other words, the owner covenants to maintain the property as a low-income housing project for at least 30 years.

Extended use agreements must:

1. specify that the applicable fraction for the building for each year in the extended use period will not be less than the applicable fraction specified in the extended use agreement and which prohibits the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or any increase in the gross rent with respect to such unit not otherwise permitted under IRC §42.

2. allow individuals (whether prospective, present, or former occupants) who meet the income limitation applicable to the building under IRC §42(g) the right to enforce in state court the requirements and prohibitions under IRC §42(h)(6)(B)(i), including maintaining the applicable fraction and prohibiting the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or any increase in the gross rent with respect to such unit not otherwise permitted under IRC §42. These prohibitions apply through out the extended use period.[1]

[1] Rev. Rul. 2004-82, 2004-35 I.R.B., Q&A #5 explains that IRC §42(h)(6)(B)(i) requires that an extended use commitment include a prohibition during the extended use period against (1) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit (no-cause eviction protection) and (2) any increase in the gross rent with respect to the unit not otherwise permitted under IRC §42. When Congress amended IRC §42(h)(6)(B)(i) to add the language cited, IRC §42(h)(6)(E)(ii) was already part of IRC §42. As a result, Congress must have intended the amendment to IRC §42(h)(6)(B)(i) to add an additional requirement beyond what was contained in IRC §42(h)(6)(E)(ii), which already prohibited the action described in that section for the 3 years following the termination of the extended use period. Because the

3. prohibit the disposition to any person of any portion of the building unless all of the building is disposed of to that person.

4. prohibit the refusal to lease to section 8 voucher holders because of the status of the prospective tenant as such a holder,

5. provide that the agreement is binding on all successors of the taxpayer, and

6. the extended use agreement must be recorded as a restrictive covenant with respect to the property under state law.

In Compliance

The owner is in compliance when the extended use agreement is executed, recorded, and meets the requirements of IRC §42(h)(6). State agencies should require documentation that the extended use agreement has been recorded before issuing the Form 8609.

Out of Compliance

The owner is out of compliance in the absence of a properly executed and recorded extended use agreement and no credit is allowable if the extended use agreement is not in effect as of the end of a taxable year in the credit period. However, if the owner executes and records an extended use agreement within one year after the determination that an extended use agreement is not in effect, the noncompliance is corrected and the taxpayer can claim the low-income housing credit for past taxable years. If the noncompliance is not remedied within one year after the notification, the taxpayer loses the credit for past taxable years until the taxable year in which the extended use agreement is properly in effect.

The one-year period for correcting the noncompliance begins when the owner is notified that an extended use agreement has not been properly executed and/or recorded. The state agency should provide *written* notification of the noncompliance immediately and document the owner's receipt. The notification should:

1. Cite IRC §42(h)(6) as authority
2. Identify the problem and corrective action needed
3. Explain that the date of the letter starts the one-year period for correcting the noncompliance.

When submitting the Form 8823, a copy of the letter should be included as an attachment.

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requirements of IRC §42(h)(6)(B)(i) otherwise apply for the extended use period, Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of IRC §42(h)(6)(E)(ii) to apply throughout the extended use period. In Rev. Proc. 2005-37, 2005-28 I.R.B. 79, the Service established a safe harbor under which housing credit agencies and project owners could meet the requirements of IRC §42(h)(6)(B)(i) in lieu of an extended use agreement which specifically included the language of subclauses (I) and (II) of IRC §42(h)(6)(E)(ii).

Example 1: Owner did not Execute and Record Extended Use Agreement

The owner of a LIHC project placed the buildings in service in February 1998 and submitted the documentation for final approval in June 1998. The state agency issued the Form 8609 in September 1998, prior to receiving the executed extended use agreement from the owner. The owner claimed the credit for the 1998 tax year. The state agency later determined that an extended use agreement was not in effect for the 1998 tax year (the first year of the credit period), issued a notice of noncompliance to the owner in February 1999, and submitted Form 8823 to the IRS in May 1999, reporting the absence of the extended use agreement and attaching a copy of the notification letter to the owner. In December 2000, the owner and state agency executed the extended use agreement, and recorded it.

The date of noncompliance is December 31, 1998, when the state agency determined that an extended use agreement was not in effect as of the end of the tax year. Since the owner failed to execute the extended use agreement within one year from the date of the notification, the owner will lose credits for 1998 and 1999, but can resume claiming the credits for 2000.

Back in Compliance

The owner is back in compliance when the extended use agreement is executed and recorded within one year of the determination of noncompliance. If the extended use agreement is not in effect within one year of the determination that an extended use agreement was not in effect, the taxpayer loses low-income housing credits for past taxable years and cannot claim credit with respect to any building for which an extended use agreement is not in affect by the end of the applicable taxable year.

References

1. IRC §42(h)(6)(A), (B) and (J)
2. Rev. Rul. 2004-82, 2004-35 I.R.B. 350
3. Rev. Proc 2005-37, 2005-28 I.R.B. 79

Chapter 17
Category 11I
Low-Income Units Occupied by Nonqualified Full-Time Students

Note

Until further guidance is provided through administrative ruling or regulation, the IRS will evaluate an owner's compliance with the rules for low-income unit occupied entirely by full-time students as explained here.

Definition

This category is used to report LIHC units occupied by nonqualified full-time student households. A unit is *not* considered to be occupied by low-income individuals if all the occupants of such unit are full-time students, no one of whom is entitled to file a joint return.[1]

Defining "Student"

IRC §152(f)(2) defines, in part, a "student" as an individual, who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins, is a full-time student at an educational organization described in IRC §170(b)(1)(A)(ii) or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in IR §170(b)(1)(A)(ii) or of a state or political subdivision of a state. Treas. Reg. §1.151-3(b) further provides that the five calendar months need not be consecutive.

The determination of student status as full or part-time should be based on the criteria used by the educational institution the student is attending.

An educational organization, as defined by IRC §170(b)(1)(A)(ii), is one that normally maintains a regular faculty and curriculum, and normally has an enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term "educational organization" includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade and mechanical schools. It does not include on-the-job training courses.

Units Comprised Entirely of Full-Time Students

Units comprised of full-time students (no one of whom is entitled to file a joint return) do not qualify as low-income units. However, there are exceptions as outlined in IRC §42(i)(3)(D). This section provides that a unit shall not fail to be treated as a low-income unit merely because it is occupied

1. by an individual who is:
    I. a student receiving assistance under Title IV of the Social Security Act,
    II. a student who was previously under the care and placement responsibility of the State agency responsible for administering a plan under part B or part E of title IV of the Social Security Act,[2] or

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

[2] IRC §42(i)(3)(D)(i), as added by the Housing Assistance Tax Act of 2008. The amendment applies to determinations made after July 30, 2008.

III. a student enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar Federal, State or local laws.

2. entirely by full-time students if such students are
   I. single parents and their children and such parents are not dependents (as defined in IRC §152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof) of another individual and such children are not dependents (as so defined) of another individual other than a parent of such children,[3] or
   II. married and file a joint return.

In the case of a single parent with children, the legislative history explains that *none* of the tenants (parent or children) can be a dependent of a third party. See S. Rpt. No. 103-37, 103d Cong., 1st Sess. 74 (1993).

Verification and Documenting Student Status

Verifying Student Status at Move In

Owners should verify student status at the time households initially move into low-income units. As with the initial income certification, the verification can be completed within 120 days before, and is effective as of, the day the household actually moves into the unit.

Annual Student Status Verification

The owner should complete student status verifications for each low-income household within 120 days before the anniversary of the effective date of the original student verification. For mixed-used projects, the student status verification can be combined with the tenant income recertification. See Chapter 5.

Documentation

Acceptable methods of verification include third party verifications, oral statements, or review of documents submitted by the student. See Exhibit 17-1 for an example.

In Compliance

A unit is in compliance when (1) it is not occupied entirely by full-time students at qualifying educational organizations for five or more months during the calendar year in which the taxable year of the taxpayer begins, or (2) it is occupied entirely by full-time students that meet one of the exceptions identified in IRC §42 (i)(3)(D). Also, a married couple that is *entitled* to file a joint tax return, but has not filed one, still satisfies the exception under IRC §42(i)(3)(D)(ii)(II).

[3] IRC §42(i)(3)(D)(ii), as amended by the Mortgage Forgiveness Debt Relief Act of 2007. The amendment applies to credit allocations before, on, or after the date of enactment and buildings placed in service before, on, or after the date of enactment if IRC §42(h)(4) applies; i.e., buildings financed by tax-exempt bonds subject to volume cap.

Example 1: Newly Married Students

A recently married full-time student couple is looking for housing. The couple is income qualified, but they have not yet filed their first tax return. Even if the couple does not file a joint tax return, they are still entitled to file a joint return and thus satisfy the exception under IRC §42(i)(3)(D)(ii)(II).

Example 2: Full Time Students

Two students attending college full time and working part time share a low-income housing unit with a third person who works full time and is not enrolled at the college. The tenants' combined incomes qualify them as a household for low-income housing.

Example 3: Qualified Educational Organization

An individual is participating in an accreditation program at a research facility. There is no tuition or degree, but the individual receives a small stipend for services provided and an accreditation certificate upon completion of the program. The program is similar to a doctor's residency. The research facility is not an educational organization and the individual would qualify for low-income housing.

Out of Compliance

A unit is out of compliance when it is occupied entirely by full-time students at qualifying educational organizations for five or more months during a calendar year in which the taxable year of the taxpayer begins and who do not meet one of the exceptions identified in IRC §42 (i)(3)(D). The out of compliance date is the first day of the fifth month during the calendar year that the full-time student attended a qualifying educational organization.

Example 1: Continuing Student Status

An otherwise qualifying low-income individual occupies a unit in June. She attended a qualifying educational organization for two months during the calendar year prior to the date she occupied the unit. From September through December of the calendar year she again attends a qualifying educational organization.

The unit is out of compliance on November 1, the first day of the fifth month she attended a qualifying educational organization during the calendar year.

A unit is also considered out of compliance if the owner fails to verify the household's student status at the time of move in, or an annual student status verification was performed late *and after notification of a state agency review.*

Back in Compliance

The unit is back in compliance when is no longer occupied entirely by full-time students or the tenant qualifies under one of the exceptions under IRC §42(i)(3)(D).

References

1. IRC §152(f)(2)
2. IRC §170(b)(1)(A)(ii)
3. IRC §42(i)(3)(D)

Exhibit 17-1
Student Status Verification

Head of Household Name: ____

Check A, B, or C, as applicable (note that students include those attending public or private elementary schools, middle or junior high schools, senior high schools, colleges universities, technical, trade, or mechanical schools, but does not include those attending on-the-job training courses):

A. _____ Household contains at least one occupant who is not a student, has not been a student, and will not be a student for five or more months during the current and/or upcoming calendar year (months need not be consecutive). If this item is checked, no further information is needed.

B. _____ Household contains all students, but is qualified because the following occupant(s) ___________________________________ is/are a part-time student(s). Documentation of part time student status is required for at least one member of the household.

C. _____ Household contains all full-time students for five or more months during the current and/or upcoming calendar year (months need not be consecutive). If this item is checked, questions 1-5, below must be completed:

1. Is at least one student receiving assistance under Title IV of the Social Security Act? Yes No
2. Was at least one student previously under the care and placement responsibility of the state agency responsible for administering foster care? (provide documentation of participation) Yes No
3. Does at least one student participate in a program receiving assistance under the Job Training Partnership Act, Workforce Investment Act, or under other similar, federal, state or local laws? (attach documentation of participation) Yes No
4. Is at least one student a single parent with child(ren) *and* this parent is not a dependent of another individual *and* the child(ren) is/are not dependent(s) of someone other than a parent? Yes No
5. Are the students married and entitled to file a joint tax return? Yes No

*Households composed entirely of full-time student that are income eligible and satisfy one or more of the above conditions are considered eligible. If questions 1-5 are marked **NO**, or verification does not support the exception indicated, the household is considered an ineligible student household.*

Verification completed by: ____

Date completed: _______________________

Chapter 18
Category 11m
Owner Did Not Properly Calculate Utility Allowance

Definition

This category is used to report noncompliance with the utility allowance requirements outlined in Treas. Reg. §1.42-10. An allowance for the cost of any utilities, other than telephone, cable television, or Internet, paid directly by the tenant(s) and not by or through the owner of the building is included in the computation of gross rent under IRC §42(g)(2)(B). A separate estimate is computed for each utility and different methods can be used to compute the individual utility allowances. The utility allowance is computed on a building-by-building basis. The maximum rent that may be paid by the tenant must be reduced by utility allowance(s) obtained in the following manner.

1. If a building receives assistance from the Rural Housing Service (RHS-assisted building) then the utility allowance is determined using the method prescribed by the Rural Housing Service (RHS) for the building, regardless of whether the building or its tenants also receive other state or federal assistance.

2. If any tenant in a building receives RHS rental assistance payments (RHS tenant assistance), the applicable utility allowance for all rent-restricted units is the applicable RHS utility allowance, including any units occupied by tenants receiving rental assistance payments from the Department of Housing and Urban Development (HUD).

3. If neither a building nor any tenant in the building receives RHS housing assistance, and the building's rents and utility allowances are reviewed by HUD on an annual basis (HUD-regulated building), then the applicable HUD utility allowance is the utility allowance for all rent-restricted units in the building.

4. If a building is neither an RHS-assisted nor HUD-regulated, and no tenant receives RHS tenant assistance, the applicable utility allowance for any rent-restricted unit occupied by tenants receiving HUD rental assistance payments (HUD tenant assistance) is the applicable Public Housing Authority (PHA) utility allowance established for the Section 8 Existing Housing Program.

5. Taxable years beginning before July 29, 2008: If neither the building nor tenants are subject to the rules described in 1-4 above, then the local public housing authority (PHA) allowance is used. However, if an estimate is obtained for any unit from a utility company, that estimate is used as the utility allowance for all similar units in the building.

   Taxable years beginning after July 28, 2008: If neither the building nor tenants are subject to the rules described in 1-4 above, then the local public housing authority (PHA) allowance is used. However, if an estimate is obtained for any unit in the building, that estimate is used as the utility allowance for all similar

units in the building. Estimates may be obtained from a local utility company or a state or local housing credit agency, or calculated using HUD's Utility Schedule Model or an energy consumption model.[1]

PHA Utility Allowance

Requirements for utility allowances are found in 24 CFR 982.517, Utility Allowance Schedule. The PHA must provide a utility allowance for utilities and services that are necessary in the locality to provide housing that complies with the housing quality standards. The PHA must classify utilities and other housing services according to specific categories and the allowance for each category must be separately stated.

Taxable Years Beginning Before July 29, 2008

State agencies reported that the local PHA utility allowances did not always reflect a fair approximation of actual utility costs for such buildings. Accordingly, until further guidance was provided in Treas. Reg. §1.42-10,[2] taxpayers were allowed to calculate utility allowances for the rent-restricted units in the building based upon an average of the actual use of similarly constructed and sized units *in the building* using actual utility usage data and rates, provided that the taxpayer had written approval from the state agency.

If an owner computed the utility allowance estimates based on the expected or historical use by the LIHC buildings/units, the estimate must have been calculated in a reasonable manner and *contemporaneously* documented[3] to show how the estimate was determined. State agencies were required to review the methodology used to calculate the estimate for reasonableness, and ensure that the estimate is computed accurately.

Paid Directly by the Tenants and not by or through the Owner of the Building – For Taxable Years Beginning after July 28, 2008

Some buildings in qualified low-income housing projects are sub-metered. Sub-metering measures tenants' actual utility consumption, and tenants pay for the utilities they use. A sub-metering system typically includes a master meter, which is owned or controlled by the utility supplying the electricity, gas, or water, with overall utility consumption billed to the building owner. In a sub-metered system, building owners (or their agents) use unit-based meters to measure utility consumption and prepare a bill for each residential unit based on consumption. The building owners (or their agents) retain records of resident utility consumption, and tenants receive documentation of utility costs as specified in the lease.

Notice 2009-44[4] clarifies that, for purposes of Treas. Reg. §1.42-10(a), utility costs paid by a tenant based on actual consumption in a sub-metered rent-restricted unit are treated as paid directly by the tenant, and not by or through the owner of the building. For RHS-assisted buildings, buildings with RHS tenant assistance, HUD-regulated buildings, and rent-restricted units in other buildings occupied by tenants receiving HUD rental assistance, the applicable RHS or HUD rules apply. For all other tenants in rent-restricted units in other buildings:

[1] The additional options for determining utility allowances apply to buildings subject to TD 9420, which was published on July 29, 2008, in the Federal Register. See reference #3 for additional information.
[2] See footnote 1 above.
[3] IRC §6001 requires all taxpayers to keep adequate records to support the items represented on their tax returns, including utility allowances.
[4] I.R.B. 2009-21 1037

1. The utility rates charged to tenants in each sub-metered rent-restricted unit must be limited to the utility company rates incurred by the building owners (or their agents).

2. If building owners (or their agents) charge tenants a reasonable fee for the administrative costs of sub-metering, then the fee will not be considered gross rent under IRC §42(g)(2). The fee must not exceed an aggregate amount per unit of $5 per month unless State law provides otherwise.

3. If the costs for sewerage are based on the tenants' actual water consumption determined with a sub-metering system and the sewerage costs are on a combined water and sewerage bill, then the tenants' sewerage costs are treated as paid directly by the tenants for purposes of the utility allowances regulations.

Notice 2009-44 is effective for utility allowances subject to the effective date in Treas. Reg. §1.42-12(a)(4). Consistent with Treas. Reg. §1.42-12(a)(4), building owners (or their agents) may rely on Notice 2009-44 for any utility allowances effective no earlier than the first day of the building owner's taxable year beginning on or after July 29, 2008.

Utility Company Estimates

Under Treas. Reg. §1.42-10(b)(4)(ii)(B), any interested party (tenant, owner, or state agency) may request a written estimated cost of that utility for a unit of similar size and construction *for the geographic area in which the building is located*. This estimate becomes the appropriate utility allowance for all rent-restricted units of similar size and construction in the building. The local utility estimate is not available to buildings/tenants subject to Rural Housing Service or HUD jurisdiction.

Taxable Years Beginning Before July 29, 2008

Before Treas. Reg. §1.42-10 was revised, the election to use a local utility company estimate was permanent; i.e., the taxpayer could not switch back and forth between the local PHA and utility company estimates. State agencies reported that although utility companies may have been willing to provide interested parties (owner, tenant, state agency) with an initial estimate, utility companies were increasingly unwilling to provide estimates on an on-going basis. Accordingly, until the regulation was revised, the IRS did not challenge the owner's return to using the applicable PHA utility allowance, provided that:

1. The taxpayer has demonstrated to the state agency that the local utility company was unwilling to provide an updated estimate, and

2. The owner had *written* approval from the state agency to use a mutually agreed upon utility allowance.

Taxable Years Beginning After July 28, 2008

If neither the building nor tenants are subject to the rules described in 1-4 *on page 18-1,* then the local public housing authority (PHA) allowance is used. However, if an estimate is obtained for any unit in the building, that estimate is used as the utility allowance for all similar units in the building. Estimates may be obtained from a local

utility company or a state or local housing credit agency, or calculated using HUD's Utility Schedule Model or an energy consumption model.

In the case of deregulated utility services, the interested party is required to obtain an estimate from only one utility company even if multiple companies can provide the same utility service to the unit. However:

1. The utility company must offer utility services to the building in order for that utility company's rates to be used in calculating the utility allowance.

2. The estimate should include all component deregulated charges for providing the utility service.

The utility allowance is "obtained" when the building owner receives, *in writing*, information from the utility company providing the estimated per unit cost of the utility. Receipt of the information from the utility company begins the 90-day period after which the new utility allowance must be used to compute gross rents.

State or Local Housing Credit Agency - Taxable Years Beginning After July 28, 2008

Under Treas. Reg. §1.42-10(b)(4)(ii)(C),[5] a building owner may obtain a utility allowance from the state agency that has jurisdiction over the building, provided the state agency agrees to provide the estimate. The building owner may obtain a utility allowance at any time during the building's extended use period[6] and the associated costs are borne by the building owner.

The utility allowance is "obtained" when the building owner receives, *in writing*, information from the state agency providing the estimated per unit cost of the utility. Receipt of the information from the state agency begins the 90-day period after which the new utility allowance must be used to compute gross rents.

Factors to Consider

The utility allowance must take into account, among other things, (1) local utility rates, (2) property type, (3) climate and degree-day variables by region in the state, (4) taxes and fees on utility charges, (5) building materials, and (6) mechanical systems.

Actual Building Usage

The state agency may use actual utility company usage data and rates of the building for which the utility allowance is requested.

1. The data used to compute the estimate is limited to the building's consumption data for a 12-month period ending no earlier than 60 days prior to the date the utility allowance will change. For newly constructed or renovated buildings with less than 12 months of consumption data, consumption data for the 12-month period for similarly sized and constructed units in the geographical area in which the building is located will be used.

[5] As amended by TD 9420.
[6] Under IRC §42(h)(6)(D), the extended use period begins on the first day of the building's 15-year compliance period under IRC §42(i)(1) and ends on the later of the date specified in the agreement or 15 years after the close of the compliance period.

2. The utility rates used to compute the estimates must be the rates in place 60 days prior to the date the utility allowance will change.

Estimates Provided by State Agency's Agent or Private Contractor

A state agency may use an agent or other private contractor to calculate the utility estimates. The agent or contractor must be a properly licensed engineer or a qualified professional. A qualified professional must be (1) approved by the state/local housing credit agency having jurisdiction over the building, and (2) must not be related to the building owner within the meaning of IRC §§ 267(b)[7] or 707(b).[8]

HUD Utility Schedule Model - Taxable Years Beginning After July 28, 2008

Under Treas. Reg. §1.42-10(b)(4)(ii)(D),[9] a building owner may calculate a utility allowance using the "HUD Utility Schedule Model" that can be found on HUD's Internet site, the Low-Income Housing Tax Credits page at www.huduser.org/datasets/lihtc.html or successor URL.

Utility rates used for the HUD Utility Schedule Model must be no older that the rates in place 60 days prior to the date the utility allowance will change.

The utility allowance is deemed "obtained" based on the date entered as the "Form Date" on the "Location" spreadsheet of the Utility Schedule Model. This date will also be reflected on the Form 52667, Allowances for Tenant-Furnished Utilities and Other Services. This date begins the 90-day period after which the new utility allowance must be used to compute gross rents.

Energy Consumption Model - Taxable Years Beginning After July 28, 2008

Under Treas. Reg. §1.42-10(b)(4)(ii)(E),[10] a building owner may calculate a utility allowance using an energy and water and sewage consumption analysis model (energy consumption model).

Factors to Consider

The energy consumption model must, at a minimum, take into account specific factors including, but not limited to: (1) unit size, (2) building orientation, design and materials, mechanical systems, appliances, and characteristics of the building location.

Building's Consumption Data and Utility Rates

The data used to compute the estimate is limited to the building's consumption data for a 12-month period ending no earlier than 60 days prior to the date the utility allowance will change. For newly constructed or renovated buildings with less than 12 months of consumption data, consumption data for the 12-month period for similarly sized and constructed units in the geographical area in which the building is located will be used.

The utility rates used for the energy consumption model must be the rates in place 60 days prior to the date the utility allowance will change.

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7 See note 1 at the end of the chapter.
8 See note 2 at the end of the chapter.
9 As amended by TD 9420.
10 As amended by TD 9420.

Estimates Provided by Licensed Engineer or Qualified Professional

The utility allowance must be prepared by a properly licensed engineer or a qualified professional. A qualified professional must be (1) approved by the state/local housing credit agency having jurisdiction over the building, and (2) must not be related to the building owner within the meaning of IRC §§ 267(b) or 707(b).[11]

Annual Review - Taxable Years Beginning After July 28, 2009

Under Treas. Reg. §1.42-10(c)(2),[12] a building owner *must* review the basis on which utility allowances have been established at least once during each calendar year and must update the allowance if required. Building owners *may* choose to calculate new utility allowances more frequently than once during a calendar year, provided the owner complies with the requirement of Treas. Reg. §1.42-10, including the requirement to notify the state/local housing credit agency and tenants.

First Year of the Credit Period

No review is required until the building has achieved 90 percent occupancy for a period of 90 consecutive days, or by [at] the end of the first year of the credit period, whichever is earlier. If the review is completed at the end of the year, the consumption rates as of December 31st of the first year of the credit period. Consequently, the 90-day period will begin no later March 1 of the year subsequent to the first year of the credit period.

Review Requirements

1. The review must take into account any changes to the building such as any energy conservation measures and affect energy consumption and changes in utility rates.

2. Owners may use different methods for computing the allowances for different utilities.

3. Owners are not prohibited from changing methods used for calculating a utility allowance in order to most accurately estimate the utility allowance.

Updating Utility Allowances – Taxable Years Beginning Before July 29, 2008

If the applicable utility allowance for a unit changes, the new utility allowance must be used to compute gross rents of LIHC units due 90 days after the change. As a practical matter, utility allowances are usually reviewed when HUD updates the Area Median Gross Income (AMGI) for the location (which may change the allowable gross rent). If the applicable utility allowance for a unit changes, the new allowance must be used to compute gross rents due 90 days after the change.

PHA Utility Estimates

As explained in 24 CFR 982.517, Utility Allowance Schedule, paragraph (4)(c)(1), a PHA must review its schedule of utility allowances each year, and must revise its allowance for a utility category if there has been a change of 10 percent or more since the last time the utility allowance was revised. The 90-day implementation period begins when the PHA makes revised utility allowances available.

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[11] See note 2 at the end of the chapter.
[12] As amended by TD 9420.

Updating Utility Allowances – Taxable Years Beginning After July 28, 2008

If the applicable utility allowance for a unit changes, the new utility allowance must be used to compute gross rents of LIHC units due 90 days after the change (90-day period). However, an owner is not required to implement new utility allowances until the building has achieved 90 percent occupancy for a period of 90 days or by the end of the first year of the credit period, whichever is earlier.

PHA Utility Estimates

As explained in 24 CFR 982.517, Utility Allowance Schedule, paragraph (4)(c)(1), a PHA must review its schedule of utility allowances each year, and must revise its allowance for a utility category if there has been a change of 10 percent or more since the last time the utility allowance was revised. The 90-day implementation period begins when the PHA makes revised utility allowances available.

Utility Company and State/Local Housing Credit Agency Estimates

If an owner obtains a utility estimate from a local utility company or state/local housing credit agency, the 90-day period will begin with the receipt of the information. The date of receipt is determined based on the date of the correspondence.

Example 1: Lower Estimate Obtained from Utility Company

> The rent for an LIHC building must be lowered because a local utility company estimate obtained by the owner shows a higher utility cost than the utility allowance currently being used. The utility company's letter is dated August 15, 2008. The lower rent must be in effect for rent due after November 13, 2008.

HUD's Utility Schedule Model

The date entered as the "Form Date" on the "Location" spreadsheet of the Utility Schedule Model and reflected on the Form 52667, Allowances for Tenant-Furnished Utilities and Other Services, begins the 90-day period after which the new utility allowance must be used to compute gross rents.

Energy Consumption Model

The 90-day period will begin 60 days after the end of the last month of the 12-month period for which data was used to compute the estimate.

Notification Requirements

1. If the owner obtained a utility allowance from a state or local housing credit agency, the owner must make the utility estimate available to all tenants in the building at the beginning of the 90-day period.

2. If the owner obtained a utility allowance from a utility company, using the HUD Utility Schedule Model, or calculated using an energy consumption model, the owner must (1) submit copies of the utility estimates to the agency having

jurisdiction over the building and (2) make the utility estimate available to all tenants in the building at the beginning of the 90-day period. An agency may require additional information from the owner during the 90-day period.

Cost of Securing Utility Estimates - Taxable Years Beginning After July 28, 2009

The building owner must pay all the costs incurred in obtaining the estimates from a utility company or state/local housing credit agency, HUD's Utility Schedule Model, or an energy consumption model. The building owner also bears the costs of notifications to the tenants and state/local agency.

Record Retention

The building owner must retain any consumption estimates and supporting data as part of the *taxpayer's* records for purposes of Treas. Reg. §1.6001-1(a). Under this requirement, taxpayers are required to keep such permanent books of account or records as are sufficient to establish the amount of gross income, deductions, *credits*, or *other matters required to be shown* by such person.

Under Treas. Reg. §1.6001-1, the IRS may require the owner to render such statements or keep such specific records as will enable the IRS to determine whether or not the owner is liable for tax. The books and records shall be kept at all times available for inspection by the IRS and shall be retained so long as the contents thereof may become material in the administration of the Internal Revenue Code.

In Compliance

Low-income housing projects are in compliance when the appropriate utility allowance is used, the utility allowance is properly calculated, rents are reduced for a utility allowance when utilities are paid directly by the tenant, *and the maximum gross rent is not exceeded. (See Chapter 11 for full discussion of Gross Rent.)*

Owners must demonstrate that that the basis on which utility allowances have been established (consumption and rates) have been reviewed at least once during each calendar year. If applicable, the owner must also demonstrate that (1) tenants and the state/local housing credit agency have been timely notified of any changes, and (2) the new utility allowance was used to compute gross rents for LIHC units due after the end of the 90-day period.[13]

Example 1: Utility Allowance Increases

> The maximum gross rent is $500. The owner charged rent of $450, which reflected a $50 utility allowance; i.e., $450 rent + $50 utility allowance = $500 gross rent. The annual utility allowance estimate increases to $75. The owner reduces the rent to $425 based upon the increased utility allowance of $75; for a gross rent of $500 ($425 + $75 = $500).

[13] The 90-day period applies to taxable years beginning after July 28, 2008 utility allowances.

Example 2: Local Utility Company No Longer Provides Estimates

The owner used estimates of utility use as provided by the local utility company to determine the utility allowance. The owner asked the local utility company for an updated estimate of use by similar units in the local area. The utility company informed the owner that they no longer provide estimates. The owner may select another method for computing the utility allowance.[14]

Example 3: First Year of the Credit Period

An owner acquired an existing building and completed substantial rehabilitations. The building has 100 rental units and was placed in service on November 7, 2008. The owner elected to begin the credit period the year after the building was placed in service, on January 1, 2009. All 51 of the in-place tenants were determined to be income-qualified households at that time.

The owner chose to use the energy consumption model and correctly determined the utility allowance using consumption data for similarly sized and constructed units in the geographical area for the period November 1, 2007 through October 31, 2008 and the utility rate on October 31, 2008.

The owner rented the 91st unit in May of 2009 and maintained an occupancy rate of at least 94% through the end of August 2009. Since the owner had achieved 90% occupancy for 90 consecutive days, the owner was required to conduct a utility allowance review. If applicable, the utility allowances should be updated.

Example 4: Increased Utility Allowance Does Not Cause Rent to Exceed Limit

The maximum gross rent limit is $500, but the owner charged $415 rent and a $50 utility allowance for a total of $465. The utility allowance increases to $60 the next year. The owner makes no adjustment to the rent. The owner is in compliance. The owner is charging $415 rent and a $60 utility allowance for a total of $475, which continues to be below the gross rent limit of $500.

Out of Compliance

Low-income housing *units* are considered out of compliance when *gross rent exceeds the maximum gross rent limit. The following examples are errors that may result in noncompliance.*

1. The appropriate utility allowance is not used. *For example, an owner uses a local utility company's estimate for a HUD-regulated building.*

[14] Most of the optional methods are only available for taxable years beginning after July 28, 2008 utility allowances.

2. The utility allowance is not properly calculated. *For example, an owner used a PHA schedule to determine the utility allowance for all-electric units, but failed to include the cost of electric heating. When the cost of electric heating is added to the utility allowance, gross rent exceeds the limit.

3. The owner failed to update rents for a revised utility allowance after the 90-day period.[15]

   Example 1: Increased Utility Allowance Causes Gross Rent to Exceed Limit

   > The maximum gross rent limit is $500, but the owner charged $445 rent and a $50 utility allowance for a total of $495. The utility allowance increased to $60 on April 1, 2010, but the owner did not adjust the rent. The owner is charging $445 rent and a $60 utility allowance for a total of $505, which exceeds the gross rent limit of $500. The owner is out of compliance beginning July 1, 2010; i.e., an owner has 60 days to implement new utility allowances.

Low-income buildings are also considered out of compliance if the owner cannot establish that the rent charged tenants does not exceed the gross rent limit. For the three fact patterns below, there is a presumption that the rent charged the tenant plus the utility allowance will exceed the gross rent limit until otherwise established.

1. Rents are not reduced for a utility allowance when utilities are paid directly by the tenant to the utility provider, even if the rent charged to the tenant is less than the maximum gross rent limit. For example, the gross rent limit is $700. The tenant's rent is $575 and pays the utilities directly to the provider, but the owner cannot provide documentation of the utility allowance computation. The noncompliance date should be determined based on the facts and circumstances; i.e., when the owner ceased using a utility allowance.

2. The owner did not review the basis on which the utility allowance is established at least once during both the prior and current calendar year; i.e., the utility allowances are not current.[16]

   Example 2: Owner Failed to Review Utility Allowance Annually

   > An owner reviewed the utility allowance and determined that the allowance was $100 effective May 1, 2009. The owner was still relying on the $100 utility allowance when the state agency reviewed the owner's compliance in April of 2011.
   >
   > The building is out of compliance because the owner failed to review the utility allowance at least once during calendar year 2010. The noncompliance date is December 31, 2010.

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[15] Applies to taxable years beginning after July 28, 2008 utility allowances.
[16] Applies to taxable years beginning after July 28, 2008 utility allowances.

NOTE: State agencies should be reviewing the most current utility allowance computations. In the example above, had the owner recognized the noncompliance issue and reviewed the utility allowances before the state agency contacted them to schedule its review, then the owner would have been in compliance at the time to the review.

3. The owner failed to maintain adequate documentation regarding the computation of utility allowances; without sufficient proof of the amount of the allowance and how it was estimated, there is no way to correctly compute the rent.

   Example 3: Insufficient Documentation of Computation

   An owner reviewed the utility allowance and determines that the utility allowance was $65 for 2009. The allowance was computed by a licensed professional approved by the state agency using an energy consumption model. Upon review by the state agency during a compliance review, the owner presented a one-page letter from the professional. While the utility allowance amount was disclosed in the letter, the letter was not signed or dated. Further, the letter did not describe the factors considered or the data used.

   The state agency could not reasonably determine that the utility allowance was correct. The noncompliance date is December 31, 2009.

Back in Compliance

Rent Exceeds Limit

A unit is considered back in compliance when the rent charged is reduced and correctly reflects the utility allowance. The date of correction is date that the rents correctly reflect the utility allowance.

Example 1: Noncompliance Corrected

The maximum gross rent is $500. Beginning on March 1, 2003, the owner charged $450 rent and a $75 utility allowance; the total rent is $525. The rent is $25 over the ceiling. The error was discovered during a state agency’s review on April 13, 2004.

The owner immediately reduces the rent charged to $425 for rents due beginning on May 1, 2004. The effective date of the new rent, or May 1, 2004, is the date the units are back in compliance.

No Utility Allowance

*When an owner does not apply a utility allowance to reduce rent and account for utility costs paid directly by the tenant, the noncompliance can only be corrected by performing an annual review to determine a utility allowance using current information.

1. If the rent paid plus the new utility allowance does not exceed the current maximum gross rent, then the owner is in compliance with the utility allowance requirements and no further action is required.

2. If the rent paid plus the new utility allowance exceeds the current maximum gross rent, the back in compliance date is the date the rents are reduced to reflect the new utility allowances.*

No Annual Review

*If the owner has applied a utility allowance, but failed to conduct an annual review, then the noncompliance can be corrected in one of three ways.

1. A retroactive annual review can be performed using information applicable to the last date the annual review should have been performed. Assuming the owner can document compliance with the utility allowance that would have been in place and that the rents were restricted, no further action is required. The owner has clarified the noncompliance and, therefore, Form 8823 should not be filed.

2. A new annual review can be performed using current information. Assuming the owner is in compliance with the new utility allowance requirement and the rents are restricted, the owner is currently in compliance. No further action is required. The owner has clarified the noncompliance and, therefore, Form 8823 should not be filed.

3. In the event that either the retroactive annual review under (1) above or the new annual review under (2) above indicates that the utility allowance needs to be increased, the back in compliance date is the date the rents are reduced to reflect the new utility allowances.*

***Insufficient Documentation”**

*When the owner reviewed the utility allowance, but the computation of the utility allowance was not sufficiently documented, the owner should be provided an opportunity to perfect the documentation to the state agency’s satisfaction.

1. If the additional documentation is satisfactory and establishes that the owner is in compliance with the utility allowance requirements, then no further action is required since the owner has clarified the noncompliance; i.e., Form 8823 need not be filed.

2. If the owner cannot provide sufficient documentation, then the owner may repeat the annual review for the year in question using the same method and facts as used for the original annual review. If the results indicate that the owner is in compliance with the utility allowance requirement, then no further action is required since the owner has clarified the noncompliance; i.e., Form 8823 need not be filed.*

***Reporting Noncompliance ***

*Noncompliance should be reported whenever the rent paid by the tenant plus the correct utility allowance exceeds the maximum gross rent limit.

Example 1: Increased Utility Allowance Causes Rent to Exceed Limit

> The maximum gross rent limit is $500, but the owner charged $415 rent and a $50 utility allowance for a total of $465. The utility allowance increases to $95 the next year. The owner should reduce the rent at least $10; i.e., $405 + $95 = $500.
>
> However, the owner does not make the adjustment to the rent and is out of compliance; i.e., the low-income units are not rent restricted. The owner is charging $415 rent and a $95 utility allowance for a total of $410, which is more than gross rent limit of $500.

Noncompliance should not be reported if;

1. Regardless of the error, correcting the utility allowance does not cause the rent to exceed the gross rent limit, or

2. Noncompliance is corrected before the owner is notified of the state agency's review.

The utility allowance requirement is a building-based rule. If the owner is noncompliant, the noncompliance will likely affect all the low-income units in the building. In which case, consideration should be given to whether the owner met the minimum set-aside under IRC §42(g)(1). See Chapter 10.*

References

1. Notice 89-6, 1989-1 C.B. 625
2. Treas. Reg. §1.42-10
3. TD 9420. Treas. Reg. §1.42-12(a) provides the following effective dates and transitional rules under TD 9420: The first sentence in §1.42-10(a), §1.42-10(b)(1), (2), (3), and (4), the last two sentences in §1.42-10(b)(4)(ii)(A), the third, fourth, and fifth sentences in §1.42-10(b)(4)(ii)(B), §1.42-10(b)(4)(ii)(C), (D), and (E), and §1.42-10(c) and (d) are applicable to a building owner's taxable years beginning on or after July 29, 2008. Taxpayers may rely on these provisions before the beginning of the building owner's taxable year beginning on or after July 29, 2008, provided that any utility allowances calculated under these provisions are effective no earlier than the first day of the building owner's taxable year beginning on or after July 29, 2008. The utility allowances provisions that apply to taxable years beginning before July 29, 2008 are contained in §1.42-10 (see 26 CFR part 1 revised as of April 1, 2008).

Notes

1. IRC §267(b), Relationships…..
   (1) Members of a family, as defined in subsection (c)(4)[17];
   (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

[17] The family of an individual shall include only his brothers and sisters (whether by the whole or half blood) spouse, ancestors, and lineal descendants.

(3) Two corporations which are members of the same controlled group (as defined in subsection (f)[18]) ;
(4) A grantor and a fiduciary of any trust;
(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
(6) A fiduciary of a trust and a beneficiary of such trust;
(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
(10) A corporation and a partnership if the same persons own—
(A) more than 50 percent in value of the outstanding stock of the corporation, and
(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;
(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

2. IRC §707(b)
(1) --
(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or
(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.
(2) –
(3) Ownership of a capital or profits interest. For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section.

[18] IRC §267(f) refers to IRC §1563 to define controlled groups for (1) parent-subsidiary groups, except that "more than 50 percent" is substituted for "at least 80 percent," (2) brother-sister groups, (3) combinations of parent-subsidiary and brother-sister groups, and (4) certain insurance companies.

Chapter 19
Category 11n
Owner has Failed to Respond to Agency Requests for Monitoring Reviews

Definition

This category is used to report owners of low-income projects that failed to respond to agency requests for monitoring reviews. Under the inspection provision Treas. Reg. §1.42-5, the state agencies must have the right to perform an on-site inspection of any low-income housing project at least through the end of the 15-year compliance period for the buildings in the project. State agencies (or their representatives) must conduct on-site inspections, inspect units, and review income (re)certifications, supporting documentation, and rent records for the tenants in those units, and otherwise meet the provisions listed in Treas. Reg. §1.42-5(a)(2)(i)(A), (B), (C), and (D).

The review of tenant records may be undertaken wherever the owner maintains or stores the records. A state agency may give an owner reasonable notice that an inspection of the building and low-income units or tenant record review will occur so that the owner may notify tenants of the inspection or assemble tenant records for review (for example, 30 days notice of inspection or review). However, the units and tenant records to be inspected and reviewed must be chosen in a manner that will not give owners of low-income housing projects advance notice that a unit and tenant records for a particular year will or will not be inspected and reviewed.

In Compliance

An owner is in compliance when requests for site visitations and access to tenants' records are honored without unreasonable postponements.

Example 1: Reasonable Request for Postponement

> A state agency notified an owner that a property was to be inspected and requested that the inspection be conducted in 30 days. The owner requested that the inspection be postponed for two weeks because the permanent on-site manager had scheduled training during that time period.
>
> This is a reasonable request. Although the owner arranged for a temporary manager, the permanent manager is more knowledgeable regarding the day-to-day operations, procedures, and tenant files.

Out of Compliance

An owner is out of compliance when requests for site visitations or tenant file inspections are denied or unreasonably postponed. A state agency should accommodate the owner's valid needs to reschedule a site visit or tenant file review, but should not allow owners to

delay or circumvent compliance monitoring reviews.[1] The date of noncompliance is the earlier of the date (1) the owner refused to allow a site visitation or access to tenants' records or (2) first postponed the site visit or access to tenant's records.

Example 1: Repetitive Delays

> A state agency notified an owner on April 21, 2004, that a project was to be inspected and requested that the inspection be conducted on May 20, 2004. On May 2, 2004, the owner requested that the inspection be postponed until June 16, 2004, to give them time to get the records together. Then, the day before the inspection, the owner called to say that the property manager would not be available. The inspection was rescheduled for June 28, 2004, but the owner called again on June 27 to say that not all the records were available at the site and it would be more convenient to work at his office during the week of July 12, 2004.
>
> The owner's repeated requests for postponements are not reasonable. The property is out of compliance on May 2, 2004.

State agencies may remove a LIHC property from the program if the owner fails to respond to repeated notices for monitoring reviews. See Chapter 21 for complete discussion.

Back in Compliance

The owner is back in compliance when the agency performs the site visit and/or reviews the tenants' files.

Example 1: Site Visit Performed Late

> A state agency filed form 8823 noting noncompliance because the owner refused to allow the state agency's representatives on the property to perform the physical inspection. The date of noncompliance was August 15, 2004. The taxpayer received the IRS' notice identifying the noncompliance, after which the site inspection was completed on December 15, 2004, when state agency resources were available.
>
> The property is back in compliance on December 15, 2004 and a Form 8823 should be filed noting the correction date.

References

1. IRC §42(i)
2. TD 8430, 1992-2 C.B. 14

[1] The IRS recommends that if the site visit/file review can be rescheduled within 45 days of the initial date, the appointment should be reschedule; longer postponements should be discouraged except under unusual circumstances. There is no legal authority for allowing this time period: it is similar to IRS policy for rescheduling audit appointments during an audit. See Internal Revenue Manual 4.10.2.8.3(4).

Chapter 20
Category 11o
Low-Income Units
Used on a Transient Basis

Definition

This category is used to report noncompliance when units have been used on a transient basis. Generally, the length of the initial lease agreement determines whether use is transient. A unit is nontransient if the initial lease term is six months or more. [1]

There are two exceptions to the general rule that the initial lease term must be 6 months or longer.

Buildings Used for Transitional Housing for the Homeless Under IRC §42(i)(3)(B)(iii)

Certain transitional housing for the homeless may be considered used other than on a transient basis provided the residential rental unit contains sleeping accommodations and kitchen and bathroom facilities and is located in a building-

1. which is used exclusively to facilitate the transition of homeless individuals[2] to independent living within 24 months, and
2. in which a government entity or qualified nonprofit organization[3] provided such individuals with temporary housing and supportive services designed to assist such individuals in locating and retaining permanent housing.

Single-Room Occupancy (SRO) Units Under IRC §42(i)(3)(B)(iv)

SRO units which permit the sharing of kitchen, bathroom, and dining facilities, shall not be treated as used on a transient basis merely because it is rented on a month-by-month basis.

In Compliance

A unit is in compliance with this requirement if the *initial* lease term *for each tenant* is at least six months. The presence of a six month initial lease is the customary evidence used to document the owner and tenant's intent to enter into a nontransient rental agreement.

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[1] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89. Residential units must be for use by the general public and all of the units in a project must be used on a nontransient basis. …Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing home, sanitarium, life care facility, retirement home providing significant services other than housing, dormitory, or trailer park may be a qualified low-income project..…certain single room occupancy housing used on a nontransient basis may qualify for the credit, even though such housing may provide eating, cooking, and sanitation facilities on a shared basis.

[2] Within the meaning of section 103 of the Stewart M. McKinney Homeless Act (42 U.S.C. 11302), as in effect on the date of the enactment of this clause.

[3] As defined in IRC §42(h)(5).

Example 1: Tenant Vacates Before End of the Lease

A couple vacates their unit before fulfilling their initial six-month lease because the husband accepted a job in another state. Because the couple was subject to a valid six-month lease and vacated the unit for a valid reason, the low-income unit was not used on a transient basis.

Out of Compliance

Other than the two exceptions for certain transitional housing and single room occupancy units, a unit is out of compliance if the unit is rented on a transient basis. The out of compliance date is the effective date of the initial tenant income certification. A unit is out of compliance if:

1. no lease is on file for the tenant, or

2. the tenant's initial lease term is not at least six months.

Example 1: Month-to-Month Initial Leases

A state agency discovers that an owner of a 100 unit LIHC property (not a SRO or transitional housing) established a policy of signing month-to-month leases at the time of initial occupancy.

At the time of the review, 84 units are occupied by households with initial month-to-month leases. All 84 units are out of compliance based on the effective date of the initial tenant income certification.

Back in Compliance

Noncompliance is corrected when a lease with a term of at least six months is executed. The correction date is the effective date of the new lease.

Chapter 21
Category 11p
Project is No Longer in Compliance
Nor Participating in the Program

Definition

This category should be used to notify the Internal Revenue Service that a building is entirely out of compliance and is no longer participating in the program.

1. The determination that an LIHC building is entirely out of compliance and will not be in compliance at any time in the future is a recapture event under IRC §42(j).

2. The filing of a Form 8823 for this category also puts the IRS on notice that the state agency is no longer performing monitoring activities with respect to the property.[1]

3. The building is no longer considered a qualified low-income building under IRC §42(c)(2)(A).[2] No credit is allowable in the remaining years of the credit period, even if the building complies with all the requirements of IRC §42.

Out of Compliance

A state agency may find that a building is no longer in compliance with the LIHC program requirements, and thus, is no longer participating in the program. The following discussion provides a broad overview of issues that may justify terminating an owner's participation in the program. It is not an exhaustive list; state agencies should consider each case individually based on the specific facts and circumstances.

Return of Credits to State Agency

Under certain circumstances, a state agency may obtain return of previously allocated low-income housing credits. In accordance with Treas. Reg. §1.42-14(d)(2)(ii), these credits may be returned up to 180 days following the close of the first tax year of the credit period for the building that received the allocation. If a credit is returned within 180 days following the close of the first taxable year of a building's credit period as provided in Treas. Reg. §1.42-14(d)(2)(ii), and a Form 8609, Low-Income Housing Credit Allocation and Certification, has been issued for the building, the state agency must notify the Internal Revenue Service that the credit has been returned.

If only part of the credit has been returned, this notification requirement is satisfied when the state agency attaches to an amended Form 8610, Annual Low-Income Housing Credit Agencies Report, the original of an amended Form 8609 reflecting

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[1] Treas. Reg. §1.42-5(e)(3).

[2] IRC §42(c)(2) states that the term "qualified low-income building" means any building which is part of a qualified low-income housing project at all times during the period beginning on the 1st day in the compliance period on which such building part of such a project, and ending on the last day of the compliance period with respect to such building.

the correct amount of credit attributed to the building together with an explanation for filing of the amended forms. The state agency must send a copy of the amended Form 8609 to the owner of the building.

If the building is not issued an amended Form 8609 because all of the credit allocated to the building is returned, notification to the Internal Revenue Service is satisfied by following the requirements prescribed by Treas. Reg. §1.42-5(e)(3) for filing Form 8823.

Treas. Reg. §1.42-14(d)(2)(iv) specifies the reasons for the return of the entire amount of allocated credit:

1. The building is not placed in service within the required time period or fails to meet the minimum set-aside requirements of IRC §42(g)(1) by the close of the first year of the credit period.

2. The building does not comply with the terms of its credit allocation. The terms of an allocation are the written conditions agreed to by the state agency and the allocation recipient in the allocation document.

3. The owner and state agency mutually agree to cancel an allocation of credit by mutual consent.

4. The state agency determines, under IRC §42(m)(2), that an amount of credit allocated to a project is not necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.

IRS Notification

An attachment should be used to explain that the credits are being returned under the authority of Treas. Reg. §1.42-14(d)(2)(ii) and why the property did not qualify.

Owner Notification

As provided in Treas. Reg. §1.42-14(d)(3)(i), after a state agency determines that building or project is not in compliance for the reasons 1, 2 or 4 above, the state agency must provide written notification to the allocation recipient, or its successor in interest, that all or part of the allocation is no longer valid. The notification must also state the amount of the allocation that is no longer valid. The date of the notification is the date the credit is returned by the state agency.

If an allocation is cancelled by mutual consent as noted in number 3 above, there must be a written agreement signed by the state agency and the allocation recipient, or its successor in interest, indicating the amount of the allocation that is returned to the state agency. The effective date of the agreement is the date the credit is returned to the state agency.

Egregious Noncompliance with Program Requirements

Egregious noncompliance is conspicuous, flagrant, and systemic in nature and includes the failure to make reasonable attempts to comply with the requirements of the program, or careless, reckless, or intentional disregard of program requirements.

Example 1: Failure to Make Reasonable Attempts to Comply with Program Requirements

The owner did not allow the state agency to conduct physical inspections or tenant file reviews after the end of the 10-year credit period.

Explanations from the owner should be solicited and analyzed for reasonableness. It is important that the owner be given an opportunity to respond and provide explanations. The reasonableness of the explanations should be evaluated for credibility, presence of corroborative or contradictory evidence, and collateral evidence from third party sources. Refer to Chapter 3 for additional guidance.

An attachment to Form 8823 should be used to explain the extent of noncompliance.

The Owner has Voluntarily and Permanently Withdrawn From the Program and is No Longer Claiming Credits

An owner, during the 15-year compliance period, may voluntarily withdraw a project from the low-income housing credit program, but retain ownership. The building still exists physically, but is not being operated as an LIHC project. For example, the owner may have converted the entire building to a use other than as an LIHC housing project or 100% of the units may be vacant (and the owner has no intention of renting any of the units in the future).

An attachment to the Form 8823 should be used to explain why the project was withdrawn and identify the last year the property was in service. This information is needed for the IRS to determine whether the owner properly recaptured accelerated credits.

Failure to Respond to Repeated Requests for Reports, Certifications, Reviews, or Other Essential Communication

State agencies may remove an LIHC property from the program if the owner fails to respond to *repeated* notices for monitoring reviews[3], or annual reports and owner certifications are not submitted, *and* Forms 8823 identifying the noncompliance were previously submitted to the IRS.

1. Under the inspection provisions of Treas. Reg. §1.42-5(d)(1), the state agency must have the right to perform an on-site inspection of any low-income housing project at least through the end of the compliance period of the buildings in the project.

2. Under the certification provisions of Treas. Reg. §1.42-5(c), state agencies may remove a property from the program if annual reports and owner certifications are not submitted

A state agency should send follow-up notices clearly stating that failure to respond will result in the agency notifying the IRS that the property is no longer in compliance and is no longer participating in the LIHC program. See Treas. Reg. §1.42-5(e)(2), which requires the state agency to provide prompt notification to the owner if the project is not in compliance with the provisions of IRC §42.

The date of noncompliance is the first day of *the first year* that the owner failed to provide annual reports or certifications or did not respond to a request for the

[3] See Treas. Reg. §1.42-5(c)(2).

physical inspection of the property.

Building No Longer Participating in the Low-Income Housing Program

When a building is no longer in compliance nor participating in the Low-Income Housing Credit Program, state agencies need to address two issues, as discussed below.

Extended Low-Income Housing Commitment

IRC §42(h)(6)(D) requires a property owner to commit to the low-income housing program for a minimum of 30 years. The commitment is documented as a restrictive covenant against the property and is recorded against the property as a deed restriction governed by state law. Commonly know as "extended use agreements", these covenants are agreements *between the owner and state agency.* Consideration should be given to enforcing the agreement through a civil court proceeding. However, when a building or project is removed from the program, state agencies have discretionary authority to release the extended use agreement and remove the deed restriction.

Protection of Tenants Rights

Under IRC §42(h)(6)(E)(ii), there are two requirements that must be met when an extended use agreement is terminated:

1. No eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit before the close of the 3-year period following the termination of the extended use agreement, and

2. No increase in the gross rent of any unit occupied by an existing tenant before the close of the 3-year period following the termination of the extended use agreement, not otherwise permitted under IRC §42. In other words, units occupied by income-qualified tenants continue to be rent restricted for three years, or until the tenants vacate the units.

Chapter 22
Category 11q
Other Noncompliance
Qualified Nonprofit Organization Failed to Materially Participate

Definition

IRC §42(h)(5) requires that each state set aside at least 10% of its state housing credit ceiling for allocations to projects in which qualified nonprofit organizations own an interest, and materially participate in the development and operation of the projects. "Qualified nonprofit organization" is defined as an IRC §501(c)(3) or 501(c)(4) organization exempt from tax under IRC §501(a) that is determined by the state agency as not being affiliated with or controlled by a for-profit organization, and one of the exempt purposes of the organization includes the fostering of low-income housing.

For purposes of this allocation, a nonprofit organization must have an ownership interest in the low-income housing project throughout the 15-year compliance period and materially participate in the *development* and *operation* of the project. Whether a nonprofit sponsor materially participates will depend on the application of IRC §469(h) to the facts and circumstances of a given project.

Under IRC §469(h)(1), the nonprofit must participate on a *regular, continuous,* and *substantial* basis in the development and operation of the project.[1] Although this standard is vague, the legislative history suggests the following guidelines in defining material participation in a business activity:

1. Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer,

2. Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else's decisions or periodic consultation with respect to general management decisions is not sufficient.

3. Participation must be maintained throughout the year. Periodic consultation is not sufficient.

4. Regular on-site presence at operations is indicative of material participation.

5. Providing services as an independent contractor is not sufficient.

Accordingly, a nonprofit entity will be considered to materially participate where it is regularly, continuously, and substantially involved in providing services integral to

[1] Treas. Reg. §1.469-5T provides rules for determining the material participation for individuals. IRC §469(h)(4) and Treas. Reg. §1.469-5T(g)(3) provide rules for determining the material participation of certain corporations. Because neither of these provisions applies to nonprofit organizations, they should be reviewed for illustrative purposes only. The general facts and circumstances test of IRC §469(h)(1) is the test applicable to nonprofit organizations.

the development and operations of a project.

Pursuant to IRC §42(h)(5)(D), the ownership and material participation test can be met by the organization if it owns stock in a qualified corporation that satisfies the ownership and material participation test. A qualified corporation must be a corporation that is 100 percent owned at all times during its existence by one or more qualified nonprofit organizations.

In Compliance

For purposes of reviewing projects for compliance with the requirements of IRC §42(h)(5) during the 15-year compliance period, the state agencies' responsibility is limited to consideration of whether the qualified nonprofit entity is *materially participating* in the *operation* of the project; i.e., both management decision making and the day-to-day operations. In order to materially participate, the qualified nonprofit must be engaged in the activities on a basis that is regular, continuous, and substantial.

Example 1: Qualified Nonprofit Organization Materially Participates

> A for-profit organization and a qualified nonprofit organization are general partners for an LIHC project. The state agency sent the review notification letter to the nonprofit and the nonprofit's executive director was on site at the time of the review to answer questions and participate in the physical inspection. The nonprofit received the compliance report, corrected a noncompliance issue and reported back to the state agency.
>
> The owner has demonstrated management involvement.

Example 2: Property Managed by Nonprofit Representatives

> A qualified nonprofit organization owns an LIHC project. Not having the expertise to operate an LIHC property on a day-to-day basis, the nonprofit hires an affordable housing management company. The management company reports to, and is paid by, the qualified nonprofit organization.
>
> The application of the material participation rules under IRC §469 should be flexible. In this case, the owner has demonstrated both management decision making and control of the day-to-day operations through their oversight of the management company.

Out of Compliance

A taxpayer is out of compliance if:

1. The qualified nonprofit organization does not materially participate (as determined under IRC §469(h)(1)), or

2. The qualified nonprofit organization does not materially participate in both the *development and operation* of the project; i.e., both management decisions and day-to-day activities.

A property is out of compliance for any taxable year where the entity does not participate on a basis that is regular, continuous and substantial within the meaning of IRC §469(h)(1) for that year. Noncompliance can be identified by interviewing the qualified nonprofit organization's management representatives and observation while at the property site.

Example 1: Qualified Nonprofit Does Not Participate in Management Decisions

> A for-profit organization and qualified nonprofit organization are general partners for an LIHC project. The nonprofit organization fully participated in the development of the project, but has not participated in (directly or through a representative) any monthly management meetings in year 3 of the compliance period and does not otherwise participate on a regular, continuous, or substantial basis.
>
> The property is out of compliance for year 3 of the compliance period.

Example 2: Management Company Employee Provides Volunteer Services

> A for-profit organization and qualified nonprofit organization are general partners for an LIHC project. The third party management company operating the project reports to the for-profit general partner. The management company employs a property manager who signed an agreement to be a "volunteer" for the non-profit and provide services for the nonprofit organization.
>
> The property is not in compliance because the property manager's agreement to be a volunteer is part of its employment responsibilities to the for-profit organization.

Should a state agency become aware of noncompliance with other requirements imposed under IRC §42(h)(5), Form 8823 should be filed noting the issue. Areas of noncompliance may include:

1. The qualified nonprofit organization loses its exempt status. As part of the preparation for a review of an LIHC property owned by a qualified nonprofit organization under IRC §42(h)(5), state agencies may confirm that the nonprofit is a qualified tax-exempt organization by using the IRS website (www.irs.gov). Enter "78" into the "Search IRS site for" feature; the response will be "Chances are you are looking for Publication 78, Search for Exempt Organizations"; clicking on the underline portion will provide an alphabetical listing of exempt organizations. The state agency should request documentation of tax-exempt status if the organization is not included on the list.

2. The qualified nonprofit organization does not have an ownership interest in the low-income housing project.

Back in Compliance

LIHC projects are considered back in compliance in a taxable year when a qualified nonprofit organization owns an interest in the project and satisfies the material participation test set forth in IRC §469(h)(1) for that taxable year.

Example 1: Qualifying Nonprofit Organization Begins Attending Management Meetings

A for-profit organization and a qualified nonprofit organization are general partners for an LIHC project. The nonprofit organization materially participated in the on-going operation of the project in years 2, 3, and 4. They did not materially participate in year 5. It was determined that in year 7 of the compliance period, the nonprofit organization materially participated.

The property is out of compliance as of December 31st of year 5 and back in compliance as of December 31st of year 7.

Reference

1. IRC §42(h)(5)
2. Senate Report. 99-313, 99th Cong. 2nd Session, 1986-3 C.B. (Vol. 3) 732

Chapter 23
Category 11q
Other Noncompliance Issues

Definition

This category should be used to report noncompliance only when the noncompliance cannot be associated with any other category. The discussion presented here is not intended to be all inclusive.

Nonreportable Compliance Issues

Nonperformance of Extended Use Agreements

Under IRC §42(h)(6), taxpayers receiving credits must execute an extended use agreement, which is recorded as a restrictive covenant against the property, as provided by state law. The extended use period ends on the later of the date specified in the agreement or 15 years after the close of the compliance period. At a minimum, the property must be maintained as low-income housing property for 30 years beginning with the first day of the compliance period. The required content of the extended use agreement is outlined in IRC §42(h)(6)(B).

In addition, state agencies may add additional terms or restrictions to reflect the terms of the credit allocation. Under IRC §42(m), state agencies are required to develop qualified allocation plans with criteria for determining housing needs in their location and selecting appropriate projects. These terms and conditions will be reflected in the extended use agreement; e.g., the targeting of special needs groups, income restrictions, rent skewing, housing types, etc. State agencies are expected to enforce the agreement. Nonperformance of the terms of the extended use agreement should *not* be reported to the IRS. See Chapter 16 for reportable noncompliance associated with extended use agreements.

Example 1: Special Set-Asides Not Reported

> The owner elected the 40/60 minimum set-aside on Form 8609. The state agency required 20/50 targeting, as evidenced in the extended use agreement. The maximum 50% gross rent is $400, but the maximum 60% gross rent is $500. The owner charges $450 rent and a $50 utility allowance, for a total of $500. The rent charged is above the limit agreed upon in the extended use agreement, but equals the rent limit for the 60 percent minimum set aside election.
>
> The owner has violated the state's requirements. However, according to the imputed income limitation applicable to the unit, the rent is in compliance within federal regulation. The state agency should *not* file a Form 8823.

Example 2: Elected Minimum Set-Aside Inconsistent with Extended Use Agreement

> An owner, at the time of application and subsequent submission of final cost certifications when the LIHC project was completed, represented to the state agency that the 20/50 minimum set-aside would be elected. The

20/50 minimum set-aside is also identified in the extended use agreement. When making the election on Form 8609 for IRS purposes, the taxpayer selected the 40/60 set-aside.

The taxpayer is in compliance with the requirements of IRC §42. Noncompliance with the terms of the extended use agreement is *not* reportable to the IRS on Form 8823.

100% Low-Income Projects: Failure to Complete Annual Income Recertifications

Under IRC §142(d)(3)(A) and IRC §42 (per IRC §42(g)(4)), owners of 100 percent low-income *projects* are no longer required to complete annual income recertifications. State agencies, however, have authority to impose additional requirements upon IRC §42 projects and may required income recertifications after completing the initial income certification at the time the household moves into the low-income unit. For example, a state agency may require a one-time income recertification after the first year of occupancy.

State agencies may place such restrictions on a project owner for a variety of reasons. For example, the state agency has little confidence that (1) an owner can consistently identify income-qualified households without frequent technical errors, or (2) is willing to provide sufficient due diligence. In other cases, the state agency may be providing financing and, as part of their own internal controls and due diligence, is ensuring that the state's funds are used for the purposes intended.

However, like other state-imposed requirements, failure to comply with a state agency's requirement for income recertifications is not a reportable noncompliance event.

Chapter 24
Line 13
Building Disposition

Definition

Recapture of the accelerated portion of credits may be caused not only by noncompliance with the LIHC program requirements, but by either the sale or other disposition of an LIHC building or the sale of an ownership interest in such a building. It is important to report all dispositions of low-income buildings that will *not* continue to be operated as a qualified low-income building after the disposition so that the IRS can determine whether the taxpayer has complied with the requirements of IRC §42(j); i.e., the credits have been appropriately recaptured.[1]

Types of Building Dispositions

Line 13a on Form 8823 identifies four categories of building dispositions.

1. SALE - Types of activities that would constitute a "sale" (which does not necessarily involve the seller receiving money) include:

   a. Fee Title Sale of Building - Fee title passes from the seller to a whole new entity (buyer)

   b. Termination of Partnership

2. FORECLOSURE - Foreclosure is the legal process reserved by a lender to terminate the borrower's interest in a property after a loan has been defaulted. On foreclosure, the *owner* is deemed to have made a sale of the property for the outstanding amount of the mortgage debt.

   a. Deed of Property in Lieu of Foreclosure - the owner voluntarily conveys the property to the mortgage holder to avoid foreclosure proceedings.

3. DESTRUCTION - Destruction is related to a building's *physical structure*, and not to the ownership interest in the building. The destruction affects the building *in its entirety*, i.e., the eligible basis of the property is reduced to $0. The destruction is *permanent* and the building is not expected to operate as a tax credit project again. Violations of the physical inspection standards, or casualty losses that are temporary in nature should not be reported as destruction, which is permanent.

4. OTHER (Attach Explanation) – Any event, not listed above, which results in the disposition of a low-income housing credit unit, building, or property.

[1] See Exhibit 24-1 for an explanation of the recapture requirements

State Agency Responsibility for Reporting Property Dispositions

The owner of a low-income housing building is the entity identified on the Form 8609. State agencies should confirm that the ownership has not changed as part of their monitoring and inspection responsibilities.

Example 1: Owners Sells LIHC Building

> ABC, a limited partnership, owns and operates an LIHC building, and is identified as the owner on Form 8609. Mr. Jones is the general partner. There are two limited partners, Mr. Smith and the XYZ investment fund. On September 17, 2008, ABC sells the building to E&F, a limited partnership, which intends to continue operating the building as an LIHC building. As included in the extended use agreement, the state agency approved the sale. The state agency is required to report the disposition on Form 8823.

Example 2: Owner Loses Ownership in Foreclosure Proceeding

> FGH, a limited partnership, owns and operates an LIHC building, and is identified as the owner on Form 8609. Mr. Jones is the general partner and the limited partner is the XYZ investment fund. On December 1, 2008, the partnership lost ownership of the building in a foreclosure proceeding. The new owner will not operate the building as a qualified low-income building. The state agency is required to report the disposition on Form 8823.

LIHC buildings are generally owned by partnerships and identifying changes in the composition of the ownership entities is not required.

Example 3: State Agency Reviews Owner's Annual Certification

> ABC, a limited partnership, owns and operates an LIHC building, and is identified as the owner on Form 8609. Mr. Jones is the general partner. There are two limited partners, Mr. Smith and the XYZ investment fund. As part of the regular monitoring procedures, the state agency reviews the owner's annual certification to confirm that ownership has not changed. The state agency is not required to ask whether Mr. Jones, Mr. Smith, or XYZ has disposed of their interest (or a portion of their interest).

References

1. IRC §42(j)(6) No recapture on disposition of building which continues in qualified use.
2. IRC §42(f)(4) Dispositions of property. If a building (or an interest therein) is disposed of during any year for which credit is allowable under subsection (a), such credit shall be allocated between the parties on the basis of the number of days during such year the building (or interest) was held by each. In any such case, proper adjustments shall be made in the application of subsection (j).

3. Rev. Rul. 91-38, 1991-26 I.R.B. 5, Q&A #5, "…For purposes of section 42(f)(4) of the Code, the owner who has held the property for the longest period during the month in which a transfer occurs is deemed to have held the property for the entire month and may claim a credit accordingly. In cases in which the transferor and transferee have held the property for the same amount of time during the month of the transfer, the transferor is deemed to have held the property for the entire month and the transferee's ownership of the property is deemed to begin the first day of the following month…"

Exhibit 24-1
Explanation of
Credit Recapture Requirements
Under IRC §42(j)

As explained in the legislative history, the disposition of an LIHC building (or interest therein) is a recapture event.[1] The amount of the recapture is 1/3 of the allowable credit for each year if the building is disposed of through year 11 of the compliance period plus interest. The interest is computed at the overpayment rate established under IRC §6621on the recaptured credit for each taxable year for the period beginning on the due date for filing the return for the prior taxable year involved. The amount of the recapture declines if the disposition occurs after year 11 of the credit period.

Taxpayers must file Form 8611, Recapture of Low-Income Housing Credit, with their tax return for the year of sale to recapture the LIHC.

Large Partnership Recapture

In the case of a large partnership (a partnership of 35 or more partners), the partnership is treated as the taxpayer to which the credit is allowable for purposes of recapture. The tax benefit rule under IRC §42(j)(4)(A) does not apply and the increase in tax because of the recapture amount is allocated among the partners in the same manner as the partnership's taxable income for the year is allocated among the partners.

The legislative history[2]also indicates that no change in ownership is deemed to occur on the disposition of a partner's interest provided that within a 12-month period at least 50 percent (in value) of the original ownership is unchanged. These conditions apply unless the partnership elects out of large partnership treatment under IRC §42(j)(5).

Other Partnerships and Recapture

For partnerships with fewer than 35 partners, and those electing out of the large partnership provisions of IRC §42(j)(5), a partner (taxpayer) may elect to avoid or defer recapture until the taxpayer has, in the aggregate, disposed of more than 33 1/3 percent of the taxpayer's greatest total interest in the qualified low-income building through the partnership at any time.

Once dispositions aggregate more than 33 1/3 percent, further deferral is possible for dispositions on or before July 30, 2008, only if a surety bond or alternative collateral was provided. The taxpayer that defers recapture by reason of the 33 1/3 percent rule will remain subject to recapture with respect to that interest. See Rev. Rul. 90-60, 1990-2 C.B. 35. For dispositions after July 30, 2008, the taxpayer is not subject to the recapture requirement if it is reasonably expected that the building will continue to be operated as a qualified low-income buildings for the remaining compliance period.

Posting Surety Bonds Upon Disposition

For dispositions on or before July 30, 2008, recapturing the accelerated portion of the credit could be avoided if it was reasonably expected that the building would continue to be operated as a qualified low-income building for the remaining compliance period and the owner selling the building, or interest therein, timely posted a bond equal to the

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[1] H.R. Conf. Rep. No. 481, 99th Cong., 2nd Sess. II-96 (1986)
[2] H.R. Conf. Rep. No. 481, 99th Cong., 2nd Sess. II-96 (1986)

amount specified on Form 8693, Low-Income Housing Credit Disposition Bond. The IRS approved the bond when it was determined that the amount of the bond was correct and that the project was expected to remain in compliance for the balance of the initial compliance period; i.e., the new owner intended to maintain the building as low-income housing throughout the 15-year compliance period. The bond remained in effect until 58 months after the end of the 15-year compliance period.

As a practical matter, surety bonds were difficult and costly to obtain. Because of the amount of the bond needed and the inability of the seller to assure that the property would continue to comply (such power effectively being with the new owner), sureties were likely to require either full collateral or very high creditworthiness from the bonded party. IRS Revenue Procedure 99-11 established a collateral program as an alternative to providing a surety bond to avoid or defer recapture of low-income housing tax credits. Under this program, taxpayers pledged certain United States Treasury securities to the IRS as collateral.

The IRS could "call a bond" to recapture credit if it subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

Dispositions after July 30, 2008

For dispositions after July 30, 2008, owners are not required to recapture the accelerated portion of the credit if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remaining compliance period. Owners are not required to place a bond or pledge collateral at the time of the disposition, nor otherwise report the disposition to the IRS for purposes of IRC §42.

However, if there is any reduction in the qualified basis of a low-income building which results in an increase in tax under IRC §42(j) in the year of the disposition *or any subsequent tax year,* then the statutory period for assessing any deficiency with respect to such increase in tax shall not expire before the expiration of three years from the date the owner notifies the IRS of such reduction in qualified basis, notwithstanding any other law or rule of law that would otherwise prevent assessment.

Election to No Longer Maintain Surety Bond or Treasury Direct Account

If an owner disposed of an LIHC property (or interest therein) on or before July 30, 2008, and timely posted a bond (or Treasury Direct Account) equal to the amount specified on Form 8693, Low-Income Housing Credit Disposition Bond, the owner may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the funds held in Treasury Direct Accounts. Instructions for making the election are included in Revenue Procedure 2008-60.

References

1. IRS Form 8609 instructions - Line 10(b) - Partnerships with 35 or more partners are treated as the taxpayer for purposes of recapture unless an election is made not to treat the partnership as the taxpayer. Check the "Yes" box if you do not want the partnership to be treated as the taxpayer for purposes of recapture.

2. IRC §42(j)(5)
3. IRC §42(j)(6)
4. Rev. Rul. 90-60, 1990-2 C.B. 3
5. Rev. Proc. 99-11, 1999-2 I.R.B. 14
6. Rev. Proc. 2008-60, 2008-43 I.R.B.1006

Chapter 25
Miscellaneous Noncompliance Topics

This chapter includes noncompliance topics not discussed elsewhere.

Tenant Misrepresentation or Fraud

LIHC property owners should demonstrate due diligence to prevent tenant fraud. Fraud includes *deliberate* misrepresentation of fact in order to induce someone else to part with something of value or surrender a legal right. In this case, the outcome of deliberate misrepresentation by a tenant can result in the property owner renting a residential unit to an ineligible tenant at a below market rate.

If misrepresentation is suspected, additional steps should be taken to verify the accuracy of information provided by the tenant. See Chapter 4. Treas. Reg. §1.42-5 gives examples of how an income certification may be documented, including the submission of federal tax returns. If necessary, tenants can be asked to complete Form 8821, Tax Information Authorization, which will allow the owner to confirm the accuracy of the tenant's tax returns with the IRS.

If an owner discovers that a tenant has *deliberately* misrepresented their income level, student status, household size, or any other item used to determine eligibility, the owner should consult state or local landlord-tenant laws to determine whether the tenant can be asked to vacate the LIHC unit or the rent raised to the market rate. The owner is not expected to complete the annual recertification if a tenant is asked to leave or an eviction proceeding is in process.

Report any suspected or known deliberate misrepresentation of income to the Internal Revenue Service's Whistleblower Office. Complete Form 211, Application for Award for Original Information, and submit the form to the address identified on the form. The following information should be provided:

1. tenant's name,

2. tenant's social security number if possible,

3. explain association with LIHC program,

4. what the tenant did that misrepresented their income or documentation (the owner may be asked to provide evidence of the tenant's fraudulent acts),

5. amount of tenant income as reported by the tenant and the amount actually verified, and

6. the difference between the market rate and restricted rent for the unit, and how long the tenant was in the unit. This is the amount of economic benefit the tenant may be deemed to have received as taxable income.

Reporting Tenant Misrepresentation or Fraud to the IRS

So that possible loss of low-income housing credit might be avoided if it is determined upon later review by the state agency that a tenant is not qualified for low-income housing, the state agency should encourage owners to immediately report any suspected deliberate misrepresentation of fraud by a tenant to the state agency. [1]

The Low-Income Housing Program will not consider there to have been reportable noncompliance if tenant fraud is discovered and addressed by the owner prior to a state agency review or an IRS audit, and the owner satisfies the state agency that: (1) the tenant provided false information; (2) the owner did everything a prudent person would do to avoid fraudulent tenants (due diligence) and has implemented any needed changes to avoid future problems; (3) the tenant has vacated the unit (if possible); and (4) there is no pattern of accepting fraudulent tenants. In such cases, the owner need not reduce the applicable fraction for determining the credit amount and the state agency need not report the noncompliance arising because of the tenant's fraud on Form 8823.

This administrative position applies only when the owner notifies the state agency before notice is given by the state agency that a review of the tenant records or a site inspection is to be conducted. As a general rule, the Internal Revenue Service does not want to disturb the credit when the owner has demonstrated due diligence to avoid fraudulent tenants, timely removes fraudulent tenants when identified, and timely notifies the state agency of their actions.

Identification of Tenant Misrepresentation or Fraud During State Agency Reviews or IRS Audits

An owner's opportunity to identify and self-correct misrepresentations or fraud by a tenant for purposes of the low-income housing credit terminates upon notification of a state agency's intended review/inspection of the LIHC project. Any noncompliance arising from such a misrepresentation or fraud discovered during a state agency's review/inspection should be reported to the IRS on Form 8823 under the appropriate category of noncompliance, regardless of the cause. As noted in Treas. Reg. §1.42-5(a), state agencies are required to report any noncompliance of which the agency becomes aware. Agencies should report all noncompliance, without regard to whether the identified outstanding noncompliance is subsequently corrected. See Chapter 3 for full discussion.

Owner/Taxpayer Fraud

If a state agency becomes aware of an apparent fraudulent act by the owner, management company, or other party associated with the low-income housing property, or a party responsible for providing income/asset verification for tenants, the state agency may submit Form 3949-A, Information Report Referral, with supporting documents to the IRS' program analyst for IRC §42.[2]

[1] The IRS wants to provide an incentive for owners to identify, and remove (if possible) fraudulent tenants. By working with the state agency up front, we can provide an opportunity to resolve the problem without harming the owner and not waiting for a state agency review, yet retaining involvement in the determination of a "fraudulent" tenant.

[2] Additional information is available on the IRS website www.irs.gov. The specific webpage is http://www.irs.gov/individuals/article/0,,id=106778,00.html or enter "reporting fraud" in the search feature to locate the webpage, "How Do You Report Suspected tax Fraud Activity?"

Chapter 26
Tenant Good Cause Eviction and Rent Increase Protection

Definition

Under IRC §42(h)(6), buildings are eligible for the low-income housing credit only if the owner has entered into an extended low-income housing commitment. The commitment is commonly known as the "extended use agreement." The extended use agreement must be recorded pursuant to state law as a restrictive covenant. See Chapter 16 for additional detail.

3-Year Good Cause Eviction and Rent Increase Protection for Tenants

The term of the agreement is at least 30 years, beginning on the first day of the compliance period and ends on the later of the date specified by the state agency or 15 years after the close of the 15-year compliance period under IRC §42(i)(1). IRC §42(h)(6)(E)(i) describes two circumstances by which the extended use agreement can be terminated:

1. the building is acquired through foreclosure, or

2. the state agency fails to present a qualified contract for the acquisition of the LIHC building (or part thereof) by a party who will continue to operate the building (or part thereof) as low-income housing.

In the event that the extended use agreement is terminated, IRC §42(h)(6)(E)(ii) provides existing low-income tenants protection against two events for three years following the termination. These events are:

1. the eviction or the termination of tenancy[1] (other than for good cause) of an existing tenant of any low-income unit, or

2. any increase in the gross rent with respect to such unit no otherwise permitted under IRC §42.

Revenue Ruling 2004-82: Prohibitions Under IRC §42(h)(6)(B)(i) Apply throughout Extend Use Period

Under section C of Rev. Rul. 2004-82[2], Q&A #5 provides further guidance regarding extended use agreements. Question 5 asks, "Must the extended low-income housing commitment prohibit the actions described in subclauses (I) and (II) of IRC §42(h)(6)(E)(ii); i.e., eviction or the termination of tenancy (other than for good cause) only for the 3-year period described in IRC §42(h)(6)(E)(ii)?"

The answer is "no". IRC §42(h)(6)(B)(i) requires that an extended low-income housing commitment include a prohibition during the entire extended use period against: (1) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit (no-cause eviction protection) and (2) any

[1] The term "termination of tenancy" has no legal definition. It was first introduced as a term of art specific to IRC §42 in the Omnibus Budget Reconciliation Act of 1990. The bill clarifies that the extended low-income housing commitment must prohibit the eviction or termination of tenancy (other than for good cause) of an existing tenant of a low-income unit or any increase in the gross rent inconsistent with the rent restrictions on the unit. See Committee Reports on P.L. 101-508 (Omnibus Budget Reconciliation Act of 1990) COM-RPT, 94 FED ¶4380.27.

[2] Rev. Rul. 2004-82, 2004-2 C.B. 350

increase in the gross rent with respect to the unit not otherwise permitted under IRC §42.

The revenue ruling includes the following explanation. When Congress amended IRC §42(h)(6)(B)(i) to add the requirement that the extended use agreement must *prohibit the actions described in subclauses (I) and (II) of subparagraph (E)(ii),* IRC §42(h)(6)(E)(ii) was already part of §42. As a result, Congress must have intended the amendment to §42(h)(6)(B)(i) to add an additional requirement beyond what was contained in §42(h)(6)(E)(ii), which already prohibited the actions described in that section for the 3 years following the termination of the extended use period. Because the requirements of §42(h)(6)(B)(i) otherwise apply for the extended use period, Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of §42(h)(6)(E)(ii) to apply throughout the extended use period.

The revenue ruling also provided guidance for updating extended use agreements to explicitly provide tenants with protection against evictions without good cause and increases in rent not allowable under IRC §42. The revenue ruling provided that if it is determined by the end of a taxable year that a taxpayer's extended use agreement does not meet the requirements for an extended use agreement under IRC §42(h)(6)(B) (for example, it does not provide no-cause eviction protection for tenants of low-income units throughout the extended use period), the low-income housing credit is not allowable with respect to the building for the taxable year, or any prior taxable year. However, if the failure to have a valid extended use agreement is in effect is corrected within 1 year of the date of the determination, the determination will not apply to the current year of the credit period or any prior year.

The revenue ruling also requires the state agencies to review its extended low-income housing commitments for compliance with the interpretation of §42(h)(6)(B)(i) by December 31, 2004. If, during the review period, the housing credit agency determines that an extended low-income housing commitment is not in compliance with the interpretation of §42(h)(6)(B)(i) provided in Revenue Ruling 2004-82, the 1-year period described under §42(h)(6)(J) will commence on the date of that determination.

Revenue Procedure 2005-37

Effective June 21, 2005, the IRS issued Rev. Proc. 2005-37[3] to provide the state agencies guidance for satisfying the review requirements under Rev. Rul. 2004-82, Q&A #5.

<u>Extended Use Agreements Entered into Before January 1, 2006,</u>

If the extended use agreement contain general language requiring building owners to comply with the requirements of' IRC §42 (catch-all language), the requirements of Rev. Ruling 2004-82, Q&A #5, are satisfied if:

1. Agencies notify building owners in writing on or before December 31, 2005, that consistent with the interpretation in Q&A #5, the catch-all language prohibits the owner from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) throughout the entire commitment period.

[3] Rev. Proc. 2005-37, 2005-28 I.R.B. 79

Further, state agencies must notify building owners that the catch-all language prohibits the owner from making an increase in the gross rent with respect to a low-income unit not otherwise permitted by IRC §42 throughout the entire commitment period;

2. The owner must, as part of its certification under Treas. Reg. §1.42-5(c)(1)(xi), certify annually that for the preceding 12-month period no tenants in low-income units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42;

Finally, if the extended use agreement is amended for any reason after December 31, 2005, it must also be amended to clearly provide for the prohibition against the eviction or termination of tenancy other than for good cause and any increase in the gross rent not otherwise permitted under IRC §42.

Commitments entered into before January 1, 2006, that do not contain specific language on the IRC §42(h)(6)(B)(i) prohibitions or catch-all language do not satisfy the requirements of Rev. Rul. 2004-82, Q&A #5 and must be amended by December 31, 2005 to clearly provide for the IRC §42(h)(6)(B)(i) prohibitions against the eviction or termination of tenancy of an existing tenant of any low-income unit (other than for good cause) and the increase in the gross rent with respect to a low-income unit not otherwise permitted by IRC §42.

Extended Use Agreements Entered into After December 31, 2005

1. Extended use agreements executed after December 31, 2005, must clearly provide for the prohibition against the eviction or termination of tenancy other than for good cause and any increase in the gross rent not otherwise permitted under IRC §42.

2. The owner must also, as part of its certifications under Treas. Reg. §1.42-5(c)(1)(xi), certify annually that for the preceding 12-month period no tenants in low-income units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42.

Eviction or "Termination of Tenancy"

Eviction is the act or process of legally dispossessing a person of land or rental property. An owner who wishes to evict a tenant must comply with applicable state and/or local laws governing evictions.

Good Cause

The owner of an IRC §42 property must be able to demonstrate if challenged in state court that good cause existed to support the eviction or termination of a tenant from a low-income unit. For purposes of IRC §42(h)(6)(E)(ii)(I), good cause is determined by the state and local law applicable to the location in which the IRC §42 property is located.

State or local law examples of good cause evictions may include nonpayment of rent, violations of the lease or rental agreement, destruction or damage to the property,

interference with other tenants or creating a nuisance, or using the property for an unlawful purpose.

Owner Fails to Renew Lease

A lease to rent low-income housing is a contract. A lease contract expires at the end of the time period specified in the lease. At that time, the tenant surrenders the low-income housing unit to the owner and the owner accepts it back. The owner and tenant may renew the contract (or enter into a new contract), thereby allowing the tenant to continue occupying the low-income unit, but the owner is not obligated to renew a lease or enter into a new one, and failure to do so does not, per se, constitute an eviction without good cause. However, the owner must be prepared to demonstrate if challenged in state court that the nonrenewal of a lease is not a "termination of tenancy" for other than good cause under IRC §42.

The owner must provide the tenant with timely notice that the lease will not be renewed as required under state law.

In Compliance

Owners are in compliance with the prohibitions against evictions or terminations of tenancy for other than good cause and increases in the gross rent not permitted under IRC §42 when all of the following four requirements are met.

1. The extended use agreement includes the prohibitions.

   a. For agreements entered into before January 1, 2006, the agreement must contain general language requiring building owners to comply with the requirements of' IRC §42 (catch-all language) and the state agency must notify the owner in writing on or before December 31, 2005, that the catch-all language prohibits the owner from evicting or terminating the tenancy of an existing tenant of any low-income unit (other than for good cause) or increases the gross rent not otherwise permitted by IRC §42 throughout the entire commitment period.

   b. For extended use agreements executed after December 31, 2005, the agreement must clearly provide for the prohibition against the eviction or termination of tenancy other than for good cause and any increase in the gross rent not otherwise permitted under IRC §42.

2. The owner must, as part of its annual certification under Treas. Reg. §1.42-5(c)(1)(xi), certify annually that for the preceding 12-month period no tenants in low-income units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42.

3. The owner must not evict or terminate the tenancy of, an existing tenant of any low-income unit for other than for good cause.

4. The owner must not increase the gross rent unless permitted by IRC §42.

Out of Compliance

Owners are out of compliance with the prohibitions against evictions or terminations of tenancy for other than good cause and increases in the gross rent not permitted under IRC §42 if any of the following three requirements is not met.

Extended Use Agreement

Generally, no credit is allowable for a building in a year unless an extended use agreement is in effect at the end of the year. The extended use agreement is not in effect and the owner is out of compliance if (1) the extended use agreement does not include the prohibitions, or (2) does not contain the general catch-all language requiring compliance with IRC §42 if the agreement was entered into before January 1, 2006.

Noncompliance is reported under category 11k, Owner Failed to Execute and Record Extended Use Agreement Within Time Prescribed by Section 42(h)(6)(J). See Chapter 16 for additional discussion.

Annual Certification

Owners are out of compliance if they fail to certify annually, or certify incompletely or inaccurately, under the penalty of perjury, that for the preceding 12-month period no tenants in low-income units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42.

Noncompliance is reported under category 11d, Owner Failed to Provide Annual Certifications or Provided Incomplete or Inaccurate Certification. See Chapter 7 for additional discussion.

Increased Gross Rent

The owner is out of compliance if the gross rent is increased in a manner not permitted by IRC §42. 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).

Noncompliance is reported under category 11g, Gross Rent(s) Exceed Tax Credit Limits. See Chapter 11 for additional discussion.

Back in Compliance

Owners are back in compliance with the prohibitions against evictions or terminations of tenancy for other than good cause and increases in the gross rent not permitted under IRC §42 if:

Extended Use Agreement

The extended use agreement is in effect and the owner is back in compliance when the extended use agreement is amended to clearly provide for the prohibition against the eviction or termination of tenancy other than for good cause and any increase in the gross rent not otherwise permitted under IRC §42.

Corrected noncompliance is reported under category 11k, Owner Failed to Execute and Record Extended Use Agreement Within Time Prescribed by Section 42(h)(6)(J). See Chapter 16 for additional discussion.

Annual Certification

The noncompliance is corrected when the owner certifies that for the preceding 12-month period no tenants in low-income units were evicted or had their tenancies terminated other than for good cause and that no tenants had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42. In the event that tenant(s) in low-income units were evicted or had their tenancies terminated other than for good cause, or that tenant(s) had an increase in the gross rent with respect to a low-income unit not otherwise permitted under IRC §42, the annual certification must disclose the violations.

Corrected noncompliance is reported under category 11k, Owner Failed to Provide Annual Certifications or Provided Incomplete or Inaccurate Certification. See Chapter 7 for additional discussion.

Increased Gross Rent

A unit is back in compliance when the rent charged does not exceed the limit. An owner cannot avoid the disallowance of the LIHC by rebating excess rent to the affected tenants. Corrected noncompliance is reported under category 11g, Gross Rent(s) Exceed Tax Credit Limits. See Chapter 11 for additional discussion.

Reference

1. IRC §42(h)(6)
2. Rev. Rul. 2004-82, 2004-35, I.R.B. 1
3. Rev. Proc. 2005-27, 2005-28 I.R.B. 1