Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Noncompliance of Common Area for purposes of § 42 Low-Income Housing Credit

This Chief Counsel Advice responds to your request for assistance. In accordance with § 6110, this advice may not be used or cited as precedent.

ISSUES

1) For purposes of the low-income housing credit under § 42 of the Internal Revenue Code, should the noncompliance of a common area in a qualified low-income building, based on a failure of the inspection standards under § 1.42-5(d) of the Income Tax Regulations or any requirements under § 42, be treated as a change in the eligible basis of the building in the taxable year in which the noncompliance occurs?

2) If the noncompliance of a common area in a qualified low-income building is treated as a change in the eligible basis of the building in the taxable year in which the noncompliance occurs, for purposes of determining if recapture under § 42(j) is appropriate, is the change a reduction in the amount of the total costs attributable to the specific common area that was included in the eligible basis of the building, or in the amount of the costs attributable only to the noncompliant portion of the common area?

3) Alternatively, should the noncompliance of a common area in a qualified low-income building, based on a failure of the inspection standards under § 1.42-5(d) or any requirements under § 42, be treated as a change in the applicable fraction of the qualified low-income building in the taxable year in which the noncompliance occurs, as if one of the low-income units located the closest to the non-compliant common area was out of compliance?

CONCLUSIONS

1) Yes. For purposes of the low-income housing credit under § 42, the noncompliance of a common area in a qualified low-income building, based on a failure of the inspection standards under § 1.42-5(d) or any requirements under § 42, should be treated as a change in the eligible basis of the qualified low-income building in the taxable year in which the noncompliance occurs.

2) For purposes of determining recapture under § 42(j), a change in the eligible basis of a qualified low-income building based on the noncompliance of a common area is a reduction in the eligible basis of the building in the taxable year in which the noncompliance occurs, in the amount of the total costs attributable to the specific common area that was included in the eligible basis of the building. The reduction in the eligible basis is not the amount of the costs attributable only to the portion of the noncompliant common area.

3) No. For purposes of the low-income housing credit under § 42, the noncompliance of a common area in a qualified low-income building should not be treated, alternatively, as a change in the applicable fraction of the building in the taxable year in which the noncompliance occurs, as if one of the low-income units located the closest to the common area was non-compliant.

LAW AND ANALYSIS

Section 42(a) provides that the amount of the low-income housing credit determined for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction of the eligible basis of the building. Section 42(c)(1)(B) defines the term "applicable fraction" as the smaller of the unit fraction or the floor space fraction. Section 42(c)(1)(C) provides that unit fraction is the fraction the numerator of which is the number of low-income units in the building, and the denominator of which is the number of residential rental units (whether

or not occupied) in such building. Section 42(c)(1)(D) provides that floor space fraction means the fraction the numerator of which is the total floor space of the low-income units in such building and the denominator of which the total floor space of the residential rental units (whether or not occupied) in such building.

Section 42(c)(2) defines a qualified low-income building as 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 is part of such a project and ending on the last day of the compliance period with respect to such building, and to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the 1st taxable year of the credit period.

Section 42(d)(2) provides that the eligible basis of an existing building, which meets the requirements of § 42(d)(2)(B), is its adjusted basis as of the close of the 1st taxable year of the credit period.

Section 42(d)(4)(A) provides that, in general, the adjusted basis of any building shall be determined without regard to the adjusted basis of any property which is not residential rental property. Section 42(d)(4)(B) provides an exception to the general rule under § 42(d)(4)(A) that the adjusted basis of any building shall be determined by taking into account the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in such building.

Section 42(f)(1) provides that the term "credit period" means, with respect to any building, the period of 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 taxable year, but only if the building is a qualified low-income building as of the close of the 1st year of such period. Such an election, once made, shall be irrevocable.

Section 42(g)(1) provides that, in general, the term "qualified low-income housing project" means any project for residential rental property if the projects meets certain minimum set-aside tests described under § 42(g)(1)(A), (B), or (C), whichever is elected by the taxpayer.

Section 42(i)(1) provides that the term "compliance period" means, with respect to any building, the period of 15 taxable years beginning with the 1st taxable year of the credit period of the building.

Section 42(i)(3)(A) provides that the term "low-income unit" means any unit in a building if such unit is rent-restricted (as defined in § 42(g)(2)) and the individuals occupying such unit meet the income limitation applicable under § 42(g)(1) to the project of which such building is a part. Further, § 42(i)(3)(B) provides in general that a unit shall not be treated as a low-income unit unless the unit is suitable for occupancy and used other than on a transient basis.

Section 42(j)(1) provides in general and in part that, if, as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the taxpayer's income tax for the taxable year shall be increased by the credit recapture amount (described under § 42(j)(2) and (3)).

Section 42(j)(4)(C) provides that § 42(j)(1) shall apply to a decrease in qualified basis only to the extent such decrease exceeds the amount of qualified basis with respect to which a credit was allowable for the taxable year by reason of § 42(f)(3) (with respect to additional credits allowable based on increases in qualified basis after the first year of the credit period).

Section 42(j)(4)(F) provides that the Secretary may provide that the increase in tax under § 42(j) shall not apply with respect to any building if such increase results from a de minimis change in the floor space fraction under § 42(c)(1) and the building is a qualified low-income building after such change.

The legislative history of § 42 provides that, for purposes of the low-income housing credit, the term "residential rental property" has the same meaning as residential rental property within § 103. Residential rental property thus includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

Section 1.103-8(b)(4) provides in part and in general that, a residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly constructed units, which are used on other than a transient basis and satisfy other relevant requirements. Further, substantially all of each project must contain such units and functionally related and subordinate facilities.

Section 1.103-8(b)(4)(iii) provides that, in part, that facilities that are functionally related and subordinate to residential rental projects include facilities for use by the tenants, for example, swimming pools, other recreational facilities, parking areas and other facilities that are reasonably required for the project, for example, heating and cooling

equipment, trash disposal equipment or units for resident managers or maintenance personnel.

Section 1.42-5(e)(3) provides, in relevant part, that a State or local housing credit agency (Agency) is required to file Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance, with the Internal Revenue Service (Service) no later than 45 days after the end of the correction period (as described in § 1.42-5(e)(4), including extensions permitted under that paragraph) and no earlier than the end of the correction period, whether or not the noncompliance or failure to certify is corrected. The Agency must explain on Form 8823 the nature of the noncompliance or failure to certify and indicate whether the owner has corrected the noncompliance or failure to certify. Any change in either the applicable fraction or eligible basis under § 1.42-5(c)(1)(ii) and (vii), respectively, that results in a decrease in the qualified basis under § 42(c)(1)(A) is noncompliance that must be reported to the Service.

Section 1.42-5(e)(4) provides that the correction period is that period specified in the monitoring procedure during which the owner must supply any missing certifications and bring the project into compliance with the provisions of § 42. Further, the correction period is not to exceed 90 days from the date the Agency notifies the owner of the low-income housing project. The Agency may extend the correction period for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

Issue One

Common areas in a qualified low-income building or a qualified low-income housing project are residential rental property if functionally related and subordinate to the qualified low-income building or qualified low-income housing project. Under § 42(d)(4)(A) and (B), the eligible basis for a qualified low-income building includes the adjusted basis of the property (of a character subject to the allowance of depreciation) used in common areas or provided as comparable amenities to all residential rental units in the building. Therefore, if a common area of a qualified low-income building is non-compliant under the inspection standards or any other requirements under § 42 during the compliance period, and if the noncompliance is uncorrected as of the close of the taxable year in which the noncompliance occurs, the noncompliance should be treated, in the taxable year in which the noncompliance occurs, as a change and reduction in the eligible basis of the building.

Issue Two

In the event that there is a reduction in the eligible basis of the qualified low-income building, due to the noncompliance of a common area, in a taxable year in the

compliance period, a recapture under § 42(j) may be triggered. *But see* § 42(j)(4)(C). For purposes of determinations under § 42(j), the reduction is in the amount of the adjusted basis of the common area property that was included in the eligible basis of the building determined as of the close of the first taxable year in the credit period. The reduction in eligible basis is not limited to the amount of the costs attributable to only the portion of the non-compliant common area property that was included in the eligible basis of the building. Thus, the eligible basis of the building is reduced by the amount of the total costs of the specific common area that caused the noncompliance.

For example, a qualified low-income building contains multiple common areas. One of the common areas is a laundry room for use by all tenants of the building without additional charge. The laundry room contains twenty laundry machines. For purposes of the low-income housing credit under § 42, the costs of the laundry room ($40,000), and those of the twenty laundry machines ($10,000), were included in the eligible basis of the building (a total of $50,000) as of the close of Year 1 in the credit period. In June of Year 3, during the compliance period, the state housing credit agency (Agency) inspected the building and discovered that ten of the laundry machines were not properly functional and, therefore, the common area (the laundry room) was deemed noncompliant. The Agency allowed the owner three months to correct the noncompliance, but the owner failed to correct the noncompliance by the end of Year 3. Therefore, in Year 3, there is a reduction of the eligible basis of the building in the amount of the total costs of the laundry room that was previously included in the eligible basis ($50,000), because the laundry room is noncompliant. The reduction is not limited to the amount of the costs attributable to the nonfunctional laundry machines ($5,000).

Further, if the adjusted basis of the common area is allocated to the eligible basis of one or more buildings in a low-income housing project for purposes of calculating the credit, such as a carport that is for use by all of the tenants of a qualified multi-building low-income housing project, the reduction in the eligible basis of the buildings based on the noncompliance of the common area should be allocated accordingly.

Issue Three

As discussed in Issues One and Two, above, the noncompliance of a common area in a qualified low-income building is properly treated as a change and reduction in the eligible basis of the building in the year of the noncompliance, in the amount of the total costs of the specific common area previously included in the eligible basis of the building. Treating the noncompliance of a common area instead as if one of the low-income units located closest to a non-compliant common area was out of compliance is not a valid alternative, as it does not properly and accurately account for the change caused by the noncompliance of a common area to the qualified basis of the building.

Therefore, the noncompliance of a common area should not be treated as a deemed noncompliance of one of the low-income units.

For reporting purposes, the Agencies should check both boxes indicating noncompliance with respect to the inspection standards and changes in eligible basis on Form 8823 (currently, Boxes 11c and 11e).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

In accordance with § 6110(k)(3), this document may not be used or cited as precedent. Please call Michael J. Torruella Costa at (202) 317-4137 if you have any further questions about this matter.