Treasury Decision 8859, IRC Sec(s). 42

Agency: Internal Revenue Service (IRS), Treasury.

Action: Final regulations.

Summary: This document contains final regulations regarding the procedures for compliance monitoring by state and local housing agencies (Agencies) with the requirements of the low-income housing credit; the requirements for making carryover allocations; the rules for Agencies' correction of administrative errors or omissions; and the independent verification of information on sources and uses of funds submitted by taxpayers to Agencies. These final regulations affect owners of low-income housing projects who claim the credit and the Agencies who administer the credit.

Dates: Effective Dates: These regulations are effective January 1, 2001, except that the amendments made to sections 1.42- 5(c)(5) and (e)(3)(i), and 1.42-13 are effective January 14, 2000, and the amendment made to section 1.42-6(d)(4)(ii) is effective January 1, 2000.

Applicability Dates: For dates of applicability of the amendments to section 1.42-5, see section 1.42-5(h). For date of applicability of the amendment made to section 1.42-6, see section 1.42-12(c). For date of applicability of the amendments made to section 1.42-13, see section 1.42-13(d). For date of applicability of section 1.42-17, see section 1.42-17(b).

For Further Information Contact: Paul Handleman, (202) 622-3040 (not a toll-free number).

Supplementary Information

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-1357. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For section 1.42-5, the estimated annual burden per respondent varies from .5 hour to 3 hours for taxpayers and 250 to 5,000 hours for Agencies, with an estimated average of 1 hour for taxpayers and 1,500 hours for Agencies. For section 1.42-13, the estimated annual burden per respondent varies from .5 hour to 10 hours for taxpayers and Agencies, with an estimated average of 3.5 hours for taxpayers and 3 hours for Agencies. For section 1.42-17, the estimated annual burden per respondent varies from .5 hour to 2 hours for taxpayers and .5 hour to 5 hours for Agencies, with an estimated average of 1 hour for taxpayers and 2 hours for Agencies.

Comments concerning the accuracy of these burden estimates and suggestions for reducing these burdens should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On January 8, 1999, the IRS published proposed regulations (REG-114664-97) in the Federal Register (64 FR 1143) inviting comments under section 42. A public hearing was held May 27, 1999. Numerous comments have been received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury Decision.

Public Comments

A. Compliance Monitoring

1. Inspection Requirement for New Buildings.

The proposed regulations require that, by the end of the calendar year following the year the last building in a project is placed in service, the Agency conduct on-site inspections of the projects and review the low-income certification, the documentation supporting such certification, and the rent record for each tenant in the project. Most commentators view the requirement for reviewing all tenant records for all buildings in a project as unnecessary and burdensome. Most commentators suggest limiting inspections for new buildings to 20 percent of the project's low-income units. Commentators also suggest extending the time limit for inspecting new buildings to the end of the calendar year following the first year of the credit period or at least until a reasonable time after the Agency issues Form 8609, "Low-Income Housing Credit Allocation Certification." This added flexibility would allow the Agency to combine a physical inspection with a file review of the first year of the credit period.

In response to the comments, the final regulations reduce the inspection burden for new buildings by requiring the Agency to conduct on-site inspections of all new buildings in the project and, for at least 20 percent of the project's low-income units, to inspect the units and review the low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those units. To allow the Agency sufficient time to review the tenant files for the first year of the credit period, the final regulations extend the time limit for inspecting new buildings to the end of the second calendar year following the year the last building in the project is placed in service.

2. Three-year Inspection Requirement.

The proposed regulations require that, at least once every 3 years, each Agency conduct on-site inspections of all buildings in each low-income housing project and, for each tenant in at least 20 percent of the project's low-income units selected by the Agency, review the low-income certification, the documentation supporting such certification, and the rent record.

Most commentators agree with requiring physical inspections of the buildings at least once every 3 years. However, commentators recommend reviewing tenant income and rent records once every 5 years, which is one of the options under the current compliance monitoring regulations (see section 1.42-5(c)(2)(ii)(B) requiring an Agency to review tenant files for 20 percent of the low- income housing projects each year). Commentators also recommend reviewing tenant files either on-site or at other locations, including desk audits.

Although the physical inspection and file review requirements for new buildings are relaxed in the final regulations, the final regulations retain the 3-year inspection cycle for existing buildings. The final regulations do not separate the physical inspection and file review cycles (every 3 years for physical inspections and every 5 years for file reviews) as suggested by commentators because it is administratively complete to do both during the same year. The tenant income and rent restrictions in section 42(g) are equally important as the habitability standards for a low-income unit in section 42(i)(3)(B)(ii). The final regulations adopt the suggestion that the file review may be done wherever the tenant files are maintained.

3. Health, Safety, and Building Code Inspections.

The proposed regulations require the Agency to determine whether the project is suitable for occupancy, taking into account local health, safety, and building codes. Many commentators object to this requirement as too costly and unadministerable because building codes vary considerably within states. Commentators also asked for guidelines as to what constitutes an "inspection." Some commentators propose defining an inspection as looking at selected units in the building and common areas for visible problems or defects without applying the local health, safety, and building codes standards. One commentator suggests inspections based on a complaint from the local jurisdiction or from a tenant. Some commentators suggest using a uniform physical standard such as the uniform physical condition standards for public housing established by the Department of Housing and Urban Development (HUD) in 24 CFR 5.703.

Section 42(i)(3)(B)(i) excludes from the definition of a "low-income unit" a unit that is not suitable for occupancy. Under section 42(i)(3)(B)(ii), suitability of a unit for occupancy shall be determined under regulations prescribed by the Secretary taking into account local health, safety, and building codes. Recognizing that these codes vary considerably within states, the final regulations require an Agency to determine whether a low-income housing project satisfies these codes, or satisfies the HUD uniform physical condition standards. The HUD standards are intended to ensure that housing is decent, safe, sanitary, and in good repair. Though it would be appropriate that an Agency use HUD's inspection protocol under 24 CFR 5.705, the final regulations do not mandate use of HUD's inspection protocol because to do so could increase costs to the Agencies as well as limit their latitude in applying standards consistent with their own operating procedures and practices. The final regulations except a building from the inspection requirement if the building is financed by the

Rural Housing Service (RHS) under the section 515 program, the RHS inspects the building (under 7 CFR part 1930(c)), and the RHS and Agency enter into a memorandum of understanding, or other similar arrangement, under which the RHS agrees to notify the Agency of the inspection results. Irrespective of the physical inspection standard selected by the Agency, a low- income housing project under section 42 must continue to satisfy local health, safety, and building codes.

The proposed regulations limit an Agency's delegation of the physical inspection of a project to only a state or local government unit responsible for making building code inspections. Commentators suggest expanding the delegation of inspections to professional firms. The final regulations remove the delegation limitation and Agencies may delegate the physical inspection requirement to state or local governmental agencies, HUD, or private contractors.

4. Local Reports of Building Code Violations.

The proposed regulations require the owner of a low-income housing project to certify that for the preceding 12-month period the state or local government unit responsible for making building code inspections did not issue a report of a violation for the project. If the governmental unit issued a report of a violation, the owner is required to attach a copy of the report of the violation to the annual certification submitted to the Agency.

A commentator noted that the number of violations attached to the annual owner certification would be considerable because even the highest quality rental housing operations do not have an inspection without a report or notice of some violation. Two commentators suggest attaching reports only for violations that have not been corrected prior to filing the annual owner certification or requiring that owners only attach reports for "major" violations. The commentators suggest defining major violations as violations not corrected within 90 days of the notice of violation or violations where the cost to comply exceeds $2,500. A commentator suggests that Agencies be allowed to distinguish between minor technical violations and serious violations (i.e., lack of heat or hot water, hazardous conditions, and security) in reporting noncompliance.

Though a minor violation will not lead to the disallowance or recapture of section 42 credits, a series of minor violations may be the equivalent of a major violation resulting in disallowance or recapture of credits. Determining the difference between a major and minor violation is subjective. The final regulations do not exclude minor violations from the reporting and recordkeeping requirement. However, to reduce the inspection violation paperwork, the final regulations require that the owner must either attach a statement summarizing the violations or a copy of each violation report to the annual owner certification submitted to the Agency. The owner must state on the certification whether the violation has been corrected. In addition, the final regulations require that the owner retain the original violation report for the Agency's physical inspection. Retention of the original violation report is not required once the Agency reviews the violation and completes its inspection, unless the violation remains uncorrected.

5. Correction of Noncompliance or Failure to Certify.

The final regulations adopt commentators' suggestion to limit to a 3-year period after the end of the correction period in section 1.42-5(e)(4) the requirement that Agencies file Form 8823, "Low-Income Housing Credit Agencies Report of Noncompliance," with the IRS reporting the correction of the noncompliance or failure to certify.

6. Compliance Monitoring Effective Dates.

Commentators suggest an effective date of at least one year after the final regulations are published in the Federal Register. Commentators also recommend on-site inspections apply only to new buildings allocated section 42 credits after the effective date of the final regulations.

Because the amendments to the compliance monitoring regulations will require amendments to qualified allocation plans, the final regulations relating to compliance generally contain a January 1, 2001, effective date. Thus, the requirements to attach local health, safety, or building code violations to the annual owner certification and to inspect buildings and review tenant files for existing projects are effective January 1, 2001. The inspection requirement and tenant file review for new buildings is effective for buildings placed in service on or after January 1, 2001.

7. Section 8 and Federal Civil Rights Laws.

Two commentators state that insufficient controls are in place to ensure that low-income housing projects adhere to the requirement in section 42(h)(6)(B)(iv) of nondiscrimination against Section 8 voucher or certificate holders. The commentators suggest that the IRS could help compensate for lack of controls by working with HUD to ensure that Section 8 voucher or certificate holders are aware of, and have access to, low-income housing projects. The commentators also suggest that Agencies provide regional HUD offices a list of low-income housing projects in that state, with information that would be helpful for prospective tenants. One commentator suggests that the prohibition on discrimination based on Section 8 status be clarified to exclude policies that bar Section 8 tenants but have no substantial business justification. For example, low- income housing projects should not be permitted to exclude Section 8 voucher or certificate holders through a rule that requires every applicant to have income equal to at least three times the total rent.

The commentators also suggest that the Agencies should be required to develop a plan for educating applicants and owners of projects of the prohibition against discrimination on the basis of Section 8 voucher or certificate status. They recommend that the Agencies should be required to have a procedure for accepting and processing complaints about discrimination against Section 8 voucher or certificate holders. They also recommend that IRS and HUD should work together to study the circumstances under which Section 8 voucher or certificate holders are, or are not, accessing projects.

Section 42(h)(6)(A) provides that no credit shall be allowed by reason of section 42 with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year. Section 42(h)(6)(B)(iv) defines the term "extended low-income housing commitment" to include any agreement between the taxpayer and the housing credit agency that prohibits the refusal to lease to a holder of a voucher or certificate of eligibility under

section 8 of the United States Housing Act of 1937 because of the status of the prospective tenant as such a holder. To help monitor compliance with section 42(h)(6)(B)(iv), the final regulations amend the annual owner certification relating to the extended low-income housing commitment under section 1.42-5(c)(1)(xi) to require owners to certify that the owner has not refused to lease a unit in the project to a Section 8 applicant because the applicant holds a Section 8 voucher or certificate.

The IRS has informed HUD of the comments received about preventing discrimination based on Section 8 status. Agencies should provide HUD with publicly available information on section 42 low- income housing projects if HUD requests it.

A commentator also suggests that the compliance monitoring regulations be amended to acknowledge the authority of Title VIII of the 1968 Civil Rights Act, as well as HUD's Title VIII regulations; specify the civil rights obligations of the Agencies; and specify what developers and owners of projects must do to satisfy their civil rights obligations.

To monitor for compliance with the Fair Housing Act, the final regulations amend the annual owner certification relating to the general public use requirement in section 1.42-5(c)(1)(v) to require owners to certify that no finding of discrimination under the Fair Housing Act has occurred for the project (a finding of discrimination includes an adverse final decision by HUD, an adverse final decision by a substantially equivalent state or local fair housing agency, or an adverse judgment from a Federal court).

B. Sources and Uses of Funds

Section 42(m)(2)(A) requires Agencies to limit the housing credit dollar amount allocated to a project to only the amount necessary for the financial feasibility of a project and its viability as a qualified low-income project through the credit period. The proposed regulations require an Agency to evaluate the housing credit dollar amount at four times:

(1) at application for the housing credit dollar amount,

(2) the allocation of the housing credit dollar amount,

(3) the date the building is placed in service, and

(4) after the building is placed in service, but before the Agency issues the Form 8609.

Commentators recommend elimination of the evaluation at the placed-in-service date. In practice, Agencies currently evaluate the credit amount at the three other times. The final regulations adopt the recommendation by deleting the fourth time requirement and clarifying that the placed-in-service evaluation may occur not later than the date the Agency issues the Form 8609.

Commentators are concerned that the opinion by a certified public accountant, based upon the accountant's audit or examination, on the financial determinations and

certifications required in the proposed regulations, could have significant cost implications, particularly for smaller developers. Commentators suggest limiting the requirement to projects with 25 or more units, or projects with total development costs of $5 million or more.

The third-party validation on financial information was recommended in the report by the General Accounting Office (GAO), "Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program," (GAO/GGD/RCED-97-55), dated March 28, 1997. The GAO report states on page 93 that an accounting firm with a tax credit speciality would charge in the $5,000 to $7,500 range per engagement for tax credit certifications (opinion on total costs, eligible basis, and tax credit amount) prepared on the basis of an audit done in accordance with AICPA audit standards even for projects costing upwards of $5 million to $10 million. As a percentage of development costs, the CPA tax credit certifications represent a minimal cost for validating financial information. However, in recognition that the cost may be burdensome for smaller developers, the final regulations limit the requirement for an audited schedule of costs for projects with more than 10 units.

Two commentators were concerned that the meaning of the term "financial determinations and certifications" is unclear. A CPA would not be able to evaluate what needs to be audited and whether there are relevant and reliable criteria against which the information can be evaluated. To conduct an audit or attestation engagement, CPAs require that the subject matter be defined and that such subject matter be capable of evaluation against reasonable criteria. Reasonable criteria are essential so that CPAs using the same criteria will be able to arrive at similar conclusions.

Another concern expressed by commentators involved uncertainty as to whether the CPA is being asked to report on financial information that is only historical or whether the CPA is also being asked to examine prospective financial information. CPAs can compile or examine and report on certain types of prospective financial information. However, such engagements generally are more costly than audits of historical information because of minimum presentation guidelines required by professional standards as well as increased risk associated with future-oriented information. The commentators believe that if an Agency were to require CPAs to be associated with prospective financial information, the related costs to the taxpayer may far exceed any perceived benefits to the Agency. Accordingly, the final regulations have been revised to specify that the CPA's opinion only relates to historical project costs.

C. Correction of Administrative Errors and Omissions

Commentators recommend filing the corrected allocation document with the current year's Form 8610, "Annual Low-Income Housing Credit Agencies Report," instead of amending the Form 8610 for the year the allocation was made. Because the administrative errors covered by the automatic approval provision will not have an effect on the total amount of credit the Agency allocated to the building(s) or project, commentators view an amended Form 8610 as unnecessary. Agency recordkeeping would be simplified if all corrected allocation documents could be submitted with the current year's Form 8610. The final regulations adopt this recommendation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the burden on taxpayers is minimal and the burden on small entity Agencies is not significant. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.