

# Low Income Housing Credit Newsletter

Internal Revenue Service

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The LIHC newsletter provides a forum for networking and sharing information about IRC §42, the Low-Income Housing Credit and communicating technical knowledge and skills, guidance and assistance for developing LIHC issues. We are committed to the development of technical expertise among field personnel. Articles and ideas for future articles are welcome!! The contents of this newsletter should not be used or cited as authority for setting or sustaining a technical position.

## Annual Income Recertifications Not Relevant for 100% LIHC Projects

As part of the Housing Assistance Tax Act of 2008, Congress amended IRC §142(d)(3)(A) to read (new language is italicized):

“...The determination of whether the income of a resident of a unit in a project exceeds the applicable income limit shall be made at least annually on the basis of the current income of the resident. *The preceding sentence shall not apply with respect to any project for any year if during such year no residential unit in the project is occupied by a new resident whose income exceeds the applicable income limit.*”

The amendment is effective for years ending after July 30, 2008. Under IRC §42(g)(4), the new exception is made applicable to IRC §42 properties. As a result, owners of §42 projects, where all the residential units are low-income units, can immediately stop completing the annual tenant income recertifications.

### Background

The new exception sounds wonderful until you start thinking about the implications. So, to understand how the new exception fits into the “big picture,” we need to understand the basic premise upon which the exception is based.

Under IRC §42(i)(3), a low-income unit is defined as a residential rental unit that is rent restricted, occupied by a household that meets the income limitation requirements, and suitable for occupancy.

Under IRC §42(g)(2)(D), if the income of an initially income-qualified household rises above the income limit, the unit is still considered a low-income unit as long as the rent continues to

be restricted. If the household’s income rises above 140% of the income limit (or 170% in deep rent skewed developments), then the unit continues to be considered a low-income unit as long as the next available unit of comparable size or smaller is rented to an income-qualified household.

Congress has concluded that the annual income recertifications are not “relevant” to 100% LIHC projects because the next available unit is *always* rented to an income-qualified household. However, Congress did not specifically except 100% LIHC projects from the application of the Available Unit Rule under IRC §42(g)(2)(D).

And that’s where Congress’ theoretical conclusion meets reality. What happens when an owner unintentionally rents a unit to a nonqualified household? How is the Available Unit Rule applied if an owner does not know which units are over-income units?

### Applying the Available Unit Rule to 100% LIHC Projects

If an owner rents a unit to a nonqualified household, the unit ceases to be a low-income unit and does not qualify for the credit. The error is accounted for when determining the Applicable Fraction at the end of the taxable year.

For purposes of applying the Available Unit Rule *only*, the IRS will treat all households documented as initially income-qualified households as income-qualified as long as the owner *demonstrates due diligence* when completing the initial income certification. Therefore, the owner does not violate the Available Unit Rule when a unit is unintentionally rented to a nonqualified household.

## Compliance

The key to compliance with the Available Unit Rule when an owner unintentionally rents a unit to a nonqualified household is demonstrating to the IRS that “ordinary business care and prudence” was exercised when income qualifying new tenants. Specifically, initial tenant income certifications should be timely, accurate, and complete. Here are some basic questions an IRS examiner might ask when considering whether the owner’s tenants are income-qualified.

1. Have all the potential sources of income been identified?
2. Was income verified with third parties?
3. Are the methods for estimating income reasonable based on the facts?
4. Was the correct income limit used?
5. Was the computation correct?
6. Is the documentation sufficient?

Examiners routinely evaluate a taxpayer’s internal controls; i.e., the procedures the taxpayer has in place to safeguard business operations. A taxpayer’s due diligence is considered as part of that evaluation. Here are some of the questions an IRS examiner might ask.

1. What *oversight* does an owner provide a property manager? Is the property manager trained?
2. Are *written* procedures are in place for qualifying households? Who makes sure the procedures are followed? Is there a review process?
3. Does the owner use standardized forms?
4. Does the owner conduct independent internal audits?
5. What happens if noncompliance occurs?
6. Are households monitored for changes in family size?
7. How are the files maintained?

Here are three examples of fact patterns that *may* be challenged during an IRS audit.

1. Renting units larger than required for the household’s size. By itself, this is not noncompliance, but is of particular concern when the household size increases soon after the initial move in and the combined income

of the new household is over the income limit.

2. The household has insufficient income to pay the rent. Why would an owner rent a unit to someone who cannot pay the rent? Is there a source of income that hasn’t been disclosed?
3. Renting units to household with income from a sole proprietorship, but the household does not file tax returns. Keep in mind that tax returns *can* be used to document income, but is not required. However, if an individual is operating a business that should be reported on Schedule C, the taxpayer *must* file a tax return even if the business activity does not generate a tax liability.
4. Household has less income when reapplying for housing. The income limits are a bright line test for determining whether a household is income-qualified. If a household has been denied housing because the anticipated income is just a little more than the limit, the household may try to manipulate that determination by slightly altering the facts – fewer overtime hours, for example. Although the income limits can seem arbitrary and the stories sympathetic, owners need to carefully consider the underlying facts before renting a low-income unit to a household under these circumstances.

## Noncompliance by 100% LIHC Projects

The Available Unit Rule is violated when an owner fails to rent a unit to an income-qualified household *and* cannot demonstrate due diligence when making that determination. The Available Unit Rule is also violated if an owner of a 100% LHC project deliberately rents a unit as a market-rate rent. In such cases of egregious noncompliance, the IRS concludes that the owner disregarded the Available Unit Rule and that the building’s qualified basis is to zero; i.e., the building is not part of a qualified low-income project *at all times* during the 15-year compliance period under IRC §42(c)(2). No credit is allowable until such time as the owner can establish compliance with the Available Unit Rule. This may seem particularly harsh, but here’s the logic.

First, the status of the other supposed low-income units is unknown; i.e., how many units are over-income units?

Second, if an owner cannot demonstrate due diligence, it is our experience that the noncompliance is not limited to just one unit.

Third, the owner must establish continuous compliance. IRS audits may be conducted as long as four years after the close of the tax year. The IRS allows taxpayer to reconstruct records, but completing tenant income recertifications so long after the fact is neither practical nor reliable.

#### Example 1

An owner of a 100% LIHC project can demonstrate due diligence and the tenant file provides sufficient documentation, but it is later determined during an IRS audit that one household was *not income*-qualified at the time the household moved into the unit.

The Applicable Fraction will be recomputed and the allowable credit for the year will be less. The taxpayer is also subject to the credit recapture rules under IRC 42(j). However, the IRS will not make a determination that the taxpayer violated the Available Unit Rule.

#### Example 2

An owner of a 100% LIHC project failed to rent a vacant unit as a rent-restricted unit; i.e., a unit is rented as a market rate unit.

The unit ceases being a low-income unit and since the owner disregarded the Available Unit Rule, the building's qualified basis is reduced to zero unless the owner can document *continuous* compliance with the Available Unit Rule. The taxpayer is also subject to the credit recapture rules under IRC §42(j).

#### Questions and Answers

Q1: Is the new law optional? No, the new rule automatically applies to all 100% LIHC projects.

Q2: How do you identify a project? Each low-income building is a separate project unless the owner, on Form 8609 line 8b, elected to treat the building as part of a multi-building project.

Q3: Does the new law apply to tax-exempt bond projects? Yes, but only if the project also has IRC §42 credits under IRC §42(h)(4).

Q4: Can a household transfer between buildings within the same 100% LIHC project? Yes, since the owner does not know which, if any of the units are over-income, the IRS will allow a household to transfer between LIHC buildings.

Q5: If an owner discovers that a household had income in excess of the limit at move-in, what should an owner do? Owner should continue to address the problem as they have in the past.

Q6: Can a 100% LIHC project switch to a mixed-use project? Yes, but to avoid noncompliance with the Available Unit Rule, 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 will reduce the allowable credit and is a credit recapture event under IRC §42(j). For more information, see LIHC Newsletter #20.

Q7: Can a mixed-use project switch to a 100% LIHC project? For some taxpayers, the savings associated with the income recertification exception are far greater than the additional rent generated by the market-rate units.

Yes, but the amount of allowable credit does not increase based on the increase in Applicable Fraction. The maximum allowable credit was fixed at the time of allocation.

Q8: Are owners who received a waiver of the annual income recertifications under IRC §42(g)(8)(B) still subject to the terms of the waiver? Well....technically yes. Congress did not repeal this particular paragraph. However, for all practical purposes, the new exception under IRC §142(d)(2) has subsumed the IRC §42(g)(8)(B) waiver. However, state agencies do not need to technically revoke the waivers.

Q9: Does the exception apply for other federal programs?

The exception is only applicable for IRC §42 purposes only. An owner will continue to be subject to the requirements for other programs. However, owners will no longer need to "merge" two sets of potentially contradictory requirements. Also, the recertifications

completed for other programs will be disregarded for IRC §42 purposes. All owners of 100% LIHC projects will be treated equally. However, the records may be sufficient if documentation must be reconstructed.

#### State Housing Credit Agency Requirements

State housing credit agencies have authority to impose additional requirements upon IRC §42 projects. For example, a state agency may require a one-time income recertification after the first year of occupancy. In my discussions with the state agencies considering placing such restrictions on a project owner, the state agencies (1) have little confidence that owners can consistently identify income-qualified households without frequent technical errors, or (2) that owners are willing to provide sufficient due diligence. This is a perception that owners will need to address individually and collectively. In other cases, the state agency is also providing financing and, as part of their own internal controls and due diligence, wants to ensure 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 is not a reportable noncompliance event on Form 8823.

#### Student Status

A unit occupied by a household composed entirely of full-time students does not qualify as a low-income unit unless that household meets one of the exceptions under IRC §42(i)(3)(D). Up until now, the annual tenant income recertification also included consideration of the household's student status.

There is no separate student status certification requirement under the Code or regulations, but the student status impact units' status as "low-income" unit. Further, owners must demonstrate "continual" compliance with IRC §42 requirements. For the moment, owners should follow their state agency's requirements or use procedures similar to those used for the annual tenant income recertification to determine the unit's student status until the IRS can provide instructions in the Guide for Completing Form 8823. Self-certification is sufficient; third-party

verification is not required and is at the owner's discretion.

#### Conclusion

While the new exception may seem like a radical change, the IRS focus has *always* been on the initially income certification. For more information, please refer to Newsletters #20, 21 and 26.

### **Military Basic Housing Allowances**

As a general rule, military basic housing allowances are included in the computation of a household's income. However, under section 3005(a) of the Housing Assistance Act of 2008, IRC §142(d)(2)(B)(ii) has been amended to *exclude* military basic housing allowances from the computation if the low-income building is located in any county, or adjacent county, in which a *qualified* military installation is located. The new rule applies to certifications completed after July 30, 2008 and before January 1, 2012.

The IRS has released, in Notice 2008-79, a list of qualifying military bases:

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

The list is not meant to be all inclusive and any qualified military installation which satisfies the requirements of IRC §142(d)(2)(B)(iii)(1) is eligible to receive similar treatment regardless of its failure to be included in Notice 2008-79 or any subsequent updates. The owner is responsible for documenting that the exception under §142(d)(2)(B)(ii) is applicable.

### **Subscribing to the LIHC Newsletter**

The LIHC Newsletter is distributed free of charge through e-mail. If you would like to subscribe, just contact Grace Robertson at [Grace.F.Robertson@irs.gov](mailto:Grace.F.Robertson@irs.gov).

## Administrative Reminders

### Expanding Audits, Project/Tracking Code:

All LIHC cases should include Project Code 0670 and ERCS Tracking Code 9812. If the audit is expanded to include additional years or related taxpayers, the additional returns should also carry the LIHC project code and tracking code designation.

**Form 5344, Revenue Protection:** The Examination Closing Record, Form 5344, contains four blocks of information to account for adjustments that reduce a credit carryforward. Blocks 46 through 47 identify the type of credit and the extent of any adjustment made. See IRM 4.4.12.4(58) and (59) for instructions.

**Surveying LIHC Tax Returns:** If you believe it is appropriate to survey an LIHC return, please fax Form 1900 to Grace Robertson, at 202-283-7008, for signature approval.

## ♪ Grace Notes ♪

*There's a bricked in flower box about 10 feet long and 4 feet high by the front door of my home. This year I planted Marigolds, which have round flowers in harvest shades of yellow and orange. I call my favorite the "turtle" Marigold because each orange petal is trimmed around the edges in a deep burnt brownish-orange, and when I look straight down at the flower, the layered petals remind me of a turtle's shell.*

*Marigolds are easy to care for -just water on a frequent and regular basis, and take off the spent blossoms. I particularly like doing this because the smell brings back pleasant memories of my mother's garden and, if you snap it off just right between the stem and base of the flower, you hear a crisp little snap as the flower cleanly breaks off. The process is called "dead-heading,"*

*Deadheading takes a little practice and a careful consideration of each individual flower. There will be some flowers that are obviously dried and shriveled, but you also want to snap*

*off the flowers that still look pretty good, but are wilting a little so that the plant won't waste more energy on a flower that is dying off anyway. It just takes a little patience.*

*Deadheading not only keeps the flower bed looking nice, but has a most interesting consequence. The more you deadhead the old flowers, the more the plant works at creating new buds. By the end of the summer, the tiny little Marigolds I planted last spring with plenty of space in between are an interwoven mass of brilliant gorgeousness. The most pleasant part of the drive home around the beltway is parking in the driveway for a moment to enjoy the colors reflected in the late afternoon sun.*

*I must admit, however, that reading through the new law for the first time wasn't nearly as relaxing. Yellow highlighter and red pen in hand, I pondered the implementation dates, twisted my brain around the double negatives, and carefully counted all the zeros with my fingers....then I got to section 3003(g), the title of which is "Repeal of Deadwood" and just smiled, took a deep breath....Congress is just "deadheading" IRC §42. Well, that's how I've come to think about the new law.*

*Since its original enactment way back in 1986, IRC §42 as been amended and tweaked several times, but this time, Congress has carefully considered each individual requirement. There are some requirements that have obviously outlived their usefulness, and there are other rules, given how the program has evolved over the last 22 year, that are no longer relevant. And getting rid of the deadwood has also given Congress room to adapt the program to meet current needs.*

*The challenge for us will be to cleanly break off the deadwood and seamlessly weave the new requirements into the program.*

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