IRC §42, Low-Income Housing Credit - Part IV Applicable Fraction

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Note: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

- Chapter 12 Applicable Fraction
  - Introduction
  - Topics.
    - Additional Resources
  - Law
    - Applicable Fraction Defined
    - Bright Line Test
    - Special Rule for the First Year of the Credit Period
    - Acquired and Rehabilitated Buildings
    - Owner-Occupied Buildings
  - Income-Qualified Households
    - Area Median Gross Income (AMGI) Defined
    - Alternative Income Limits
    - Determining Income Limits Before 2009
    - Determining Income Limits After 2008
    - HERA Special Income Limits
    - Reliance on HUD Income Limits
    - Household Defined
    - Household Income Defined
    - Increases in Household Size
    - Decreases in Family Size
    - Deep Rent Skewing
    - Qualified Low-Income Student Households
    - Units Occupied by On-Site Managers, Maintenance Personnel, and Security Guards
    - Emergency Housing Relief
    - Documenting Qualified Low-Income Households
    - Additional Resources
    - Audit Technique #1: Evaluate Internal Controls
    - Audit Technique #2: Reviewing Tenant Files
    - High Risk of Error
    - Audit Technique #3: First Year of the Credit Period
    - Audit Technique #4: 40-50 Rule
    - Audit Technique #5: Deep Rent Skewing

        - Audit Technique #6: Units Occupied by On-Site Managers, Maintenance Personnel and Security Guards
    - Rent Restrictions
        - Rent-Restricted Units, Gross Rent, and Imputed Income Limits
        - Assistance Provided Under the HOME Investment Partnership Act or NAHASDA
        - Deep Rent Skewing
        - Rural Development Assistance
        - Section 8 or Comparable Rental Assistance
        - Household Pays Towards Purchase of the Low-Income Unit
        - Utility Allowance
        - Provision of Services in Addition to Housing
        - Supportive Services
        - Common Areas
        - Determining Whether Units are Rent-Restricted
        - Additional Resources
        - Audit Technique #1: Internal Controls and Taxpayer Interview
        - Audit Technique #2: Review Tenant Leases Rent Rolls
        - Audit Technique #3: Compare Rents Paid to the Maximum Gross Rent
        - Audit Technique #4: Reconcile Tenant Records to Rent Rolls
        - Audit Technique #5: Complete Minimum Income Probes
    - Suitability for Occupancy
        - Law
        - Annual Certifications
        - State Agency Inspections
        - Documentation Requirement
        - Casualty Losses
        - Casualty Losses in Federally Declared Disaster Areas
        - Additional Resources
        - Audit Technique #1: Taxpayer's Annual Certification
        - Audit Technique #2: Vacant Units
        - Audit Technique #3: Tour the Project Site
        - Audit Technique #4: State Agency Reports Noncompliance
        - Audit Technique #5: Documentary Evidence of Compliance
        - Evaluating Evidence
        - Local Code v. UPCS
        - Noncompliance was Minor or Corrected Within Reasonable Period
        - Portion of Annual Credit Should Be Allowed in the Event of a Casualty Event
    - Available Unit Rule
        - Law
        - Annual Income Recertifications
        - Treas. Reg. §1.42-15
        - Additional Resources
        - Key Concepts
        - Audit Techniques: Mixed Use Buildings

    - Audit Techniques: 100% Low-Income Buildings
  - Vacant Unit Rule
    - Legislative History
    - Vacant Unit Available for Rent
    - Treas. Reg. §1.42-5
    - Rev. Rul. 2004-82: Reasonable Attempts
    - Additional Resources
    - Available Unit Rule has Precedence
    - Audit Techniques: Mixed Use Buildings
    - Audit Techniques: 100% Low-Income Buildings
  - General Public Use & Transient Use
    - Law
    - Fair Housing Noncompliance
    - Other Noncompliance Conduct
    - IRC §42(g)(9)
    - Transient Use
    - Provision of Services
    - Condition of Credit Allocation
    - Additional Fact Patterns
    - Noncompliance Issues
    - Audit Techniques
  - On-Going Business Activity
    - Law
    - Fact Patterns
    - Audit Techniques
  - Computing the Applicable Fraction
    - Determined at the End of the Taxable Year
    - Unit Fraction or Floor Space Fraction
    - First Year of the 10-Year Credit Period: New Construction
    - First Year of the 10-Year Credit Period: Acquisition and Rehabilitation of an Occupied Building
    - Year 11 of the 15-Year Compliance Period
    - Additions to Qualified Basis
    - Common Computation Errors
  - Minimum Set-Aside
    - Law
    - Making the Election
    - Project Defined
    - Project Identified
    - Date for Meeting Requirement
    - Continuous Compliance
    - Waiver of De Minimis Errors
    - Testing for the Minimum Set-Aside Requirement
    - Failure to Satisfy Minimum Set-Aside Requirement
  - Deep Rent Skewing
    - Deep Rent Skewing

        - Relationship to Minimum Set-Aside
        - Failure to Satisfy Deep Rent Skewing Election
    - Summary

Chapter 12 Applicable Fraction

Introduction

The applicable fraction is the percentage of rental units in a building that qualify as low-income units. The taxpayer reports the applicable fraction on Form 8609-A, Annual Statement for Low-Income Housing Credit, line 2.

To qualify as a low-income unit under IRC §42(i) (3), a residential rental unit must meet three basic requirements:

- the unit must be occupied by an income-qualified household,
- the rent must be restricted, and
- the unit must be suitable for occupancy.

In addition, there are four IRC §42 requirements that affect the applicable fraction and may impact compliance on a unit-by-unit basis, at the building level, or the entire project: the Available Unit Rule, the Vacant Unit Rule, the General Public Use Requirement, and the Transient Use Rule. Consideration is also given to whether the low-income units are placed in service and whether the building is depreciable. Finally, the taxpayer must provide a minimum amount of low-income housing, determined at the project level.

Topics

- Law
- Income-Qualified Households
- Rent Restrictions
- Suitability for Occupancy
- Available Unit Rule
- Vacant Unit Rule
- General Public Use
- Transient Use
- On-Going Business Activity
- Computing the Applicable Fraction
- Minimum Set-Aside
- Deep Rent Skewing
- Summary

Additional Resources

The IRS maintains a Guide for Completing Form 8823 to assist state agencies in completing the compliance monitoring responsibilities and report noncompliance on Form 8823 consistently. References to specific chapters of the "Form 8823 Guide" are included in this chapter as a source of additional information. The Guide is available on irs.gov or by contacting the IRC §42 program analyst.

Law

Applicable Fraction Defined

Under IRC §42(c) (1) (B), the applicable fraction is the smaller of the unit fraction or the floor space fraction.

- IRC §42(c) (1) (C) defines "unit fraction" as 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 in such building.
- IRC §42(c)(1)(D) defines "floor space fraction" as the fraction, the numerator of which is the total floor space of the low-income units in such building, and the denominator of which is the total floor space of the residential rental units. Floor space includes the entire footprint of the unit, including closets within the unit and balconies attached to the unit for the sole use of the tenants occupying the unit.

The applicable fraction is carried out four decimal places on Form 8609-A, line 2.

Bright Line Test

Under IRC §42(c) (1) (A), the applicable fraction is determined on the last day of the taxable year.

Special Rule for the First Year of the Credit Period

Under IRC §42(f) (2) (A), there is a special rule for computing the applicable fraction for the first year of the credit period. The numerator is the sum of the applicable fractions determined as of the close of each full month of the taxable year that the building was placed in service, and the denominator is 12. The result is an "averaged" applicable fraction that accounts for the period of time during the taxable year that the units were not placed in service or available for occupancy. Examples are provided later in this chapter.

Under IRC §42(f) (2) (B), any reduction in allowable credit for the first year of the credit period under IRC §42(f) (2) (A) is allowable in the eleventh year of the compliance period and is accounted for on Form 8609-A, line 17.

Acquired and Rehabilitated Buildings

If a building was acquired and then rehabilitated, there are two credit allocations and the taxpayer will file two Forms 8609-A with its tax return; one for the acquisition credit and another

for the rehabilitation credit. The taxpayer, however, is not required to determine two applicable fractions. Under IRC §42(e) (4) (B), the applicable fraction for the substantial rehabilitation credit is the same as the applicable fraction for the acquisition credit.

Owner-Occupied Buildings

Under IRC §42(i) (3) (C), for buildings with four or fewer residential units, no unit in the building is treated as a low-income unit if the units in the building are owned by:

- any individual who occupies a residential unit in such building, or
- any person who is related to such individual (as defined in IRC §42(d)(2)(D)(ii)); i.e., a person is related to any person if the related person bears a relationship to such person specified in IRC §§267(b) or 707(b)(1), or the related person and such person are engaged in trades or businesses under common control (within the meaning of IRC §52(a) and (b)).

However, under IRC §42(i) (3) (E), for owner-occupied buildings having four or fewer units eligible for the credit, IRC §42(i) (3) (C) does not apply to the acquisition or rehabilitation of a building pursuant to a development plan of action sponsored by a state or local government or a qualified nonprofit organization (as defined in IRC §42(h) (5) (C)). Under this exception, the applicable fraction cannot exceed 80% of the unit fraction and any unit which is not rented for 90 days or more is treated as occupied by the owner of the building as of the first day it is not rented.

Income-Qualified Households

Area Median Gross Income (AMGI) Defined

Under IRC §42(g)(1), the taxpayer elects to provide low-income housing for individuals whose incomes is either (1) 50% or less of AMGI or (2), 60% or less of AMGI. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10c.

Under §142(d)(2)(B), the AMGI and an individual's income are determined in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937. The determinations are adjusted for family size and are specific to the IRC §42 project's location. IRC §42(g) (4) applies §142(d) (2) (B) to IRC §42 projects.

Notice 88-80 explains that AMGI (adjusted for family size) and individuals' income for purposes of IRC §42(g)(1) are determined using HUD's definitions of income for section 8 purposes and will not be made by reference to items of income used in determining gross income for purposes of computing federal income tax liabilities. In CCA 201046014, Chief Counsel confirmed that:

> "..the published 50% or 60% income limitations for the HUD section 8 program should [be applied]…IRC §142(d) (2) (B) (i), through IRC §42(g) (4), controls income limits for IRC §42(g) (1) purposes. We read that section as Exam does that it is the Secretary of Treasury

(not the Secretary of HUD) that makes the determination of what income limitations control for IRC §42 purposes in a manner consistent with determinations of lower income limits under HUD section 8…Ultimately, the issue comes down to how one interprets the first sentence of IRC §142(d) (2) (B) (i), particularly the words "in a manner consistent with." We interpret this language, literally, to mean that the published HUD section 8 limits are used."

Alternative Income Limits

The National Nonmetropolitan Median Gross Income (NNMGI) is used instead of the AMGI, if:

- IRC §1400N(c) (4), Special Rule for Applying Income Tests, is applicable. The IRC §42 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); i.e., the term "nonmetropolitan area" means any county (or portion thereof) which is not within a metropolitan statistical area.
- IRC §42(i) (8) is applicable. The IRC §42 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 low-income building is financed with tax-exempt bonds. IRC §42(g) (8) is applicable to determinations made after July 30, 2008.

Under the terms of an extended use agreement, a taxpayer may agree to provide housing for tenant populations at income levels lower than identified in IRC §42(g). Nonperformance of such state imposed requirements is not noncompliance resulting in loss of credit.

Determining Income Limits Before 2009

The AMGI amounts are determined by HUD. For years before 2009, HUD published three income limits for its housing programs; 30% of AMGI, 50% of AMGI (very low income) and 80% of AMGI (low-income). Taxpayers electing to provide low-income housing for household with income at 50% of AMGI or less, could use HUD's AMGI determination for very low income (50%) without further adjustments. However, HUD did not provide income at 60% of AMGI. As explained in Rev. Rul. 89-24, if the taxpayer elected to provide low-income housing for house-holds with income at 60% or less than AMGI, the 50% AMGI value is multiplied by 120% to compute the 60% AMGI. The value is not rounded.

Determining Income Limits After 2008

Before 2009, HUD applied a general "hold harmless" policy when determining the income limits so that the income limits never decreased for any housing program relying on HUD's AMGI determinations.

In 2009, HUD began publishing separate income limits for 50% and 60% of AMGI for low-income housing provided under IRC §§ 42 and 142(d), which HUD refers to as "Multifamily Tax Subsidy Projects" (MTSP). It became necessary to separately determine income limits for MTSPs in order to apply a specific "hold harmless" rule under IRC §142(d)(2)(E) for calendar years after 2008 that is not applicable to income limits used for HUD's housing programs.

Effectively, the income limits used to determine whether a household is income qualified will never be less than the income limits the taxpayer initially used to determine whether a household was income-qualified. As a result:

- the instructions in Rev. Rul. 89-24 to compute 60% AMGI are no longer needed.
- the income limits used for HUD section 8 apply to IRC §42 projects placed in service after 2008 and the MTSP hold harmless rule apply.

For 2010 and later taxable years, "MTSP" income limits and AMGI are interchangeable terms.

HERA Special Income Limits

In areas where the income limits did not decrease in 2007 and 2008, the MTSP tables include a second set of income limits identified as "HERA Special 50%" and "HERA Special 60%." These income limits are applicable if the taxpayer relied on HUD's income limits in either 2007 or 2008.

- If the project was in service, or placed in service during 2007 or 2008, the taxpayer relied on HUD's income limits to determine whether household were income-qualified.
- The hold harmless rule is applied at the project level. Every low-income building is a separate project unless the taxpayer elects to include the building in a multi-building project as documented on Form 8609 line 8b.
- If the taxpayer has grouped the buildings into multiple multi-building projects, then the HERA special income limits will apply to the projects placed in service before 2009 and the regular MTSP income limits will apply to projects placed in service after 2008.
- If at least one building in the project was placed in service during 2007 or 2008, then all the buildings in the project are subject to the HERA Special 50% and 60% income limits.
- If a taxpayer relied on Rev. Proc. 2003-82 to qualify tenants before 2009, then the taxpayer relied upon the HUD income limits and the project is subject to the HERA special income limits even though the rehabilitation was not placed in service until after 2008.
- If the project is subject IRC §1400N(c)(4) because it was placed in service during 2007, is located in the Gulf Opportunity Zone, and is in a nonmetropolitan area as defined in IRC §42(d)(5)(B)(iv)(IV), then the HERA special income limits are not applicable. The taxpayer continues to use the NNMGI to determine the income limits.
- If the IRC §42 project is located in a rural area (as defined in section 520 of the Housing Act of 1949), then the taxpayer will use the greater of the HERA special income limits or the NNMGI.
- If a taxpayer placed an IRC §42 project in service in 2008, but did not begin the 10-year credit period until 2009, then the HERA special income limits should be used because the project was placed in service no later than 2008. Presumably, if the building and units are ready and available for occupancy in 2008, the taxpayer relied on HUD's income limits for 2008 to determine whether households are income-qualified and could rely upon the Rev. Proc. 2003-82 safe harbor to rent low-income units to income-qualified tenants before the beginning of the credit period.

- If the taxpayer is subject to the 40-50 rule under former IRC §42(i)(2)(E), then the MTSP income limits, AMGI, or the alternative HERA Special Income Limits should be used to determine the 50%. This rule is explained later in this chapter.
- The "HERA Special" income limits are applicable to the project for the entire extended use period under IRC §42(h) (6). However, if the taxpayer (or a subsequent owner) receives a new allocation of credit and begins a new credit period in the future, the taxpayer would use the normal MTSP income limits because the taxpayer did not rely upon HUD's income limits in either 2007 or 2008 for the new allocation.

Reliance on HUD Income Limits

A taxpayer may rely on HUD's income limits until 45 days after the IRS publishes notice of such change in the Internal Revenue Bulletin, or a new effective date is published by HUD in connection with revised income limits. See Rev. Rul. 94-57.

During the 45-day implementation period, the outdated and new income limits "overlap" and a taxpayer can use either the old or new income limits.

Example 1: A taxpayer placed a new low-income building in service in July of 2014 and started renting units using the 2014 income limits to determine whether households are income-qualified. 2015 will be the first year of the credit period. The 2015 income limits, released by HUD on December 1, 2014, are lower than the 2014 income limits. The 45-day implementation period is December 1, 2014 through January 14, 2015.

- All of the tenants determined to be income-qualified using the 2014 income limits before the beginning of the credit period on January 1, 2015, continue to be qualified low-income households. Further, for purposes of "testing" income at the beginning of the credit period under Rev. Proc. 2003-82, the taxpayer may rely on the 2014 income limits to determine whether the Available Unit Rule is applicable.
- Since the taxpayer relied upon the 2014 income limits to determine whether tenants are income-qualified, the 2014 income limits are the "base" year for purposes of the hold harmless rule under IRC §142(d)(2)(E)(i). The taxpayer may continue to qualify new tenants using the 2014 income limits.

For buildings placed in service during the 45-day implementation period, the taxpayer can choose which income limits to use for all purposes (including elections), and may choose which income limits to use (outdated or new) based on which provides the greater tax benefit.

Example 2: The 2015 income limits are released by HUD on December 1, 2014. The 45-day implementation period is December 1, 2014 through January 14, 2015. The 2015 income limits are lower than the 2014 income limits for the location of a building, which the taxpayer places in service on January 3, 2015. The taxpayer decides to use the higher 2014 income limits.

- Beginning January 3, 2015, the taxpayer may use the higher 2014 income limit to determine whether a household is income-qualified.

- Since the taxpayer initially relied upon the 2014 income limits to determine whether tenants are income-qualified, the 2014 income limits are the "base" year for purposes of the hold harmless rule under IRC §142(d)(2)(E)(i). The taxpayer can continue to use the 2014 income limits after January 14, 2015.

Household Defined

As a general rule, a "household" consists of all individuals residing in a unit. See Chapter 4 of the Guide for Completing Form 8823 for an in-depth discussion.

Household Income Defined

A household's income is determined using HUD's definitions of income rather than using the definition of income for computing federal income taxes. See Notice 88-80. Generally, income is based on wages, business activities, and the use of assets. Refer to Chapter 4 of the Guide for Completing Form 8823 for complete discussion.

Qualified Low-Income Household

To determine whether a household is a qualified low-income household, the combined anticipated annual income of all occupants of the unit, whether or not legally related, is compared to the appropriate percentage of AMGI for a family with the same number of members. The household is a qualified low-income household if the household's income is equal to or less than the income limit for a family of equal size at the time the household moves into the unit.

Increases in Household Size

A household's size may increase during tenancy.

- For mixed-use projects, with both market rate and low-income units, a new tenant's income is added to the income disclosed on the existing household's most recent tenant income certification, which is For mixed-use projects, with both market rate and low-income units, a new tenant's income is added to the income disclosed on the existing household's most recent tenant income certification, which is completed annually. The new household continues to be income qualified for purposes of the Available Unit Rule under IRC §42(g) (2) (D), which will be discussed later in this chapter.
- For a 100% low-income project, the new tenant's income is added to the income disclosed on the existing household's original income certification because, beginning July 31, 2008, a taxpayer is no longer required to complete annual income certifications for 100% low-income project. The same rule applies for tax years ending before July 31, 2008, if the taxpayer received a waiver of the income recertification requirement under Rev. Proc. 2004-38 or Rev. Proc. 94-64. Otherwise, the treatment for mixed-use projects described in (1) above is applicable completed annually. The new household continues to be income qualified for purposes of the Available Unit Rule under IRC §42 (g) (2) (D), which will be discussed later in this chapter.

- For a 100% low-income project, the new tenant's income is added to the income disclosed on the existing household's original income certification because, beginning July 31, 2008, a taxpayer is no longer required to complete annual income certifications for 100% low-income project. The same rule applies for tax years ending before July 31, 2008, if the taxpayer received a waiver of the income recertification requirement under Rev. Proc. 2004-38 or Rev. Proc. 94-64. Otherwise, the treatment for mixed-use projects described in (1) above is applicable.

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:

- 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, or
- for 100% low-income buildings, the remaining tenants were independently income qualified at the time they moved into the unit.

Decreases in Family Size

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

40-50 Rule: Assistance Provided Under the HOME Investment Partnership Act or NAHASDA

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% present value percentage. Former IRC §42(i) (2) (A) provided 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 any below market federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation, such as assistance provided under the HOME Investment Partnership Act or the Native American Housing and Assistance and Self-Determination Act of 1996.

For buildings placed in service on or before July 30, 2008, former IRC §42(i) (2) (E) (i) generally provided that assistance provided under either Act with respect to any building will not be treated as a below market federal loan if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of the AMGI. This is commonly referred to as the 40-50 rule.

Key points:

- Buildings subject to this rule are identified on Form 8609, line 6f.
- This requirement must be satisfied each taxable year of the extended use period described in IRC §42(h) (6) (D). The determination is based on the household occupying the unit at the end of the taxable year, or the last tenant if the unit is vacant and otherwise qualifying.
- If a taxpayer fails to satisfy this requirement, then the applicable percentage for the year of the failure and all subsequent years of the compliance period is limited to the 30% present value credit under IRC §42(b)(1)(B)(ii). See Chapter 14.
- 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.

Refer to Rev. Rul. 2004-82, Section D, and Chapter 9 of the Guide for Completing Form 8823 for additional discussion.

Deep Rent Skewing

Under IRC §142(d) (4) (B) (i), a taxpayer can elect to provide housing to households with incomes of 40% or less of AMGI. The election is made on Form 8609, Low-Income Housing Certification, line 10d. The project qualifies if 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI. Taxpayer is also subject to specific rent limitations which will be discussed later in this chapter.

Qualified Low-Income Student Households

Residential rental units occupied by households composed entirely of full-time students are not considered low-income units unless at least one member of the household meets one of the exceptions under IRC §42(i) (3) (D), which provides that a unit shall not fail to be treated as a low-income unit merely because it is occupied:

- by an individual who is:
  - a student receiving assistance under Title IV of the Social Security Act,
  - 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 (as added by the Housing Assistance Tax Act of 2008, and applicable to determinations made after July 30, 2008), or
  - 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.
- entirely by full-time students if such students are
  - 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 or
  - married and file a joint return. A married couple that is entitled to file a joint tax return, but has not filed one, satisfies the exception.

A unit is not a low-income unit if 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). A unit is also considered nonqualifying if the taxpayer failed to verify the household's student status at the time of move in and on a continuous basis throughout the 15-year compliance period.

Refer to Chapter 17 of the Guide for Completing Form 8823 for addition discussion.

Units Occupied by On-Site Managers, Maintenance Personnel, and Security Guards

Treas. Reg. §1.103-8(b) (4) states that facilities functionally related and subordinate to residential rental units are considered residential rental property. Treas. Reg. §1.103-8(b(4)(iii) provides that facilities that are functionally related and subordinate to residential rental units include facilities for use of the tenants and other facilities reasonably required for the project. The examples specified in the regulation include units for resident managers or maintenance personnel. Therefore, units occupied by resident managers or maintenance personnel are residential rental property for purposes of IRC §42.

Rev. Rul. 92-61 clarifies that (1) the cost of units occupied by full-time on-site property managers and maintenance personnel is included in the building's eligible basis. However, the units are "facilities" rather than "units" and are excluded from both numerator and denominator for purposes of determining a building's applicable fraction. Rev. Rul. 2004-82, Q&A #1, applies the same principle to include units occupied by full-time security officers.

Emergency Housing Relief

In the event of a federally declared disaster, a taxpayer may choose to provide emergency housing for displaced persons. If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act:

- on or after July 2, 2007, and before August 21, 2014, see Rev. Proc. 2007-54.
- on or after August 21, 2014, see Rev. Proc. 2014-49.

Documenting Qualified Low-Income Households

Under Treas. Reg. §1.42-5(b)(1)(vii), owners of IRC §42 projects must keep "documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation)." The regulation makes an exception for tenant receiving housing assistance payments under Section 8. The requirement is satisfied if the public housing authority provides a statement to the owner stating that the tenant's income doesn't exceed the income limit.

Taxpayers must retain these records for at least 6 years after the due date (with extensions) for filing the federal income tax return for the tax 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 building's 15-compliance period.

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 (TIC) and supporting documentation should include the following documentation:

- Application/Income and Asset Questionnaire - A document completed by the household that the taxpayer uses to gather information about the household, such as household composition, income, income from assets, and student status.
- Verification of Income and Assets - All sources of income and assets must be verified to establish move-in eligibility. The preferred verification method is through third party contact, and where applicable, written documentation such as copies of check stubs, Forms W-2, or self-certifications. The verification should be no older than 120 days before the household moved in. Under Rev. Proc. 94-65, a tenant (or prospective tenant) may provide a signed, sworn statement that includes (1) that the net family assets do not exceed $ 5,000, and (2) the tenant's annual income from the family assets. Taxpayers may not rely on a low-income tenant's signed, sworn statement if a reasonable person would conclude that the tenant's income is higher than the tenant has represented. In such cases, the taxpayer must obtain other documentation to satisfy the documentation requirements. See Treas. Reg. §1.42-5(b) (1) (vii).
- Student Status - Depending upon the student status of each household member, student verification may be required.
- 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.

As explained in Rev. Rul. 2004-82, Q&A #11, a taxpayer may use an electronic storage system to maintain tenant files if it satisfies the requirements of Rev. Proc. 97-22.

Additional Resources

Refer to Chapters of 4, 5, 9, and 17 of the Guide for Completing Form 8823 for additional information.

Audit Technique #1: Evaluate Internal Controls

First, the taxpayer's internal controls and efforts to ensure that tenants are income-qualified at move-in should be analyzed to determine if a material control risk existed and may have allowed nonqualifying tenants to occupy low-income units during the tax year under audit.

- As part of the interview with the taxpayer, determine who prepares the tenant files, how the files are maintained, and where the files are stored. Also determine whether the taxpayer is subject to the 40-50 rule or elected deep rent skewing.
- Review the taxpayer's internal controls for ensuring that new tenants are qualified low-income households at move-in. Does the taxpayer train employees? Does the taxpayer review tenant files? Is an independent property management company operating the project? Is the taxpayer frequently changing management companies? Does the taxpayer conduct internal audits?
- Review the on-site property manager's procedures for qualifying new tenants. Determine how the property manager conducts interviews, contacts third parties for verification, and maintains the files. How does the property manager handle certain fact patterns; e.g., what happens when the total anticipated income for the upcoming year is less than what it will cost to reside in the unit or a one-person household requests a three bedroom unit? How is the tenant's student status determined? How does the property manager know when it is time for the annual recertification (if required)?
- Consider the property manager's internal controls. Does the manager use a standardized income certification document? Who reviews the property manager's work? Is the staff trained?
- Contact the state housing agency and request information about any tenant file reviews the agency may have conducted during the tax year under audit.

Based on the analysis of the taxpayer's internal controls, consider:

- Are the taxpayer's internal controls sufficient to minimize to opportunity for systemic misstatements of tenant income?
- Can the tenant files be relied on?
- Do some tenants represent a higher risk of not being qualified than others? For example, is there a significant risk that nonqualifying full-time student households are occupying the units?

The results of the analysis will determine the extent to which tenant files should be reviewed and the depth of that review.

Audit Technique #2: Reviewing Tenant Files

The taxpayer should provide documentation for the income limits used to identify qualified tenants throughout the year. Since the income limits are updated annually by HUD, the income limits may change during the year. The state housing agency can be contacted for confirmation if needed.

Sampling

The initial sample of units can be selected by reviewing the rent roles. A statically valid sample may be appropriate for larger housing projects, or alternatively, judgment may be used to select a representative sample of units.

If the state housing agency reviewed the tenant files for the year under audit, the results can be relied upon for examination purposes, unless otherwise established, but only for the tenant files actually reviewed; i.e., the results cannot be projected to all the low-income units.

For example, a 100% low-income building consists of 50 units. The state agency reviews tenant files for 10 of the units and determined that three of the units were occupied by nonqualifying households. The IRS can rely on the state agency's determination for the 10 units, but cannot conclude that 30% of all of the units in the building were occupied by nonqualifying tenants solely because 30% of the units sampled by the state agency were occupied by nonqualified tenants.

High Risk of Error

Units representing a higher risk for noncompliance should be reviewed. Examples include:

- The number of individuals in the household is less than the number of bedrooms in the unit. Why did the tenant want or need more bedrooms? How does the tenant pay the higher rent for the larger unit? Is the household larger than reported?
- The household size increased during the year. Why was an additional member added to the household? How long had the original household lived in the unit before additional members were added. Did the income of the resulting new household exceed the income limit? If the taxpayer or tenants manipulated the income limits, then the unit should not be treated as a low-income unit as of the date the household originally occupied the unit.
- The tenant transferred to another unit. Why did the tenant transfer to another unit? Did the tenant move to another unit in the same building, or a unit in a different building? When a household moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit and the vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident. See Treas. Reg. §1.42-15(d). Under Rev. Rul. 2004-82, Q&A #8, a similar rule applies to households 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.

Contemporaneously Prepared Documentation

Were the files prepared in a timely manner and concurrent to the events? Most likely, there will be some standardization between files (e.g.; use of forms) and individual notations explaining unusual circumstances.

Evaluating Tenant Files

The primary purpose of the tenant file review is to determine whether the taxpayer reasonably estimated the income the household would receive in the year following the certification. The methods for estimating income includes (1) annualizing current sources of income, (2) identifying specific amounts from specific sources, (3) anticipated changes in income, and (4)

using the prior year's income when the household's circumstances have not changed or are not expected to change.

Consider whether the household was income qualified when the household initially moved into the unit.

- Did the tenant disclose all taxable sources of income? Compare the information in the files with IRS records of income reported on the tax return; e.g., wages, alimony received, etc. Generally, if taxable income reported on the tax return is more than the income disclosed in the file, further inquiry is required.
- Did the tenant disclose all sources of nontaxable income? Consider whether likely sources of nontaxable includes have been identified. For example, if the tenant is a senior and retired, it is reasonable to expect that is tenant was receiving income from social security, an insurance annuity, or another retirement plan.
- Is the tenant's income as reported in the file sufficient to pay the rent and provide a reasonable amount for basic living expenses? If not, are there additional sources of funds that have not been disclosed? Does the tenant have a roommate, whose income should be included in the determination? Additional household members might be identified by securing a list of taxpayers who filed tax returns using the IRC §42 project's address as their residence and comparing the list of names to the rent records.
- Is the income accurately reported and summarized?

Specific units may be identified as not occupied by income-qualified households. Units may be determined to be nonqualifying units as of the end of the taxable year, if, for example:

- the taxpayer cannot provide documentation that the household was income-qualified,
- the taxpayer did not make reasonable attempt to identify and verify all sources of income,
- the taxpayer did not accurately determine the household's income, or
- the household is a nonqualifying student household.

Based on the results, consider whether the review should be expanded to include more (or all) of the low-income units.

Audit Technique #3: First Year of the Credit Period

If the first year of the credit period is under audit, additional information is needed from the tenant files to compute the applicable fraction under IRC §42(f) (2) (A) for each full month of the taxable year that the building was placed in service, which will be discussed later.

- Determine when the building containing the low-income units was placed in service.
- Determine the month that the low-income units were first occupied be an income-qualified tenant.

Audit Technique #4: 40-50 Rule

If the taxpayer is subject to the 40-50 Rule, follow the guideline above for Audit Technique #2, except review the tenant files for all the units rented to households with income at or below 50% of AMGI to confirm that at least 40% of all the units are occupied by households who had income at or below 50% AMGI at the time the household moved in. See Chapter 14 for additional information.

Audit Technique #5: Deep Rent Skewing

If the taxpayer is subject to the deep rent skewing requirement, follow the guideline above for Audit Technique #2, except review the tenant files for all the units rented to households with income at or below 40% of AMGI to confirm that at least 15% of all the units are occupied by households who had income at or below 40% AMGI at the time the household moved in.

Audit Technique #6: Units Occupied by On-Site Managers, Maintenance Personnel and Security Guards

A unit occupied by an on-site manager, maintenance personnel, or security guard should be treated as a facility reasonably required for the project and not treated as a residential rental unit if:

- The services provided are required, given the character and size of the project,
- The resident manager, maintenance personnel, or security officer is providing services required for the project that could not be properly provided unless the employee resides on the project premises. Revenue Rulings 92-61 and 2004-82, Q&A #1, presume that property managers, maintenance personnel, and security officers could not provide their service properly without occupying a unit on the premises, and
- The resident manager, maintenance personnel, or security officer is working full time at the site.

The following fact patterns are not relevant to the determination:

1. Charging the resident managers, maintenance personnel, or security officers rent, utilities, or both for units in a qualified low-income building does not make the units residential rental units and not facilities reasonably required for the project under Treas. Reg. §1.103-8(b)(4)(iii). See Chief Counsel Advice dated June 2, 2014 (POSTN-111812-14).
2. The unit designated for a resident manager, maintenance personnel, or security officer can vary; e.g., to accommodate the resident manager's family size. When the designation is "switched" the units' character also switches. For example, a vacant unit (A), last occupied by a nonqualified tenant, is "switched" with a unit (B) currently occupied by a resident manager to accommodate the resident manager's family size. Unit A is treated as a facility required for the project and unit B is treated as a vacant residential rental unit not qualifying for the credit (included in the denominator of the applicable fraction, but not the numerator).
3. A unit designated for a resident manager, maintenance personnel, or security officer may be converted to a residential rental unit, in which case the unit will be included in the denominator of the applicable fraction for that year. The unit's status will be its status

immediately before being occupied by a resident manager, maintenance personnel, or security officer.

CAUTION: #2 and #3 above will not apply if the unit occupied by the resident manager, maintenance personnel, or security office is a single-family home. IRC §42 credit will not be allocated to the designated home and, therefore, it cannot be "switched" as described above.

Possible noncompliance issues include:

- The unit is occupied by an employee that does not provide services required by the project. For example, the employee may be providing services for the building's tenants. See Treas. Reg. §1.42-11 for additional information about the provision of services in addition to housing.
- The unit is temporarily occupied by an employee not providing services specific to the project. For example, an independent property management company operates ten IRC §42 projects within a 50-mile radius. To provide proper supervision for the managers living at the ten projects, a supervisor makes quarterly visits to each site. The supervisor travels from out of town, stays at the IRC §42 project nearest the airport in a unit held vacant for the supervisor, and then travels each day by car to a different project. Although the supervisor may be a full-time employee for the property management company, the supervisor is not working "full-time" on the premises where the employee has temporary lodgings.
- The unit is occupied by an employee providing services at multiple IRC §42 project. For example, a taxpayer contracts with an independent property management company to operate its IRC §42 project on a day-to-day basis. The management company has contracts with three taxpayers owning IRC §42 projects in close proximity and directs the property manager occupying a unit at the taxpayer's project to manage all three projects. The property manager generally visits each site daily. The unit is not a "facility reasonably required for the project because the employee is not working full-time on the premises where the employee is occupying a unit. It may also be argued that it is not necessary to live on the project's premises to perform the services.

In the event of noncompliance, the unit is considered a residential rental unit that is included in the denominator of the applicable fraction. The unit is not included in the applicable fraction's numerator, even if the employee is an income-qualified tenant, because a residential rental unit provided by an employer for its employees is not for use by the general public and is not eligible for credit under IRC §42. See Treas. Reg. §1.42-9(b).

Rent Restrictions

Rent-Restricted Units, Gross Rent, and Imputed Income Limits

To qualify as a low-income unit, the rent must be restricted as described in IRC §42(g) (2). In general, a unit is rent-restricted if the gross rent does not exceed 30% of the imputed income limit applicable to the unit.

Under IRC §42(g)(2)(A), the imputed income limit for any period 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. As noted earlier, HUD applied a "hold harmless policy" when determining income limits so the income limits never decreased for any housing program relying on HUD's AMGI determinations for years before 2009. Beginning with 2009, HUD began publishing separate income limits for IRC §§ 42 and 142(d) project and now applies a "hold harmless" rule under IRC §142(d) (2) (E).

The imputed income limit is based on the number of bedrooms in the unit. Under IRC §42(g) (2) (C), the imputed income limit is the income limit which would apply to the household if the number of individuals occupying the unit were:

- In the case of a unit which does not have a separate bedroom, 1 individual.
- In the case of a unit which has 1 or more separate bedrooms, 1.5 individuals for each separate bedroom.

For IRC §42 projects financed with tax-exempt bonds under IRC §142(d), the imputed income limits under IRC §42(g) (2) are used rather than the applicable income limitations under IRC §142(d) (4) (B) (ii).

Assistance Provided Under the HOME Investment Partnership Act or NAHASDA

For buildings placed in service on or before July 30, 2008, former IRC §42(i)(2)(E)(i) generally provided 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% or more of the residential units in the building are occupied by individuals whose income is 50% or less of the Average Median Gross Income (AMGI).

The gross rent, however, for all the low-income units in the building, including the units used to satisfy the rules under former 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. Therefore, if a household qualifies with income of less than or equal to 50% of the AMGI, the gross rent may be determined using 60% of AMGI if the taxpayer elected the 40-60 minimum set-aside under IRC §42(g)(1).

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.

If the taxpayer fails this test, the applicable percentage is reduced from the 70% value to the 30% value. See Chapter 14.

Deep Rent Skewing

Under IRC §142(d)(4)(B)(i), a project qualifies as a "deep rent skewed" project if 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI

and the taxpayer elects to treat the project as a deep rent skewed project. The election is made on Form 8609, Line 10d.

- The gross rent with respect to each low-income unit in the project does not exceed 30% of the applicable income limit which applies to the individuals occupying the unit, and
- The gross rent with respect to each low-income unit in the project may not exceed half of the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

Rural Development Assistance

Gross rent for projects with Rural Development assistance are determined using Rural Development rules and may exceed the IRC §42 gross rent limit. Under IRC §42(g)(2)(B)(iv), gross rent does not include any rental payment to the taxpayer to the extent the taxpayer pays an equivalent amount to the USDA Rural Housing Service (formerly known as the Farmer's Home Administration) under section 515 of the Housing Act of 1949. In other words, as long as the taxpayer pays Rural Development any rent amount paid in excess of the IRC §42 rent limit for a unit, the IRC §42 rent restriction requirements are satisfied for the unit.

Section 8 or Comparable Rental Assistance

Under IRC §42(g) (2) (B) (i), gross rent is determined based on the amount paid by the tenant and does not include any payment under section 8 of the United States Housing Act of 1937 (42 USCS § 1437f) or any comparable rental assistance program applicable to either the rental unit or the household occupying the unit.

See Chapter 11 of the Guide for Completing Form 8823 for a complete discussion.

Under IRC §42(g)(2)(E), if federal assistance is required to be reduced as the tenant's income increases, so that the amount required to be paid by the tenant exceeds the gross rent limit, the unit continues to be considered rent-restricted if:

- a federal rental assistance payment continues to be made with respect to the unit or its tenants, and
- the sum of the rental assistance payment and the gross rent with respect to such unit does not exceed the sum of the amount of such payment which would be made and the gross rent that would be payable for the unit if the tenants' income did not exceed the income limit and the units were rent restricted.

Household Pays Towards Purchase of the Low-Income Unit

A taxpayer and tenant can enter into an agreement for the purchase of a low-income unit after the end of the 15-year compliance period. Under IRC §42(g) (6), the tenant can make de minimis equity contributions while renting a low-income unit. The unit continues to be a low-income unit qualifying for the IRC §42 credit if:

- the payments made by the tenant are paid on a voluntary basis (not as a condition of occupancy), the amount is de minimis, and the amount is held toward the purchase of a unit in the project;
- all amounts paid are refunded to the tenant when the tenant stops occupying a unit in the project;
- the purchase of the unit is not permitted until after the close of the 15-year compliance period with respect to the building in which the unit is located; and
- any amount paid to the taxpayer as equity contributions is included in gross rent for purposes of determining whether the unit is rent-restricted.

The unit the tenant is buying does not need to be the low-income unit the tenant is occupying. See Rev. Rul. 95-49.

Utility Allowance

The maximum rent payable by a household is reduced by any applicable utility allowance. Under IRC §42(g)(2)(B)(ii) and Treas. Reg. §1.42-10, gross rent includes any utility 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. Notice 2009-44 clarifies that utility costs paid by a tenant to the taxpayer 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.

Treas. Reg. §1.42-10 and Chapter 18 of the Guide for Completing Form 8823 provide detailed information about utility allowances. Key points of this guidance include the following:

- A separate utility allowance is computed for each utility. Different methods of determining utility allowances are available.
- The utility allowances must be reviewed at least once during each calendar year and updated if required. As a practical matter, utility allowances are reviewed and updated when HUD releases the annual income limits.
- Utility allowances are computed on a building-by-building basis.
- For buildings receiving Rural Housing Service (RHS) assistance, or if any tenant in a building receives RHS assistance, then the method prescribed by RHS is used to determine the utility allowance for all the units in the building.
- If the RHS rules are not applicable and the building is HUD-regulated, then the HUD utility allowance is used for all rent-restricted units in the buildings. If the building is not HUD-regulated, the applicable utility allowance for any unit occupied by a tenant receiving HUD rental assistance payments is the Public Housing Authority (PHA) utility allowance for section 8.
- If the building is not subject to the RHS or HUD rules, then the taxpayer may choose to use the applicable PHA utility allowance, a utility company estimate, an estimate provided by the housing agency, the HUD Utility Schedule Model, or a utility allowance based on energy consumption model. The methods available for use for tax years beginning before July 29, 2009, are limited to the use of the PHA utility allowance and the utility company estimate.

The utility allowance requirement is satisfied when:

- the appropriate utility allowance is used,
- the utility allowance is properly calculated,
- gross rent includes the utility allowance, and
- the maximum gross rent is not exceeded.

Documentation Requirements

Treas. Reg. §1.42-10(d) specifically alerts taxpayers that any consumption estimates and supporting data must be retained 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.

Provision of Services in Addition to Housing

Units may be residential rental property notwithstanding the fact that services other than housing are provided. See Chapter 8. A taxpayer may charge a fee in addition to the rent if the service is optional. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent. See Treas. Reg. §1.42-11.

- A service is optional when the service is not a condition of occupancy; i.e., low-income housing can be occupied without accepting the services. For example, a taxpayer may charge a separate fee for access to cable television.
- If continual or frequent nursing, medical, or psychiatric services are provided by the taxpayer, it is presumed that the services are not optional and the building is ineligible for the credit, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See Treas. Reg. §1.42-9(b).
- If a tenant is required to pay a fee for services as a condition of occupancy, then the fee must be included in gross rent even if federal or state law requires that the services be offered to tenants by building owners.
- Refundable fees associated with renting a low-income unit (e.g., security deposits) are not included in the rent computation. Required costs or fees, which are not refundable, are included in the rent computation; e.g., fees for month-to-month tenancy or renter's insurance.
- A taxpayer may charge all applicants an application fee 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 expected out-of-pocket costs of checking tenant qualifications. It is

also acceptable for the applicant to pay the fee directly to the third party actually providing the applicant's rental history. For an example, see PLR 9330013, Issue 1.

- Some fees are impermissible, such as a fee for preparing a unit for occupancy, and must not be charged. Taxpayers are responsible for physically maintaining low-income units in a manner suitable for occupancy. See IRC §42(i) (3) (B) (i) and Treas. Reg. §1.42-5(g). However, in accordance with state law, a taxpayer may require a tenant to pay for damages.

Treas. Reg. §1.42-11 provides exceptions to the general rule for (1) supportive services provided under IRC §42(g) (2) (B) (iii) discussed below, and (2) on a project basis, for the cost of mandatory meals in any federally-assisted project for the elderly and handicapped (in existence on or before January 9, 1989) that is authorized by 24 CFR 278 to provide a mandatory meals program.

Supportive Services

Under IRC §42(g)(2)(B)(iii), gross rent does not include any fee for a supportive service which is paid to the taxpayer (on the basis of the low-income status of the tenant of the unit) by any governmental program of assistance (or by an organization described in IRC §501(c)(3) and exempt from tax under IRC §501(a)) if such program (or organization) provides assistance for rent and the amount of assistance provided for rent is not separable from the amount of assistance provided for supportive services.

"Supportive service" means any service provided by the taxpayer under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. In the case of a single-room occupancy unit or a building described in IRC §42(i)(3)(B)(iii) related to transitional housing for the homeless, or IRC §42(i)(3)(B)(iv) related to single-room occupancy, such term includes any service provided to assist tenants in locating and retaining permanent housing. See Treas. Reg. §1.42-11(b) (3) (ii) (A).

Common Areas

If the cost of common areas is included in eligible basis (see Chapter 8), then, as explained in the legislative history for the original enactment of IRC §42, no fee can be used for the use of the facility.

"…the allocable cost of tenant facilities, such as swimming pools, other recreational facilities and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project."

Alternatively, if the taxpayer excludes the allowable cost relating to the facility from eligible basis, IRC §42 does not control the taxpayer's use of the facility related to the excluded costs.

Determining Whether Units are Rent-Restricted

Under IRC §42(g) (2) (A), a unit qualifies as a low-income unit when the gross rent does not exceed 30% of the imputed income limitation applicable to such unit, which is an annual amount. Therefore, taxpayers must satisfy the rent-restrictions requirements on a tax year basis, as of the end of the tax year.

IRC §42(g) (2) (B) defines gross rent to exclude certain payments and includes consideration of any utility allowances and fees on a monthly basis. Therefore, taxpayer's must also satisfy the rent-restrictions each month of the tax year.

As a result, a unit can fail to satisfy the rent restriction requirements if the rent exceeds the limit on a tax year basis or on a monthly basis; i.e., any one or more months during the tax year. A unit also fails to satisfy the rent restriction requirement if an owner charges impermissible fees.

Additional Resources

Refer to Chapters 11 and 18 of the Guide for Completing Form 8823 for additional information.

Audit Technique #1: Internal Controls and Taxpayer Interview

First, the taxpayer's internal controls and efforts to ensure that the rents are correctly limited should be analyzed to determine whether there is a material risk that the rents exceed the rent limit during the tax year under audit.

As part of the interview with the taxpayer, ask:

- How is the maximum gross rent determined and what procedures are in place to make sure maximum rent is correct?
- What procedures are in placed to make sure the rents are updated annually when HUD releases the updated AMGI amounts?
- Who collects the rents? Who records the rents in the books? Who deposits the rents? What internal controls are in place to ensure all rents are reported as income on the tax return?
- Are the buildings 100% low-income buildings, or do the building have market-rate units? How many bedrooms does each low-income and market rate unit have?
- What are the vacancy rates and turnover rates for the low-income and market rate units?

Rental practices should also be reviewed with the taxpayer.

- Do tenants pay utilities or are utilities included in the rent? If the tenants pay utilities, how is the utility allowance determined and who makes the determination?
- Does the taxpayer require a security deposit or charge other fees such as a late payment fee, key replacement fee, or pet fee?
- Does the taxpayer provide services for the tenants in addition to housing? Does the taxpayer charge a fee for the services?
- Is the taxpayer renting to section 8 tenants? In which case, rent collected might be more than the maximum allowable gross rent.

- If the project is using Rural Development assistance, is the rent collected in excess of the maximum allowable gross rent? Is the taxpayer making payments to Rural Housing Service as required? How often are payments made? How are the payments made?

Audit Technique #2: Review Tenant Leases Rent Rolls

Review tenant leases to determine the rent charged, as well as any other fees that might be charged as a condition of occupancy. For example, in addition to rent, a taxpayer may charge a fee for access to cable television, which would be a fee charged in addition to rent. However, charging a fee for entering into a month-to-month lease agreement would be includable in rent.

Audit Technique #3: Compare Rents Paid to the Maximum Gross Rent

Once the amount of rent actually paid by tenants is determined, compare to the maximum gross rent and determine whether the rent is correctly limited on both a monthly and annual basis. If the rent exceeded the maximum gross rent, then the unit is not a low-income unit for purposes of calculating the Applicable Fraction.

Audit Technique #4: Reconcile Tenant Records to Rent Rolls

Reconcile the rents and fees paid by the tenant as recorded in the tenant records to the amounts recorded in the rent rolls, which are mostly likely the same summary records used to report rent income on the taxpayer's tax return.

Audit Technique #5: Complete Minimum Income Probes

Complete the Minimum Income Probes as required in Internal Revenue Manual (IRM) 4.10.4.3.4, for businesses. See Chapter 20.

Suitability for Occupancy

Law

Under IRC §42(i) (3) (B) (ii), a unit shall not be treated as a low-income unit unless the unit is suitable for occupancy under regulations prescribed by the Secretary taking into account local health, safety, and building codes.

Annual Certifications

Under Treas. Reg. §1.42-5(c) (1) (vi), a taxpayer must certify annually to the state agency that, for the preceding 12-month period:

- the buildings and low-income units in the project were suitable for occupancy, taking into account local health, safety, and building codes (or other habitability 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 a copy of the violation report or notice to the annual certification submitted to the state agency and explain whether the violation has been corrected.

State Agency Inspections

State agencies are required to physically inspect IRC §42 projects throughout the entire 15-year compliance period. The inspection includes all the low-income buildings and a sample of at least 20% of the low-income units in the project. Under Treas. Reg. §1.42-5(c) (2) (ii), the inspections are conducted:

- by the end of the second calendar year following the year the last building in the project is placed in service, and
- at least once every 3 years thereafter.

The state agency can choose the standard used for conducting inspections and determining compliance. The state agency can choose either:

- local health, safety, and building codes (or other habitability standards), or
- the uniform physical condition standards for public housing established by HUD. If the state agency uses HUD's physical condition standards to conduct inspections, HUD's standards do not supersede or preempt local health, safety, and building codes. A low-income housing project under IRC §42 must continue to satisfy the local health, safety and building codes.

The state agency must also review any local health, safety, or building code violations reports or notices retained by the taxpayer.

Documentation Requirement

Under Treas. Reg. §1.42-5((b)(3), a taxpayer must retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit for the state agency's inspection. Retention of the original violation reports or notices is not required once the state agency reviews the violation reports or notices and completes its inspection, unless the violation remains uncorrected.

Casualty Losses

The determination that a unit is unsuitable for occupancy is based on its physical condition, without regard for the cause of the noncompliance, at the end of the taxable year. However, relief is available in the event of a casualty loss within the meaning of IRC §165. CCA 200134006 provides that "the definition of "casualty loss" under IRC §42(j)(4) would be the same as the definition utilized in Publication 547, Casualty, Disaster, and Thefts, and Publication 584, Casualty, Disaster, and Theft Loss Workbook; i.e., damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

CCA 200912012 provides that if a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, then there is no recapture and no loss of credits. However, if the building is not restored by the end of the taxable year, no credit would be allowed for the entire taxable year even if the reasonable period (or reasonable restoration period) extends into the next taxable year. See Chapter 16 for more information.

IRC §42(j) (6) (E) provides relief from the credit recapture provisions to the extent the loss is restored by reconstruction or replacement within a reasonable period established by the Secretary. CCA 200134006 clarifies that a period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties. See IRC §1033.

Casualty Losses in Federally Declared Disaster Areas

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after July 2, 2007, and before August 21, 2014, then Rev. Proc. 2007-54 provides the following relief for projects that have been placed in service. (Similar relief provisions are provided in Rev. Proc. 95-28 for locations declared major disaster areas before July 2, 2007.)

- If the low-income building is beyond the first year of the credit period, the taxpayer may continue to claim the credit even though the units are not suitable for occupancy if the units are restored within a reasonable restoration period. The state agency determines what a reasonable restoration period is, but the restoration period is not to exceed 24 months after the end of the calendar year in which the President issued the major disaster declaration. If the taxpayer fails to restore the building within the reasonable restoration period determined by the state agency, the taxpayer loses all credits claimed during the restoration period and is subject to the IRC §42(j) credit recapture provisions.
- For buildings in the first year of the credit period, the state agency has the discretion to treat the allocation as returned credit under Treas. Reg. §1.42-14(d) (3) or may toll the beginning of the first year of the credit period until the project is restored. The tolling time period cannot be more than 24 months after the end of the calendar year in which the President declared the area a major disaster area. No qualified basis shall be established until the building is restored and no low-income housing credit shall be claimed during the restoration period of such first-year buildings.

NOTE: Rev. Proc. 2007-54 applies to IRC §42 credits, including credits through the volume cap under IRC §142(d). For example, compliance monitoring relief, first year of the credit period relief, and the restoration amount equally apply to bond-financed buildings.

If the IRC §42 project is located in an area declared a major disaster area by the President under the Stafford Act on or after August 21, 2014, then Rev. Proc. 2014-49 provides the following relief for projects that have been placed in service. The key difference between Rev. Proc. 2007-54 and Rev. Proc. 2014-49 is the definition of the restoration period.

- If the low-income building is beyond the first year of the credit period, the taxpayer may continue to claim the credit even though the units are not suitable for occupancy if the units are restored within a reasonable restoration period. The state agency determines what a reasonable restoration period is, but the restoration period is not to extend beyond the end of the 25th month following the close of the month of the major disaster declaration. To determine the allowable credit during the restoration period, the taxpayer must use the building's qualified basis at the end of the taxable year immediately preceding the first day of the incident period for the major disaster. If the taxpayer fails to restore the low-income building within the restoration period, the allowable credit, if any, is determined using the building's qualified basis at the end of each year of the credit period during the restoration period, and the taxpayer is subject to the IRC §42(j) credit recapture provisions.
- For buildings in the first year of the credit period, the state agency has the discretion to treat the allocation as returned credit under Treas. Reg. §1.42-14(d) (3) or may toll the beginning of the first year of the credit period until the project is restored. The tolling time period must not extend beyond the end of the 25th month following the close of the month of the major disaster declaration. The taxpayer may not claim any low-income housing credit during the restoration period of these first-year building.

NOTE: Rev. Proc. 2014-49 applies to IRC §42 credits, including credits through the volume cap under IRC §142(d). For example, compliance monitoring relief, first year of the credit period relief, and the restoration amount equally apply to bond-financed buildings.

Additional Resources

Refer to Chapter 6 of the Guide for Completing Form 8823 for additional information.

Audit Technique #1: Taxpayer's Annual Certification

The taxpayer's annual certification to the state agency should be reviewed. If the taxpayer cannot provide the certification; request documentation from the state agency.

Ask the taxpayer to explain what internal controls are in place to ensure that the units are suitable for occupancy. What procedures are in place to maintain the project, identify physical deficiencies, and correct noncompliance issues on a continuing basis? Does the taxpayer follow a routine maintenance schedule? Does the taxpayer regularly inspect the units?

If an independent property manager operates the IRC §42 project, what oversight does the taxpayer provide to ensure that the manager maintains the project in compliance? Does the taxpayer conduct internal audits or personally visit the project and inspect the site?

Audit Technique #2: Vacant Units

Vacant units must be suitable for occupancy. While a reasonable period to clean a unit and repair any damages caused by a prior tenant is acceptable, vacant units that are not move-in ready are not suitable for occupancy.

- Ask the taxpayer to explain the policies and procedures in place to prepare a vacated unit for a new tenant and how long it usually takes. For example, if the vacancy rate is high, a taxpayer may not be willing to expend funds to prepare a unit until a new tenant has been identified.
- Review the tenant rent rolls to identify rental units that are vacated during the year and estimate the average time the units were vacant.
- Identify rental units that are vacant for unusually long periods of time. Ask the taxpayer to document that the units were prepared for occupancy. For example, the taxpayer may show receipts for cleaning expenses or repairs.

Audit Technique #3: Tour the Project Site

Tour the project site (see Chapter 3) to observe the project's current physical condition and the taxpayer's on-going efforts to physically maintain the housing.

Audit Technique #4: State Agency Reports Noncompliance

If the state agency reported to the IRS on Form 8823 that the buildings were not suitable for occupancy during the year under audit, then:

- Contact the state agency to obtain documentation supporting the determination that a specific low-income unit, building, or project was physically unsuitable for occupancy. The state agency should be able to provide reports (including descriptions), correspondence with the taxpayer or property manager, and in some cases, photographs.
- Ask the taxpayer whether the noncompliance has been corrected. If the project is back in compliance, ask for documentation showing exactly when the project was restored.

Audit Technique #5: Documentary Evidence of Compliance

While it is not generally possible to physically observe a project during the taxable year under audit, documentary evidence of compliance should be reviewed.

- Ask the taxpayer for a copy of the annual certification to the state agency made for the year under audit. See Treas. Reg. §1.42-5(c).
- Ask the owner whether a state or local government conducted an inspection, and if so, if any violations were noted. Copies of the reports should be secured and reviewed to determine if any noted violations were corrected. Alternatively, state and local governments may be contacted directly to determine whether inspections occurred and whether violations were identified.
- Determine whether the project was physically inspected for another purpose and secure any findings. For example, regular inspections will be conducted if the taxpayer is participating in HUD's housing programs or a commercial lender may conduct inspections to ensure that the assets securing the debt maintain their value.
- Ask the taxpayer to provide a copy of the report issued by the state agency as a result of the agency's last physical inspection of the project. Even if the inspection was not

conducted during the year under audit, the report will provide information about the taxpayer's due diligence in maintaining the project in good repair.

Evaluating Evidence

To facilitate consistent evaluations, the IRS uses HUD's Uniform Physical Condition Standards (UPCS) and supporting Dictionary of Deficiency Definitions, which provides descriptions and levels of severity for five inspectable areas of the IRC §42 project: (1) site, (2) building exterior, (3) building systems, (4) dwelling units, and (5) commons areas. The Dictionary also includes a sixth category to address health and safety hazards associated with any of the five physical areas. The Dictionary's three levels of severity are disregarded for purposes of IRC §42. See the Guide for Completing Form 8823, Chapter 6, for detailed discussion. The taxpayer must also comply with local health, safety, and building codes.

The determination that low-income units are suitable for occupancy is based on the units' condition as of the last day of the taxpayer's tax year. Generally,

- If the noncompliance is confined to specific low-income units, an adjustment will be made to the applicable fraction on a unit-by-unit basis.
- If the noncompliance impacts the entire low-income building, and therefore affects all the households residing in the building, then none of the units are suitable for occupancy. As explained in CCA 201042025, the "suitable for occupancy" requirement of IRC §42(i) (3) (B) does not have to be determined on a unit-by-unit basis if the facts exist that the condition of the exterior components of the building (e.g., wall, roof, etc.) are so poor as to lead to a factual determination that all the units in a building are not suitable for occupancy. For example, if an earthquake created large fissures in the foundation and exterior walls of a building then the building could be determined not suitable for occupancy for safety reasons without having to check each unit.

Local Code v. UPCS

Under IRC §42(i) (3) (B), low-income units may be considered suitable for occupancy under local code, even if HUD's physical condition standard was not met. As explained in CCA 201042025, a violation of the HUD physical condition standard alone is sufficient for a violation of IRC §42(i) (3) (B). However, a taxpayer, in response to the IRS finding a violation, may prove that local health, safety, or building codes address the specific point in question, and after application of the facts, local law reaches a taxpayer favorable result whereas the HUD standard does not reach a taxpayer favorable result. Under these circumstances, the local law would control as respects the violation itself.

Noncompliance was Minor or Corrected Within Reasonable Period

The taxpayer may argue that the noncompliance was of a minor nature or that the noncompliance was corrected within a reasonable time. The Committee Report on P.L. 103-66, the Omnibus Budget Reconciliation Act of 1993, provides this explanation:

> "…the Committee expects that a facts and circumstances test will be applied to determine whether a unit is suitable for occupancy. A history of continuous noncompliance with local health, safety, and building code provisions that are not of a minor nature and that affect the safety and well-being of tenants is evidence that a unit is not suitable for occupancy. It is anticipated that minor code violations will not affect a unit's status as a low-income unit…"

> "…The rules requiring correction of violations should adopt a facts and circumstances analysis taking into consideration the types of repairs required, the cost and extent of such repairs, whether the repairs are scheduled for correction according to a reasonable maintenance schedule, and whether procedural requirements (such as a required formal bid process) are imposed on the owner to gain approval for the repairs…"

The legislative history for the original enactment of IRC §42 provides a general explanation:

> "Owners and operators of low-income housing projects...must correct any noncompliance with the set-aside requirement or with a reduction in qualified basis within a reasonable period after the noncompliance is discovered or reasonably should have been discovered. If any noncompliance is corrected within a reasonable period, there is no recapture."

When addressing these arguments, consider the following:

- The IRS has adopted HUD's UPCS and Definitions of Deficiencies as the objective standard for evaluating whether IRC §42 projects are suitability for occupancy. Regardless of the source of information, if the observed physical condition of the low-income buildings, units, or site matches HUD's descriptions of deficiencies, the deficiency results in noncompliance rendering the building or unit unsuitable for occupancy under IRC §42; i.e., the deficiency is not minor in nature.
- Taxpayers are required to certify annually that low-income buildings and units are suitable for occupancy based on direct knowledge. The reasonable period for discovery and correction of noncompliance ends on the last day of the calendar year, which coincides with the end of the tax year for most taxpayers.
- State agencies determine the correction period based on the type of noncompliance and the actions needed to correct the violations. While the correction period may be as long as six months under extenuating circumstances, the correction period is generally 90 days. Life threatening health and safety hazards require immediate correction.
- IRC §42(c) (1) (A) provides a bright-line test for determining the applicable fraction as of the last day of the taxable year. The Code is clear and unambiguous. Reliance on interpretations and explanations in legislative history is not necessary.

Portion of Annual Credit Should Be Allowed in the Event of a Casualty Event

A taxpayer may argue that the units were qualified low-income units before a casualty event and a portion of the credit associated with the unit should be allowed.

- If the President has issued a major disaster declaration under the Stafford Act and Rev. Proc. 2014-49 or Rev. Proc. 2007-54 applies, refer to Chapter 13.

- If neither Rev. Proc. 2014-49 nor Rev. Proc. 2007-54 applies, then the determination of the applicable fraction is based on whether the units were suitable for occupancy at the end of the taxable year.

CCA 200913012 clarified that Rev. Proc. 2007-54 were issued under the authority of Treas. Reg. §1.42-13(a), which provides that, under IRC §42(n), the Secretary has authority to provide guidance through various publications in the Internal Revenue Bulletin. Rev. Proc. 2014-49 was also issued under the authority of Treas. Reg. §1.42-13(a).

Available Unit Rule

Law

The Available Unit Rule addresses the circumstance where the household's income rises above the income limit subsequent to moving into the low-income unit.

IRC §42(g) (2) (D), Treatment of units occupied by individuals whose incomes rise above limit.

(i) In general.

Except as provided in clause (ii), notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under IRC §42(g)(1), such unit shall continue to be treated as a low-income unit if the income of such occupants initially met such income limitation and such unit continues to be rent-restricted.

(ii) Next available unit must be rented to low-income tenant if income rises above 140% of income limit.

If the income of the occupants of the unit increases above 140% of the income limitation applicable under IRC §42(g) (1), clause (i) shall cease to apply to 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. In the case of a project described in IRC §142(d)(4)(B), the preceding sentence shall be applied by substituting "170%" for "140%" and by substituting "any low-income unit in the building is occupied by a new resident whose income exceeds 40% of area median gross income" for "any residential 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."

Annual Income Recertifications

To determine whether an existing tenant's income has increased, taxpayers are required to complete an annual income certification for each low-income household. See Treas. Reg. §1.42-5(b) (1) (vi). The recertification process is identical to the initial certification in terms of documenting household composition, income, and income from assets. Taxpayers are expected to complete the annual income recertification process within 120 days before the anniversary of the effective date of the original tenant income certification.

Under Treas. Reg. §1.42-5(c) (4), a state agency may except certain buildings from the annual income recertification as part of its certification and review provisions.

These buildings are:

- financed by the Rural Housing Service (RHS) under the section 515 program, or
- 50% or more of the aggregate basis (taking into account the building and land) are financed with the proceeds of tax-exempt bonds.

Under this exception, taxpayers are not required to perform annual income recertifications specific to IRC §42, and instead may use the income recertifications for the RHS program or the tax-exempt bond program to determine whether a unit is over-income. Note, however, that 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 taxpayer should modify "adjusted annual income" to determine the household's income for IRC §42 purposes.

For the exception to the annual income recertification under IRC §142(d) (3) (A), see section below titled "Audit Techniques: 100% Low-Income Buildings."

See Chapter 5 of the Guide for Completing Form 8823 for additional discussion.

Treas. Reg. §1.42-15

Treas. Reg. §1.42-15 provides guidance for applying the Available Unit Rule, including operational definitions and examples.

Additional Resources

Chapter 14 of the Guide for Completing Form 8823 includes additional discussion for evaluating compliance with the Available Unit Rule.

Key Concepts

Key concepts of the Available Unit Rule include:

- The Available Unit Rule ensures that the appropriate number of available units is rented to income-qualified households when there are over-income units in the building.
- Over-income units may be returned to low-income status if the household's income decreases or the income limit for the household increases prior to renting the next available unit. See Rev. Rul. 94-57.
- In a project containing more than one low-income building, the Available Unit Rule applies separately to each building.
- A low-income unit containing a household whose income rises above 140% (or 170% for deep rent skewed projects) of the current income limit is still considered a low-income units as long as the rent remains restricted and the next available units of comparable or smaller size is rented to a qualified low-income household and the rent is restricted.

- 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, a taxpayer may consider a residential unit with the same number of bedrooms (or fewer) and comparable amenities to be a comparable unit.
- All comparable units that are available or that subsequently become available in the same building must be rented 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.
- 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).

Audit Techniques: Mixed Use Buildings

If a building contains both low-income and market rate units, the following audit techniques should be used to evaluate whether a taxpayer is compliant with the Available Unit Rule throughout the tax year(s) under audit.

- Review the taxpayer's internal controls for maintaining compliance; i.e., how does the taxpayer identify and track over-income units?
- Evaluate whether the taxpayer is timely completing the annual income recertifications by reviewing a sample of tenant files for residents who have occupied their units for more than a year. If a unit was determined to be over-income, ask the taxpayer to demonstrate how the specific over-income unit was tracked and replaced by renting a unit of comparable size or smaller to an income-qualified tenant.
- Review the rent roles to identify when units were rented at market rate; i.e., the unit was not rented as a low-income unit with restricted rent. Ask the taxpayer to demonstrate that at the time the unit was rented, there were no over-income units of comparable or larger size.

Audit Techniques: 100% Low-Income Buildings

The Available Unit Rule has no immediate application for 100% low-income buildings because the next available unit is always presumed to be rented to an income-qualified household. As a result, for tax years ending after July 30, 2008, Congress amended IRC §142(d)(3)(A), so that if all the low-income buildings in the project are 100% low-income buildings, taxpayers are not required to complete annual tenant income recertifications. IRC §42(g) (4) applies IRC §142(d) (3) (A) to IRC §42 low-income projects.

Therefore, for purposes of the Available Unit Rule only, households documented as initially income-qualified households continue to be income-qualified as long as the taxpayer

demonstrates due diligence when completing initial income certifications. Further, the taxpayer does not violate the Available Unit Rule when a unit is unintentionally rented to a nonqualified household.

Compliance with the Available Unit Rule should be an audit issue if:

- A taxpayer fails to rent a unit to an income-qualified household and cannot demonstrate due diligence when making the determination of income eligibility.
- The taxpayer deliberately rents a unit as a market-rate unit; i.e., the rent is not restricted.

In such cases, the taxpayer has disregarded the Available Unit Rule and the building's qualified basis is deemed to be 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 taxpayer can establishes compliance with the Available Unit Rule. The records need to be reliably reconstructed to clearly demonstrate that the units continued to be low-income units, or if a unit was determined to be an over-income unit, then the Available Unit Rule was correctly applied.

Vacant Unit Rule

Legislative History

The Vacant Unit Rule is not included in the Code, but is described in the legislative history for the initial enactment of IRC §42. It reads:

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 [IRC §42(g) (1)] (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit and no other units of comparable or smaller size in the project are rented to nonqualifying individuals.

Vacant Unit Available for Rent

The vacant unit rule does not apply to a vacant unit if the unit is no longer available for 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. See Rev. Rul. 2004-82, Q&A #10.

Treas. Reg. §1.42-5

Treas. Reg. §1.42-5(c) requires taxpayers to certify at least annually to the state agency that, for the preceding 12-month period, the project met the requirements for claiming the IRC §42 credit. The regulation lists the specific requirements for which the certification must be made. In part, Treas. Reg. §1.42-5(c) (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."

The language used in the regulation differs slightly from the language in the legislative history. The regulation requires taxpayers to make reasonable attempts to rent low-income units before renting comparable units to nonqualifying tenant while the legislative history prohibits the taxpayer from renting comparable units to nonqualifying tenants until after the low-income units are rented. The language in the regulation is relied upon for evaluating compliance with the Vacant Unit Rule.

Rev. Rul. 2004-82: Reasonable Attempts

Rev. Rul. 2004-82 provides guidance for evaluating whether a taxpayer is making reasonable attempts to rent vacant low-income units. Q&A #9 provides the following example and discussion.

Q-9.

Ten units previously occupied by income-qualified tenants in a 200-unit mixed-use housing project are vacant. None of the low-income units in the project had been over-income units. The project 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 list of section 8 voucher holders about the low-income unit vacancies. These are customary methods of advertising apartment vacancies in the area of the project for identifying prospective tenants. Subsequent to the low-income unit vacancies, a market-rate unit of comparable size to the low-income units became vacant. Will the owner violate the vacant unit rule if the owner rents the market-rate unit before any of the low-income units?

A-9.

No. In accordance with Treas. Reg. §1.42-5(c)(1)(ix), the owner of a qualified low-income housing project has to use reasonable attempts to rent a vacant low-income unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project are rented to tenants not having a qualifying income. Thus, if the project owner makes reasonable attempts to rent the vacant low-income units to income-qualified tenants, the owner may rent the newly vacated market-rate unit before renting the low-income units and continue to characterize the vacant low-income units as low-income units for purposes of the minimum set-aside requirements in IRC §42(g) (1) and calculation of the applicable fraction under 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 is considered reasonable. Under the facts in this situation, the owner used reasonable methods of advertising an apartment vacancy in the area of the project before the owner rented the market-rate unit. Thus, the owner made reasonable attempts to rent the vacant low-income units.

Additional Resources

Chapter 15 of the Guide for Completing Form 8823 includes additional discussion for evaluating compliance with the Vacant Unit Rule.

Available Unit Rule has Precedence

The Vacant Unit Rule is similar to the Available Unit Rule and, generally, uses the same operational definitions. The Available Unit Rule, however, has precedence over the Vacant Unit; i.e., regardless of reasonable attempts to rent vacant low-income units, a taxpayer cannot rent a unit to a nonqualifying household as long as there are outstanding over-income units.

Audit Techniques: Mixed Use Buildings

The Vacant Unit Rule has immediate application for low-income buildings with both low-income and market rate rental units. The following audit techniques should be used to evaluate whether a taxpayer is compliant with the rule throughout the tax year(s) under audit.

- Determine that the taxpayer is compliant with the requirements for the Available Unit Rule and whether there were outstanding over-income units during the year before reviewing the Vacant Unit Rule.
- Review the taxpayer's marketing strategies and whether marketing efforts are reasonable. In part, this can be accomplished by reviewing the expense claimed for advertising and the supporting documentation.
- Review the rent roles to identify when units were rented at market rate; i.e., the unit was not rented as a low-income unit with restricted rent. Ask the taxpayer to demonstrate that at the time the unit was rented, the taxpayer had made reasonable attempts to first rent the low-income units.

Audit Techniques: 100% Low-Income Buildings

Like the Available Unit Rule, the Vacant Unit Rule has no immediate application for 100% low-income buildings because available units are only rented to qualifying households.

As a result, for purposes of applying the Vacant Unit Rule, the IRS will treat all households documented as initially income-qualified households as income-qualified as long as the taxpayer demonstrates due diligence when completing the initial income certification. Further, the taxpayer does not violate the Vacant Unit Rule when a unit is unintentionally rented to a nonqualified household.

The Vacant Unit Rule is violated when a taxpayer fails to make reasonable attempts to rent vacant units to qualified households, and either:

- the taxpayer attempted, but failed to rent a unit to an income-qualified household, and cannot demonstrate due diligence when making the determination of income eligibility, or
- The taxpayer deliberately rents a unit as a market-rate unit; i.e., the rent is not restricted.

Unless a taxpayer can document which units were vacant low-income units when the taxpayer deliberately violated the Vacant Unit Rule, the building's qualified basis is deemed to be 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 taxpayer establishes compliance with the Vacant Unit Rule; i.e., the applicable fraction is deemed to be zero. Note: The taxpayer must first demonstrate that the Available Unit Rule was not applicable, or if applicable, was applied correctly. (See discussion of this rule above.)

General Public Use & Transient Use

Law

The General Public Use Requirement is not included in the Code, but is described in the legislative history for the initial enactment of IRC §42. It reads:

Residential rental units must be for use by the general public and all of the units in a project must be used on a non-transient basis. Residential rental units are not used 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. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing, sanitarium, life care facility, retirement home providing significant services other than housing dormitory, or trailer park may be a qualified low income project. Factory-made housing which is permanently fixed to real property may be a qualified low-income building…"

General Public Use

Treas. Reg. §1.42-9

Treas. Reg. §1.42-9 provides guidance for applying the General Public Use Requirement.

(a) General rule.

Treas. Reg. §1.42-9 provides guidance for applying the General Public Use Requirement.

If a residential rental unit in a building is not for use by the general public, the unit is not eligible for an IRC §42 credit. A residential rental unit is for use by the general public if the unit is rented

in a manner consistent with housing policy governing nondiscrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD) (24 CFR subtitle A and chapters I through XX). See HUD Handbook 4350.3 (or its successor)…"

(b) Limitations. Notwithstanding paragraph (a) of this section, if a residential rental 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. In addition, any residential rental unit that is part of a hospital, nursing home, sanitarium, life care facility, trailer park, or intermediate care facility for the mentally and physically handicapped is not for use by the general public and is not eligible for credit under IRC §42.

(c) Treatment of units not for use by the general public. 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.

Fair Housing Noncompliance

Under Treas. Reg. §1.42-9(a), the general public use requirement incorporates the Fair Housing Act's prohibitions against discrimination in housing because of race, color, national origin, religion, sex, familial status, or disability. The Fair Housing Act 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.

By Memorandum of Understanding with the Department of Justice (DOJ) and the Department of Housing and Urban Development (HUD), the IRS is notified when a Fair Housing Act violation has occurred. See Chapter 13 of the Guide for Completing Form 8823 for additional in-depth discussion.

Other Noncompliance Conduct

In addition to complying with housing policy governing non-discrimination, the taxpayer must also comply with the specific requirements under IRC §42. Specifically, residential rental units are not for use by the general public if:

- A residential rental unit is provided only for a member of a social organization or provided by an employer for its employees, or
- A residential rental unit is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally and physically handicapped.

IRC §42(g) (9)

As part of the Housing Assistance Act of 2008, IRC §42(g) was amended to add, and apply retroactively, a clarification of the General Public Use Requirement. IRC §42(g) (9) reads:

Clarification of general public use requirement. A project does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants—

(A) with special needs,

(B) 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

(C) who are involved in artistic or literary activities.

Refer to Chapters 12 and 13 of the Guide for Completing Form 8823 for additional discussions.

Transient Use

As stated in the legislative history, all of the units in a project must be used on a non-transient basis. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. There are two exceptions to the general rule that the initial lease term must be six months or longer.

Transition of Homeless Individuals to Independent Living

Under IRC §42(i)(3)(B)(iii), transitional housing for homeless individuals is not considered to be used on a transient basis if the unit contains sleeping accommodations and kitchen and bathroom facilities and is located in a building, and which is used exclusively to facilitate the transition of homeless individuals (within the meaning of section 103 of the Stewart B. McKinney Homeless Assistance Act [McKinney-Vento Homeless Assistance Act] (*42 U.S.C. 11302*), as in effect on the date of the enactment of this clause [enacted Nov. 5, 1990]) to independent living within 24 months, and in which a governmental entity or qualified nonprofit organization (as defined in IRC §42(h) (5)) provides such individuals with temporary housing and supportive services designed to assist such individuals in locating and retaining permanent housing.

Single Room Occupancy Unit

Under IRC §42(i) (3) (B) (iv), a single-room occupancy unit is not treated as used on a transient basis merely because it is rented on a month-by-month basis.

See Chapter 20 of the Guide for Completing Form 8823 for additional discussion of the nontransient use requirement.

Provision of Services

The provision of services by the taxpayer for tenants to live independently is not a violation of the General Public Use Requirement, even when it can be anticipated that a large percentage (if not all) tenants will contract with the taxpayer for the provision of the services.

- The provision of services may, or may not, be intended to address a special need under IRC §42(g) (9) (A).
- The taxpayer can charge a fee in addition to rent for providing the services, however the use of the services must not be a condition of occupancy.
- The services cannot include continual or frequent nursing, medical, or psychiatric services, presumed not be optional services. See Treas. Reg. §1.42-11.

For example, a taxpayer may provide housing units on a non-transient basis for individuals of retirement age or older. All of the units in the project are available to members of the general public. Each unit has living, cooking, sleeping, bathing, and sanitation facilities. The taxpayer also makes other services available to the tenants so that they can live independently, such as laundry, housekeeping, meals in a common dining area, planned social activities, transportation, and a 24 hour monitored emergency call service. The services are optional and the fees charged for providing the services are separately stated from the rent. The provision of these services does not violate the General Public Use Requirement. See Rev. Rul. 98-47.

Condition of Credit Allocation

Under IRC §42(m)(1), a state housing agency is required to determine housing priorities and give preference to projects serving the lowest income tenants for the longest periods in areas where the housing will contribute to a community revitalization plan. As a result, a state agency may require a taxpayer to provide housing to households with income less than the Area Median Gross Income (AMGI) required for IRC §42 purpose as a condition of receiving an IRC §42 credit allocation. The specific conditions will be recorded in the extended use agreement and are enforceable by the state agency under state contract law. See Chapter 6.

Additional Fact Patterns

A taxpayer is compliant with the General Public Use Requirement in the following scenarios, provided that the unit is rented in a manner consistent with housing policy governing nondiscrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD) (24 CFR subtitle A and chapters I through XX). See HUD Handbook 4350.3 (or its successor):

- IRC §42 housing is likely to be used (exclusively or predominantly) by a specific group not otherwise allowable under IRC §42(g) (9), but there is no evidence that the taxpayer is discriminating in violation of the Fair Housing Act.
- The taxpayer rents low-income units exclusively to income-qualified households in which one or more of the household's members are involved in artistic or literary activities under IRC 42(g)(9)(C); e.g., the graphic arts (drawing, painting, sculpture, ceramics, and architecture), literature and journalism, music, dramatic arts and dancing.
- IRC §42 project is located on Indian land and it is anticipated that only income qualified members of the designated Indian tribes will occupy the low-income units.

Noncompliance Issues

Noncompliance occurs if:

- Under Treas. Reg. §1.42-9(a), the owner failed to comply with the Fair Housing Act, as documented by notification from the Department of Justice or HUD under the MOU Under Treas. Reg. §1.42-9(b), a residential unit is provided only for members of a social organization or provided by an employer for its employees.
- Under Treas. Reg. §1.42-9(b), any residential rental unit that is part of a hospital, nursing home, sanitarium, life care facility, trailer park, or intermediate care facility for the mentally and physically disabled is not for use by the general public.
- The taxpayer is renting low-income units to members of a specified group allowable under IRC §42(g)(9)(B), but cannot document association with or participation in a federal program or state program or federal/state policy that supports housing for such a specified group as required under IRC §42(g)(9)(B).

Noncompliance may also occur when the following fact patterns are identified. This list is not intended to be all inclusive. Other scenarios requiring evaluation of the taxpayer's compliance with the General Public Use Requirement may be identified during an audit.

- The taxpayer sets aside a portion of the low-income units for the exclusive use of income-qualified households referred by a third party. For example, a taxpayer may enter into an agreement with a third party to set-aside 25 of its 100 low-income units for the exclusive use of income-qualified households referred by the third party and the third party guarantees rent payments for the 25 units while vacant.
- A taxpayer restricts low-income units to student households, even if the student households meet one of the exceptions under IRC §42(i) (3) (D) for households comprised entirely of full-time students. The student households are not a qualified group under IRC §42(g) (9) and the General Public Use Requirement has precedence over the exceptions under IRC §42(i) (3) (D).
- The tenants' special needs require physical adaptations or services such that the taxpayer is effectively providing nursing, medical, or psychiatric services, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See Treas. Reg. §1.42-11(b) (2). For example, tenants diagnosed with dementia are isolated in an area where the taxpayer has installed combination locks on doors so that the tenants, who cannot remember the combination or operate the lock, cannot wander off the premises.

Audit Techniques

Potential violations of the General Public Use Requirement may be identified using the following audit techniques.

- Request a copy of any fair housing-related violations not reported on Forms 8823.
- Review the tenant files, including rental applications and income certifications, to determine whether particular qualifications or criteria, in addition to IRC §42 requirements, were used to select tenants or assign units to tenants. Determine if the

tenants share a common characteristic in addition to being income-qualified under IRC §42(g) (1); e.g., all the tenants are students at a nearby university.

- Review the rent records, which may indicate that low-income units remain vacant for extended periods of time or that low-income units are not rented in the name of the household for which the unit is the primary residence.
- Review the taxpayer's advertising efforts for the year under audit to determine whether the owner advertised to a wide audience within the market area and made reasonable attempts to rent vacant low-income units. "Reasonable attempts" will vary depending on factors such as size and location of the project, tenant turnover rates, and market conditions. 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. Also, advertising methods should be designed to be accessible to all prospective tenants. See Rev. Rul. 2004-82, Q&A #9.
- Review the taxpayer's written materials such as printed advertisements, pamphlets, and brochures. These documents are likely to provide prospective tenants with detailed information about the housing and qualifications for living in the low-income unit.
- Review the taxpayer's web site, which may provide information suggesting that the owner is targeting specific audiences (not otherwise allowable under IRC §42(g) (9)) to the exclusion of the general public.
- Request a copy of the taxpayer's credit application from the state agency. The application should include a market study demonstrating that there is a need for low-income housing and identifying the potential market in the property's location.
- Review the extended use agreement between the taxpayer and the state agency. This document is helpful for understanding the terms of the credit allocation and the state agency's expectations for meeting the needs of the community, such as serving tenants at levels lower that required under IRC §42. See IRC §42(h) (6) and Chapter 7.
- Tour of the property: Note any evidence that access to the housing is limited to specific groups not otherwise allowable under IRC §42(g) (9). Also note any qualifications for living there, such as a social group's logo or school decals in car windows or physical features that would not normally be expected to be present in housing for the general public.

On-Going Business Activity

Law

IRC §42(c)(2)(B) refers to low-income buildings as any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply; i.e., costs includable in eligible basis must be depreciable property under IRC §168, Accelerated Cost Recovery System. IRC §168(a) references IRC §167(a), which reads:

(a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Treas. Reg. §1.167(a)-10(b) explains that the period for depreciation of an asset begins when the asset is placed in service and ends when the asset is retired from service. Treas. Reg. §167(a)-11(e)(1)(i) defines "placed in service" as when first placed in a condition or state of readiness and available for a specifically assigned function" and references Treas. Reg. §1.46-3(d), which provides the same "placed in service" definition for property qualifying for the IRC §38 Investment Tax Credit.

To qualify for the IRC §42 credit, a low-income unit must be placed in service; i.e.

- Placed in a condition or state of readiness, and
- Be available for a specifically assigned function. In this case, made available for rent to a qualified low-income household.

Failure to meet either requirement will result in the low-income unit no longer being placed in service and no credit for the unit would be allowable.

Fact Patterns

A taxpayer may cease efforts to make vacant low-income units available for rent. For example:

- the vacant units are extensively damaged or not prepared for a new tenant.
- the vacancy rate is high and there is no immediate need for the unit, or
- the taxpayer anticipates a disposition of the low-income project that will result in the termination of the extended use agreement and, through attrition, is attempting to reduce the number of low-income tenants protected under IRC §42(h)(6)(E)(ii) from evictions without cause and rent increases not otherwise allowed under IRC §42.

Audit Techniques

Individual low-income units, or entire low-income buildings, may no longer be placed in service. To determine whether the taxpayer is pursuing an on-going business activity:

- Review the rent records to identify low-income units remain vacant for unexpectedly long periods of time.
- Review the taxpayer's marketing and advertising efforts to determine whether the taxpayer is making reasonable attempts to rent vacant units. As noted earlier, "reasonable attempts" will vary. See Rev. Rul. 2004-82, Q&A #9.

Computing the Applicable Fraction

To summarize, the audit of the Applicable Fraction begins with a unit-by-unit evaluation to determine whether the housing meets the three basic requirements:

- the unit must be occupied by an income-qualified household,

- the rent must be restricted, and
- the unit must be suitable for occupancy.

In addition, the low-income units are subject to the following rules, for which the taxpayer's compliance should be evaluated.

- Available Unit Rule
- Vacant Unit Rule
- General Public Use Requirement and Transient Use Rule

Consideration may also be given to whether individual low-income units (or entire buildings) are placed in service and qualify as depreciable property under IRC §168. Once the qualifying low-income units have been identified, the applicable fraction can be determined for each low-income building. The applicable fraction is always a fraction carried out four decimal places.

Determined at the End of the Taxable Year

Under IRC §42(c) (1) (A), the applicable fraction is determined on the last day of the taxable year.

Example 1: Applicable Fraction Determined as of the Last Day of Taxable Year

A taxpayer owns one low-income building consisting of 15 residential rental units of equal size. All of the units are intended to be low-income units. The taxpayer reports the applicable fraction is 100% (15/15) on Form 8609-A, line 2, included with its tax return.

For various reasons, 4 units are determined to be nonqualifying units at the end of the taxable year. The correct applicable fraction is (15-4) ÷15, or 73.33%

A taxpayer may suggest that consideration should be given to low-income housing provided during the taxable year, rather than basing the applicable fraction on a "snap shot" computation at the end of the taxable year. The interpretation of "on the last day of the taxable year" was explained in CCA 200913012, in which Chief Counsel concluded that if a taxpayer "failed to restore the building by [the end of the tax year], no credits would be allowed for the entire taxable year…even if the reasonable period (or reasonable restoration period) to the restore the building extends into [the subsequent tax year]."

Example 2: "Snap Shot" Determination

A taxpayer owns one low-income building consisting of 15 residential rental units. All of the units were qualified low-income unit from the beginning of the tax year on January 1st until December 15th, when the building was completely destroyed by a fire. The building was rebuilt and placed back in service in June of the subsequent year. The taxpayer prorated the applicable fraction, computed as (15/15) x (11/12) or 91.67%, to account for the eleven full months that low-income housing was provided.

The applicable fraction is zero at the end of the year and no credit is allowable for the entire taxable year.

Unit Fraction or Floor Space Fraction

Under IRC §42(c) (1) (B), the applicable fraction is the smaller of the unit fraction or the floor space fraction.

Example 3: Lesser of Unit Fraction or Floor Space Fraction

A taxpayer owns one low-income building consisting of 15 residential rental units. Five units are 1-bedroom units with 950 square feet, five units are two-bedroom units with 1,100 square feet, and five of the units are 3-bedroom units with 1,500 square feet. All of the units are intended to be low-income units. The taxpayer reports the applicable fraction is 1.0000 (15/15 or 17,750/17,750 square feet) on Form 8609-A, line 2, included with its tax return.

For various reasons, 4 of the 3-bedroom units are determined to be nonqualifying units at the end of the taxable year.

The correct applicable fraction is 67.14%, which is the lesser of:

- The unit fraction: (15-4) ÷ 15, which is 73.33%, or
- the floor space fraction: [17,750 – 4(1,500)] ÷ 17,750, which is 67.14%

First Year of the 10-Year Credit Period: New Construction

Under IRC §42(f) (2) (A), the numerator is the sum of the applicable fractions determined as of the close of each full month of the taxable year that the building was placed in service, and the denominator is 12.

Example 4: First Year Computation for Newly Constructed Building

A taxpayer constructed a new IRC §42 building with 10 units. Units 1 through 5 are 750 square feet and Units 6 through 10 is 1,000 square feet. The total square footage of all the units is (5 x 750 sq. ft.) + (5 x 1,000 sq. ft.) = 8,750 sq. ft. The building was place in service on June 15, 2009, and 2009 is the first year of the credit period. The following chart indicates with an "X" which months during 2009 that the units were qualified low-income units.

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1						x	x	x	x	x	x	x
2										x	x	x
3							x	x	x	x	x	x
4								x	x	x	x	x

5									x	x	x	x
6								x	x	x	x	x
7								x	x	x	x	x
8							x	x	x	x	x	x
9							x	x	x	x	x	x
10							x	x	x	x	x	x
Units	0	0	0	0	0	0	.5000	.8000	.9000	1.00	1.00	1.00
Sq. Ft.	0	0	0	0	0	0	.5143	.8286	.9143	1.00	1.00	1.00

The applicable fraction for January through June is zero. Even though a tenant lived in a unit during June, the unit was not placed in service the entire month. The applicable fraction for 2009 using the Unit Fraction method is computed as

(.50 + .80 + .90 + 1.00 + 1.00 + 1.00) ÷ 12 which equals 0.4333, or 43.33%.

Using the Floor Space Fraction method, the applicable fraction is computed as:

(.5143 + .8286 + .9143 + 1.00 + 1.00 + 1.00) ÷ 12 which equals 0.4381, or 43.81%

The applicable fraction is 0.4333, the smaller of the Unit Fraction or the Floor Space Fraction.

First Year of the 10-Year Credit Period: Acquisition and Rehabilitation of an Occupied Building

A taxpayer may acquire and rehabilitate a building qualifying for both the acquisition and rehabilitation credit under IRC §42, but the taxpayer is not required to determine two applicable fractions for the separate allocation of credit. 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.

Example 5: First Year Computation for Acquired and Rehabilitated Building

A building has 10 units which were all occupied at the time the building was purchased. Units 1-5 have 750 square feet and Units 6-10 have 1,000 square feet.

The total square footage of all the units is (5 x 750 sq. ft.) + (5 x 1,000 sq. ft.) = 8,750 sq. ft.

The building was placed in service on May 15, 2008, the acquisition date, and the taxpayer elected to begin the credit period the following year, 2009.

The following chart indicates with an "x" which months during 2009 that the units were qualified low-income units. Typically, gaps occur (1) at the beginning of the year because the units are not occupied by qualifying tenants, and (2) while the units are being rehabilitated.

Unit	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
1		x	x	x		x	x	x	x	x	x	x
2	x	x	x	x			x	x	x	x	x	x
3		x	x	x	x		x	x	x	x	x	x
4	x	x	x	x	x			x	x	x	x	x
5					x	x	x	x	x	x	x	x
6			x	x	x	x	x	x	x	x	x	x
7		x	x	x				x	x	x	x	x
8	x	x	x	x	x		x	x	x	x	x	x
9	x	x	x	x			x	x	x	x	x	x
10		x	x	x	x		x	x	x	x	x	x
Units	.40	.80	.9000	.9000	.60	.3000	.80	1.00	1.00	1.00	1.00	1.00
Sq. Ft.	.40	.80	.9143	.9143	.60	.2857	.80	1.00	1.00	1.00	1.00	1.00

The applicable faction for 2009 using the Unit Fraction is computed as

[.40 + .80 + .90 + .90 + .60 + .30 + .80 + (4 x 1.00)] ÷ 12, which equals 0.7250, or 72.50%.

Using the Floor Space Fraction, the applicable fraction for 2009 is computed as:

[.40 + .80 + .9143 + .9143 + .60 + .2857 + .80 + (4 x 1.000)] ÷ 12,

Which equals .7262 or 72.62%

The applicable fraction is 0.7250 or 72.50%, the smaller of the Unit Fraction or the Floor Space Fraction.

Refer to Chapter 4 of the Guide for Completing Form 8823 for additional information.

Year 11 of the 15-Year Compliance Period

Under IRC §42(f) (2) (B), any reduction in allowable credit for the first year because of the special computation of the applicable fraction is allowable in the eleventh year of the compliance period and is accounted for on Form 8609-A, line 17.

Additions to Qualified Basis

Units first qualifying as low-income units after the end of the first year of the credit period are accounted for under IRC §42(f) (3) by modifying the applicable percentage. The modification doesn't affect the computation of the applicable fraction at the end of the taxable year, but it is helpful to identify units that were not qualified low-income units at the end of the first year of the credit period. See Chapter 13.

Common Computation Errors

- For the first year of the credit period, the taxpayer computed the applicable fraction based on the month the building was placed in service. For example, the building was placed in service in April, so the taxpayer reports on Form 8609-A that the applicable fraction is .7500, computed as 9 month ÷ 12 months.
- For the first year of the credit period, the taxpayer included the month the unit was placed in service if the unit was occupied the same month, even though the unit was not in service the entire month. To include the unit in the applicable fraction, the unit must be in service the entire month and occupied at least one day.
- The taxpayer does not compute both the unit fraction and floor space fraction to determine the lesser fraction.

Minimum Set-Aside

To qualify for the IRC §42 credit, a taxpayer must provide a minimum number of low-income units, which is referred to as the "minimum set-aside." If a taxpayer fails to meet the minimum set-aside requirement after the first year of the credit period, then no credit is allowable for the tax year. If the taxpayer fails to meet the minimum set-aside for the first year of the credit period, then the buildings do not qualify as low-income buildings under IRC §42 and no credit is allowable for any year of 10-year credit period.

Law

IRC §42(g)(1) defines a qualified low-income housing "project" as any project for residential rental property if the project meets one of the three following tests, as elected by the taxpayer.

- 20-50 test. The project meets the requirements if 20% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50% or less of area median gross income.
- 40-60 test. The project meets the requirements of this subparagraph if 40% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60% or less of area median gross income.
- 25-60 test. For projects located in a city having 5 boroughs and a population in excess of 5,000,000, the 40-60 minimum set-aside test is applied by substituting 25% for 40%. See IRC §142(d) (6), which is made applicable to IRC §42 projects under IRC §42(g) (4).

Making the Election

The election is made on Form 8609, line 10c. As noted in language following IRC §42(g) (1), the minimum set-aside election, once made, is irrevocable.

Project Defined

Under IRC §42(g) (3) (D), each low-income building is considered a separate project unless the taxpayer identifies each building which is, or will be, part of the project. Under IRC §42(g) (7) and Treas. Reg. §1.103-8(b) (4) (ii), two or more qualified low-income buildings can be included in a project only if the buildings:

- are located on the same tract of land, unless all the units in all the "scattered site" buildings to be included in the project are low-income units.
- are owned by the same person (entity) for federal tax purposes.
- are financed under a common plan for financing, and
- have similarly constructed housing units.

A taxpayer may elect to group low-income buildings in any combination to best satisfy IRC §42 requirements and maximize the allowable credit for the first year of the credit period. The decision is often based on when the buildings are placed in service and "leased-up."

Project Identified

Under IRC §42(g) (3) (D), a low-income project with more than one building must be identified. A project is treated as consisting of only one building unless each building which is (or will be) part of the project is identified in such form and manner as the Secretary may provide.

Multi-building projects are identified as part of the taxpayer's first year certification on Form 8609, line 8b. In addition to checking the box "yes," the taxpayer must include an attachment to the Form 8609, with the following information:

- Name and address of the project and every building included in the project.
- Building Identification Number (BIN) for every building in the project,
- Aggregate credit dollar amount for the project, and
- Credit allocated to each building in the project.

If the taxpayer checks the "yes" box on Form 8609, but fails to include the attachment with the required information, then each building is considered a separate project.

Date for Meeting Requirement

Under IRC §42(g)(3)(A), a building is treated as a qualified low-income building only if the project of which such building is a part satisfies the minimum set-aside requirement not later than the close of the first year of the credit period for such building.

IRC §42(g) (3) (B) provides an alternative when a building relies on one or more buildings placed in service after the building for qualification as a qualified low-income building. The taxpayer can use this method to effectively create a "project" if two conditions are met:

- The later buildings must be placed in service within 12 months of the date the first building is placed-in-service.
- Within the 12-month period after the first building is placed in service, all the subsequent buildings collectively must meet the minimum set-aside requirement.

If the taxpayer uses this methodology, then the building relying on subsequent buildings for qualification as a low-income building is treated as placed in service on the most recent date any additional building was placed in service. See IRC §42(g) (3) (B). The alternative treatment under IRC §42(g) (3) (B) is seldom applied.

For tax planning reasons and ease of operating the project during the 15-year compliance period, taxpayers usually (but not always) organize a multi-building project such that all the low-income buildings begin the credit period at the same time. IRC §42 does not require that all the buildings in a project begin the credit period at the same time. The only requirement is that a low-income building is part of a project that meets the minimum set-aside no later than at the end of the first year of the building's credit period.

Continuous Compliance

The minimum set-aside must be met each year of the 15-year compliance period. Under IRC §42(c)(2)(A), a "qualified low-income building" is any building which is part of a "qualified low-income housing project" at all times during the building's 15-year compliance period. That is:

- beginning on the first day in the compliance period for which the building is a part of the project, and
- ending on the last day of the compliance period with respect to the building. Under IRC §42(g)(5), a taxpayer may elect to treat a building as not part of a qualified low-income housing project for any period beginning after the compliance period for such building.

Waiver of De Minimis Errors

Under IRC §42(g) (8), the IRS may waive de minimis errors in meeting the minimum set-aside requirement.

- Taxpayers can request private letter rulings to obtain the waiver.
- If a de minimis error is discovered as part of an IRS audit, the examiner should contact the IRC §42 program analyst. Examiners do not have authority to waive de minimis errors.

Testing for the Minimum Set-Aside Requirement

Once the applicable fraction for each low-income building in the project has been determined, the taxpayer's compliance with the minimum set-aside requirement can be tested.

Example 1: Minimum Set-Aside Test

A taxpayer owns IRC §42 low-income housing consisting of 10 single family homes. The homes are equal in size and comparably constructed. Each home was allocated IRC §42 credit equaling $10,000 and the taxpayer elected the 40-60 minimum set-aside. The taxpayer claimed credit equaling $100,000 on its tax return

for the 2014 tax year, the sixth year of the credit period.

The 2014 return was audited and the examiner determined that, at the end of the 2014 taxable year:

- Homes #1 and #3 were occupied by households whose income exceeded 60% of AMGI at the time of move-in during 2014.
- Home #4 was occupied by a household composed entirely of full-time students that was not a qualified low-income student household under IRC §42(i)(3)(D).
- Home #5 was vacant at the end of the year. The taxpayer could not find the last tenant's file to establish that the unit was last occupied by a low-income tenant.
- Home #7 was vacant at the end of the year. The state housing agency filed Form 8823 to report that the unit was not suitable for occupancy; i.e., it not been cleaned and prepared for a new tenant.
- Homes #8 and #9 were not low-income unit because the rent paid by the tenants exceeded the gross rent limit after considering utility allowances and fees paid by the tenants.
- Homes #2, #6, and #10 were qualified low-income units at the end of the taxable year.

Homes #1, #3, #4, #5, #7, #8 and #9 are not qualified low-income buildings. The examiner must now consider how the taxpayer defined the "qualified low-income project" by reviewing the taxpayer's elections on Form 8609.

- If the taxpayer treated each home as a separate project, then homes #2, #6 and #10 are qualified low-income projects and the taxpayer's allowable credit for 2014 is $30,000, computed as 3 x $10,000.
- If the taxpayer treated all the homes as a single project, then at least four of the ten homes must be qualified low-income units to meet the 40% minimum set-aside requirement. In this case, however, only three of the buildings are qualified low-income units. The taxpayer has failed the test and no credit is allowable because the taxpayer did not provide the minimum amount of low-income housing.

The above example demonstrates the two most likely project configurations. A taxpayer may choose to create multiple projects with any combination of buildings meeting the definition of a qualified low-income project.

Failure to Satisfy Minimum Set-Aside Requirement

If the project fails the minimum set-aside requirement, then the qualified basis of each building in the project is deemed to be zero. See Chapter 13 for discussion of qualified basis.

Deep Rent Skewing

Deep Rent Skewing

Under IRC §142(d) (4) (B) (i), a taxpayer can elect to provide housing to households with incomes of 40% or less of AMGI. The election is made on Form 8609, Low-Income Housing Certification, line 10d. The project qualifies if:

- 15% or more of the low-income units are occupied by individuals whose income is 40% or less of the AMGI;
- The gross rent with respect to each low-income unit in the project does not exceed 30% of the applicable income limit applicable to the individuals occupying the unit; and
- The gross rent with respect to each low-income unit in the project does not exceed half of the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

Relationship to Minimum Set-Aside

Low-income units satisfying the deep rent skewing election also satisfy the minimum set-aside requirement.

Failure to Satisfy Deep Rent Skewing Election

If the project fails to satisfy the deep rent skewing election, then none of the units purported to satisfy the deep rent skewing election are low-income units for purposes of determining the building's applicable fraction or whether the minimum set-aside requirement is met.

Summary

The applicable fraction is the percentage of rental units in a building that qualify as low-income units, measured as a percentage of floor space or as a percentage of units.

The applicable fraction is determined on the last day of the taxable year and is a fraction carried out four decimal places.

The applicable fraction for the "rehabilitation" credit is the same for the "acquisition" credit.

There are special rules for determining the applicable fraction for the first year of the credit period.

To qualify as a low-income unit, the unit must satisfy three basic requirements:

(1) the unit must be occupied by an income-qualified household,

(2) the rent must be restricted, and

(3) the unit must be suitable for occupancy.

The taxpayer is also subject to four rules governing the operation of the IRC §42 project: (1) the Available Unit Rule, (2) the Vacant Unit Rule, (3) the General Public Use Requirement, and (4) the Transient Use Rule.

The low-income units must be placed in service.

The taxpayer must provide a minimum amount of low-income housing to qualify for any credit. The taxpayer may elect to provide a minimum of:

- 40% of the housing for households with income at or below 60% of the Area Median Gross Income (AMGI).
- 20% of the housing for households with income at or below 50% of AMGI.
- 25% of the housing for households with income at or below 60% of the Area Median Gross Income, but only if the project is located in a city having 5 boroughs and a population in excess of 5,000,000. The election, referred to as the "minimum set-aside," is made on Form 8609 and is irrevocable.

If the taxpayer fails the minimum set-aside for the first year of the credit period, then the project never qualifies for the credit.

In addition to the minimum set-aside, the taxpayer may elect deep rent skewing, so that at least 15% of the housing is occupied by households with income at or below 40% of AMGI.