

**Low-income housing credit.** This ruling answers 12 questions about the low-income housing credit provisions under section 42 of the Code.

## Rev. Rul. 2004–82

### PURPOSE

This revenue ruling answers certain questions about the low-income housing credit under § 42 of the Internal Revenue Code.

### LAW AND QUESTIONS AND ANSWERS

#### A. ELIGIBLE BASIS AND QUALIFIED BASIS ISSUES

##### Law

Section 42(a) provides for a credit for investment in certain low-income housing buildings. The amount of the low-income housing credit for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building (as defined in § 42(c)(2)).

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under § 42(d)).

Section 42(c)(1)(B) defines the applicable fraction as the smaller of the unit fraction or the floor space fraction. Section 42(c)(1)(C) defines the unit fraction as the fraction the numerator of which is the number of low-income units (as defined in § 42(i)(3)(A)) in the building and

the denominator of which is the number of residential rental units (that is, all units in the building which are available to rent as personal residences), whether or not occupied, in the building. Section 42(c)(1)(D) defines the floor space fraction as the fraction the numerator of which is the total floor space of the low-income units in the building and the denominator of which is the total floor space of the residential rental units, whether or not occupied, in the building.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period. Section 42(d)(4)(A) provides that, except as provided in § 42(d)(4)(B) and (C), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property. Section 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property of a character subject to the allowance for depreciation (1) used in common areas or (2) provided as comparable amenities to all residential rental units in the building.

Section 42(d)(4)(C)(i) provides that the adjusted basis of any building located in a qualified census tract is determined by taking into account the adjusted basis of property (of a character subject to the allowance for depreciation and not otherwise taken into account) used throughout the taxable year in providing any community service facility. Section 42(d)(4)(C)(iii) provides that the term “community service facility” means any facility designed to serve primarily individuals whose income is 60 percent or less of area median income (AMGI) (within the meaning of § 42(g)(1)(B)). Section 42(d)(5)(C)(ii)(I) defines the term “qualified census tract” as any census tract (1) which is designated by the Secretary of Housing and Urban Development (HUD), and (2) for the most recent year for which census data are available on household income in the tract, either in which 50 percent or more of the households have an income which is less than 60 percent of the AMGI for the year or which has a poverty rate of at least 25 percent. See

<http://www.huduser.org/datasets/qct.html> for a listing of census tracts designated by the Secretary of HUD.

Section 42(d)(4)(C)(ii) provides that the increase in the adjusted basis of any building which is taken into account because of a community service facility may not exceed 10 percent of the eligible basis of the qualified low-income housing project (as defined in § 42(g)(1)) of which the community service facility is a part. For this purpose, § 42(d)(4)(C)(ii) provides that all community service facilities which are part of the same qualified low-income housing project are treated as one facility.

Rev. Rul. 2003–77, 2003–29 I.R.B. 75, provides that the requirement that a community service facility must be designed to serve primarily individuals whose income is 60 percent or less of AMGI will be satisfied if the following conditions are met. First, the facility must be used to provide services that will improve the quality of life for community residents. Second, the taxpayer must demonstrate that the services provided at the facility will be appropriate and helpful to individuals in the area of the project whose income is 60 percent or less of AMGI. This may, for example, be demonstrated in the market study required to be conducted under § 42(m)(1)(A)(iii), or another similar study. Third, the facility must be located on the same tract of land as one of the buildings that is part of the qualified low-income housing project. Finally, if fees are charged for services provided, they must be affordable to individuals whose income is 60 percent or less of AMGI.

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

In the Tax Reform Act of 1986 (the “1986 Act”), Congress reorganized §§ 103

and 103A of the Internal Revenue Code of 1954 (the “1954 Code”) regarding tax-exempt bonds into §§ 103 and 141 through 150 of the Internal Revenue Code of 1986. Congress intended that to the extent not amended by the 1986 Act, all principles of pre-1986 Act law would continue to apply to the reorganized provisions. H.R. Conf. Rep. No. 841, 99<sup>th</sup> Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686. Because no regulations have been promulgated relating to residential rental property for purposes of § 103, the regulations relating to residential rental property promulgated pursuant to the 1954 Code continue to apply except as otherwise modified by the 1986 Act and subsequent law.

Under § 1.103-8(b)(4)(i) of the Income Tax Regulations, facilities that are functionally related and subordinate to residential rental projects are considered residential rental property. Section 1.103-8(b)(4)(iii) provides that functionally related and subordinate facilities include facilities for use by the tenants, such as swimming pools and other recreational facilities, parking areas, and other facilities reasonably required for the project. Examples in § 1.103-8(b)(4)(iii) of facilities reasonably required for a project include units for resident managers or maintenance personnel.

Q-1. A new qualified low-income building (Building) is located in an area in which owners of apartment buildings typically employ security officers due to the level of crime in the area.

(a) If a unit in Building is occupied by a full-time security officer for that building and Building’s owner requires the security officer to live in the unit, is the adjusted basis of that unit includable in Building’s eligible basis under § 42(d)(1)?

(b) If yes, is that unit a residential rental unit includable in the numerator and denominator of Building’s applicable fraction under § 42(c)(1)(B)?

A-1. (a) Yes. The legislative history of § 42 indicates that residential rental property includes, in addition to the residential rental units, facilities for use by the tenants and other facilities reasonably required by the project.

Under § 1.103-8(b)(4)(iii), functionally related and subordinate property is property that is reasonably required for the project. Examples of functionally related and subordinate property are units

for resident managers or maintenance personnel. See § 1.103-8(b)(4)(iii). Thus, while units for resident managers or maintenance personnel are not residential rental units, they are treated as part of residential rental property because these units are functionally related and subordinate to the project. The unit occupied by a full-time security officer is similar to the units described in the examples contained in § 1.103-8(b)(4)(iii), and is reasonably required by the project because of the level of crime in the area. Thus, the unit is functionally related and subordinate to Building. As a result, the unit is residential rental property for purposes of § 42 and its adjusted basis is includable in Building’s eligible basis under § 42(d)(1).

(b) No. The term “residential rental unit” has a different meaning than the term “residential rental property” for purposes of § 42. Under § 1.103-8(b)(4)(iii), units for resident managers or maintenance personnel are residential rental property because they are functionally related and subordinate to residential rental projects, not because they are residential rental units. Similarly, a unit occupied by a full-time security officer is not a residential rental unit. Only residential rental units are includable in Building’s applicable fraction under § 42(c)(1)(B).

If in a later year of the credit period, the unit occupied by the full-time security officer is converted to a residential rental unit, the unit will be includable in the denominator of Building’s applicable fraction for that year. If the unit also becomes a low-income unit in a later year, the unit will be includable in the numerator of Building’s applicable fraction for that year.

Q-2. A new qualified low-income building (Building) received a housing credit allocation on June 1, 2003, and was placed in service in 2004. Building is located in a qualified census tract (as defined in § 42(d)(5)(C)). The neighborhood in which Building is located is an area with a high rate of crime. In 2004, the local police department leases a unit in Building to be used as a police substation (Facility). The Facility is part of the police department’s community outreach program. This Facility is intended to serve as a deterrent to crime in the community, assist the community with solving crime-related problems, reduce the response time to area calls for service, and provide the locally

assigned police officers with a local office. The services provided by the police are free of charge. The adjusted basis of the property constituting the Facility (of a character subject to the allowance for depreciation and not otherwise taken into account in the adjusted basis of Building) does not exceed 10 percent of the eligible basis of Building.

As required by § 42(m)(1)(A)(iii), prior to the allocation of low-income housing credit to Building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by Building. The study found, among other items, that due to the high rate of crime in the community in which Building is located, providing a police substation would be appropriate and helpful to individuals in the area of Building whose income is 60 percent or less of AMGI.

(a) Is the adjusted basis of the Facility includable in Building’s eligible basis under § 42(d)(1)?

(b) If yes, is the Facility includable in Building’s applicable fraction under § 42(c)(1)(B)?

A-2. (a) Yes. The Facility qualifies as a community service facility under § 42(d)(4)(C)(iii). Under the facts presented, the Facility is designed to serve primarily individuals whose income is 60 percent or less of AMGI for the following reasons: (1) the services provided at the Facility are services that will help improve the quality of life for community residents; (2) the market study required to be conducted under § 42(m)(1)(A)(iii) found that the services provided at the Facility would be appropriate and helpful to individuals in the area of Building whose income is 60 percent or less of AMGI; (3) the Facility is located within Building; and (4) the services provided at the Facility are affordable to individuals whose income is 60 percent or less of AMGI.

Because the other requirements set forth in § 42(d)(4)(C) are met, the adjusted basis of Building will be determined by taking into account the adjusted basis of the Facility. Thus, the adjusted basis of the Facility is includable in Building’s eligible basis.

(b) No. The Facility is not a residential rental unit for purposes of § 42. Therefore, the Facility is not includable in either the

numerator or denominator of Building's applicable fraction.

Q-3. On applying to the housing credit agency for an allocation of § 42 credits for a new building, the housing credit agency requires that the applicant pay a nonrefundable application fee. If the applicant is successful, an allocation fee is payable to the housing credit agency. Are the application fee and allocation fee includable in the eligible basis of the applicant's low-income housing building?

A-3. No. The application fee and allocation fee are not includable in the eligible basis of the applicant's low-income housing building because the fees are not capitalizable into the adjusted basis of the building. See § 263 and § 263A. However, depending on the facts and circumstances, all or a portion of these fees may be required to be capitalized as amounts paid to create an intangible asset. See § 1.263(a)-4. Any portion of these fees not required to be capitalized under § 1.263(a)-4 may be deductible as an ordinary and necessary expense under § 162 or § 212, provided the taxpayer satisfies the requirements of those sections.

## B. FIRST-YEAR LOW-INCOME UNIT ISSUE

### Law

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

Section 42(f)(1) defines the "credit period" for a low-income housing credit building as the period of 10 taxable years beginning with (A) the taxable year in which the building is placed in service or (B) at the election of the taxpayer, the succeeding taxable year, but in either case only if the building is a qualified low-income building as of the close of the first year of the period.

Section 42(f)(2)(A) provides a special rule for determining the amount of the low-income housing credit allowable for the first year of the credit period. It provides that the credit allowable under § 42(a) with respect to any building for the first taxable year of the credit period must be determined by substituting for the applicable fraction under § 42(c)(1) the fraction (i) the numerator of which is the sum of the applicable fractions determined under § 42(c)(1) as of the close of each full month of the first taxable year of the credit period during which the building was in service, and (ii) the denominator of which is 12.

Q-4. On initial occupancy of a unit in the first year of a newly constructed building's credit period, an income-qualified tenant moved into the unit on the last day of a month. The unit was rent-restricted in accordance with § 42(g)(2). In determining the low-income housing credit for the building for the first year of the credit period, is the unit treated as a low-income unit for that month for purposes of the fraction calculated under § 42(f)(2)(A)?

A-4. Yes. The unit is treated as a low-income unit eligible for inclusion in the numerator and denominator of the monthly applicable fraction calculated under § 42(f)(2)(A)(i) if the tenant, who meets the income limitation under § 42(g)(1), resides in the rent-restricted unit on the last day of the month. However, in accordance with § 42(f)(2)(A), the building must have been placed in service for a full month for the unit to be includable in the numerator and denominator of the monthly applicable fraction.

## C. EXTENDED LOW-INCOME HOUSING COMMITMENT ISSUE

### Law

Section 42(h)(6)(A) provides that no credit will be allowed with respect to any building for the taxable year unless an extended low-income housing commitment (as defined in § 42(h)(6)(B)) is in effect as of the end of the taxable year. Section 42(h)(6)(B)(i) provides that the term "extended low-income housing commitment" means any agreement between the taxpayer and the housing credit agency which requires that the applicable fraction (as defined in § 42(c)(1)) for the building for each taxable year in the extended use

period will not be less than the applicable fraction specified in the agreement *and which prohibits the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii)*" (emphasis added).

Section 42(h)(6)(E)(ii) provides that the termination of an extended low-income housing commitment under § 42(h)(6)(E)(i) will not be construed to permit before the close of the 3-year period following the termination (I) the eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or (II) any increase in the gross rent with respect to a low-income unit not otherwise permitted under § 42.

Section 42(h)(6)(D) defines the term "extended use period" as the period beginning on the first day in the compliance period on which the building is part of a qualified low-income housing project and ending on the later of (1) the date specified by the agency in the extended low-income housing commitment, or (2) the date which is 15 years after the close of the compliance period.

Section 42(h)(6)(J) provides that if, during a taxable year, there is a determination that a valid extended low-income housing commitment was not in effect as of the beginning of the year, the determination will not apply to any period before that year and § 42(h)(6)(A) will be applied without regard to the determination provided that the failure is corrected within 1 year from the date of the determination.

In the Omnibus Budget Reconciliation Act of 1990, 1991-2 C.B. 481, 531 (the "1990 Act"), Congress amended § 42(h)(6)(B)(i) by adding the language emphasized above, which prohibits the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii). At the time of this amendment, however, § 42(h)(6)(E)(ii) was already part of § 42.

The legislative history to § 42 states that the extended low-income housing commitment must prohibit the eviction or termination of tenancy (other than for good cause) of an existing tenant of a low-income unit or any increase in the gross rent inconsistent with the rent restrictions on the unit. H. Rep. No. 894, 101<sup>st</sup> Cong., 2d Sess. 10, 13 (1990).

Q-5. Must the extended low-income housing commitment prohibit the actions described in subclauses (I) and (II) of

§ 42(h)(6)(E)(ii) only for the 3-year period described in § 42(h)(6)(E)(ii)?

A-5. No. Section 42(h)(6)(B)(i) requires that an extended low-income housing commitment include a prohibition during the extended use period against (1) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit (no-cause eviction protection) and (2) any increase in the gross rent with respect to the unit not otherwise permitted under § 42. When Congress amended § 42(h)(6)(B)(i) to add the language emphasized above, § 42(h)(6)(E)(ii) was already part of § 42. As a result, Congress must have intended the amendment to § 42(h)(6)(B)(i) to add an additional requirement beyond what was contained in § 42(h)(6)(E)(ii), which already prohibited the actions described in that section for the 3 years following the termination of the extended use period. Because the requirements of § 42(h)(6)(B)(i) otherwise apply for the extended use period, Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii) to apply throughout the extended use period.

If it is determined by the end of a taxable year that a taxpayer's extended low-income housing commitment for a building does not meet the requirements for an extended low-income housing commitment under § 42(h)(6)(B) (for example, it does not provide no-cause eviction protection for the tenants of low-income units throughout the extended use period), the low-income housing credit is not allowable with respect to the building for the taxable year, or any prior taxable year. However, if the failure to have a valid extended low-income housing commitment in effect is corrected within 1 year from the date of the determination, the determination will not apply to the current year of the credit period or any prior year.

Pursuant to this revenue ruling, each housing credit agency is required to review its extended low-income housing commitments for compliance with the interpretation of § 42(h)(6)(B)(i) provided in this question and answer. This review must be completed by December 31, 2004. If during the review period the housing credit agency determines that an extended low-income housing commitment is not

in compliance with the interpretation of § 42(h)(6)(B)(i) provided in this question and answer, the 1-year period described under § 42(h)(6)(J) will commence on the date of that determination.

#### D. HOME INVESTMENT PARTNERSHIP ACT LOAN ISSUES

##### Law

Section 42(b)(2)(A) provides that for a qualified low-income building placed in service by the taxpayer after 1987, the term "applicable percentage" means (1) the 70-percent present value credit under § 42(b)(2)(B)(i) for new buildings which are not federally subsidized, and (2) the 30-percent present value credit under § 42(b)(2)(B)(ii) for new buildings which are federally subsidized and for existing buildings.

In general, § 42(d)(5)(C)(i) provides that in the case of any building located in a designated qualified census tract or difficult development area (as defined in § 42(d)(5)(C)(ii) and (iii)), (I) the eligible basis of a new building will be 130 percent of the eligible basis determined without regard to this rule, and (II) in the case of an existing building, the rehabilitation expenditures taken into account under § 42(e) will be 130 percent of the expenditures determined without regard to this rule.

Section 42(g)(1) defines the term "qualified low-income housing project" as any project for residential rental property if the project meets the requirements of § 42(g)(1)(A) or (B), whichever the taxpayer elects. The election is irrevocable. The project meets the requirements of § 42(g)(1)(A) if 20 percent or more of the residential units in the project are rent-restricted and occupied by individuals whose income is 50 percent or less of AMGI. The project meets the requirements of § 42(g)(1)(B) if 40 percent or more of the residential units in the project are rent-restricted and occupied by individuals whose income is 60 percent or less of AMGI. The requirement a taxpayer elects is referred to as the "minimum set-aside" for the project.

Section 42(g)(2)(A) provides that for purposes of § 42(g)(1), a residential unit is rent-restricted if the gross rent with respect to the unit does not exceed 30 percent of

the imputed income limitation applicable to the unit.

Section 42(g)(2)(C) provides that the imputed income limitation applicable to a unit is the income limitation which would apply under § 42(g)(1) to individuals occupying the unit if the number of individuals occupying the unit were: (i) in the case of a unit which does not have a separate bedroom, 1 individual; and (ii) in the case of a unit which has one or more separate bedrooms, 1.5 individuals for each separate bedroom.

Section 42(g)(3)(A) provides that a building will be treated as a qualified low-income building only if the project (of which the building is a part) meets the requirements of § 42(g)(1) not later than the close of the first year of the credit period for the building.

Section 42(i)(2)(A) provides that for purposes of § 42(b)(1), a new building will be treated as federally subsidized for any taxable year if, at any time during the taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under § 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or operation thereof.

Section 42(i)(2)(B) provides that a loan or tax-exempt obligation will not be taken into account under § 42(i)(2)(A) if the taxpayer elects to exclude from eligible basis of the building for purposes of § 42(d), in the case of a loan, the principal amount of the loan, and in the case of a tax-exempt obligation, the proceeds of the obligation.

Section 42(i)(2)(C) provides that § 42(i)(2)(A) will not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if (i) the obligation or loan (when issued or made) identified the building for which the proceeds of the obligation or loan would be used, and (ii) the obligation is redeemed, and the loan is repaid, before the building is placed in service.

Section 42(i)(2)(D) provides that the term "below market Federal loan" means any loan funded in whole or in part with Federal funds if the interest rate payable on the loan is less than the applicable Federal rate (AFR) in effect under § 1274(d)(1) (as of the date the loan was made).

Section 42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnerships Act (HOME) with respect to any building will not be treated as a below market Federal loan under § 42(i)(2)(D) if 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of AMGI (the special set-aside). Section 42(d)(5)(C) (the 130 percent eligible basis increase) does not apply to any building to which the preceding sentence applies.

Q-6. Taxpayer owns a new qualified low-income housing project consisting of Buildings 1 and 2, each containing 100 residential rental units. Forty percent of the units in each building are low-income units. Taxpayer elected the minimum set-aside for the project under § 42(g)(1)(B). Also, Taxpayer elected on Form 8609, *Low-Income Housing Credit Allocation Certification*, to treat the buildings as part of a multiple building project. A HOME loan at less than the AFR was provided with respect to the project.

(a) How does the special set-aside under § 42(i)(2)(E)(i) apply to qualify Buildings 1 and 2 for the 70-percent present value credit under § 42(b)?

(b) What rent restriction applies to the low-income units used to satisfy the special set-aside under § 42(i)(2)(E)(i)?

A-6. (a) To qualify the project for the 70-percent present value credit, Taxpayer must rent at least 40 units in each of Buildings 1 and 2 to tenants whose income is 50 percent or less of AMGI throughout the 15-year compliance period because the rule under § 42(i)(2)(E)(i) applies on a building-by-building basis. Because these units are to be low-income units and Taxpayer elected the minimum set-aside under § 42(g)(1)(B), the same units used to satisfy the special set-aside under § 42(i)(2)(E)(i) will also satisfy the project's minimum set-aside.

(b) The rent restriction that applies for all of the low-income units in the project, including the units in Buildings 1 and 2 which are used to satisfy the special set-aside under § 42(i)(2)(E)(i), is based on the applicable income limitation under § 42(g)(1)(B) because § 42(g)(2)(C) contains no exception for buildings that satisfy the special set-aside contained in § 42(i)(2)(E)(i). Therefore, the imputed income limitation (as defined in

§ 42(g)(2)(C)) applicable to the units in this project is 60 percent of AMGI. Under § 42(g)(2), rent may not exceed 30 percent of this imputed income limitation.

Q-7. (a) Taxpayer owns a newly constructed qualified low-income housing project consisting of one building located in a qualified census tract (Building). A HOME loan at less than the AFR was provided with respect to Building. Construction of Building was funded in part with an obligation the interest on which is exempt from tax under § 103 that was outstanding after Building was placed in service. Taxpayer did not elect to exclude from eligible basis the principal amount of the HOME loan or the proceeds of the tax-exempt obligation as provided under § 42(i)(2)(B). Forty percent of the residential units in Building are occupied by individuals whose income is 50 percent or less of area median gross income. Is Building eligible for the increase in eligible basis provided under § 42(d)(5)(C)(i)(I)?

(b) The facts are the same as in (a) above except that the interest rate on the HOME loan when made was not less than the AFR in effect under § 1274(d)(1), and the tax-exempt obligation was redeemed before Building was placed in service. Is Building eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I)?

(c) The facts are the same as in (a) above except that the special set-aside under § 42(i)(2)(E)(i) was not met, and the tax-exempt obligation was redeemed before Building was placed in service. Is Building eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I)?

A-7. (a) Yes. Because the tax-exempt obligation is outstanding after Building was placed in service and the proceeds of the obligation were not excluded from Building's eligible basis under § 42(i)(2)(B), Building is treated as federally subsidized under § 42(i)(2)(A). Inasmuch as the building is treated as federally subsidized, the 30-percent present value credit under § 42(b) will apply to Building. The fact that the tax-exempt obligation caused Building to be federally subsidized makes § 42(i)(2)(E)(i) (which provides that certain HOME loans will not cause a project to be federally subsidized if the special set-aside requirement under that section is satisfied, and whose applicability prohibits the increase in eligible basis under § 42(d)(5)(C)) inap-

licable. Accordingly, Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

If the tax-exempt obligation was redeemed before Building was placed in service or the proceeds of the obligation were excluded from Building's eligible basis, Building would no longer be treated as federally subsidized by the tax-exempt obligation under § 42(i)(2)(A). Therefore, § 42(i)(2)(E)(i) would be applicable, and cause Building not to be treated as federally subsidized by the HOME loan under § 42(i)(2)(A). Accordingly, the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) would apply, and Building would not be eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I). The 70-percent value credit under § 42(b) would apply to Building.

(b) Yes. When the HOME loan was made, the interest rate on the loan was not less than the AFR. Therefore, the loan is not described in § 42(i)(2)(D), and the building will not be treated as federally subsidized under § 42(i)(2)(A). The 70-percent present value credit will apply to Building. Because § 42(i)(2)(E)(i) is inapplicable to HOME loans not described in § 42(i)(2)(D), this loan is not subject to § 42(i)(2)(E)(i), and the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) does not apply. Accordingly, Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

(c) Yes. Although Building meets the exception under § 42(i)(2)(C) with respect to the tax-exempt obligation, Building is treated as federally subsidized under § 42(i)(2)(A) because it received a HOME loan at less than the AFR and does not meet the special set-aside under § 42(i)(2)(E)(i). The 30-percent present value credit will apply to Building as it is treated as federally subsidized. Because Building does not meet the special set-aside under § 42(i)(2)(E)(i), the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) does not apply, and Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

If Taxpayer elected to exclude the principal amount of the HOME loan from the eligible basis of Building under § 42(i)(2)(B) (whether or not the special set-aside under § 42(i)(2)(E)(i) was met), Building would not be treated as federally subsidized under § 42(i)(2)(A),

and the 70-percent present value credit would apply to Building. Because the HOME loan would not be taken into account, § 42(i)(2)(D) and § 42(i)(2)(E)(i) do not apply to Building. Therefore, Building would not be described in § 42(i)(2)(E)(i). Accordingly, the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) would not apply, and Building would be eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

## E. VACANT UNIT RULE ISSUES

### Law

Section 1.42-5(c)(1)(ix) provides that a housing credit agency must require the owner of a low-income housing project to certify at least annually to the housing credit agency that, for the preceding 12-month period, if a low-income unit in the project became vacant during the year, 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 “vacant unit rule”).

The legislative history to § 42 indicates that vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by qualified low-income individuals for purposes of the minimum set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit. H. R. Conf. Rep. No. 841, *supra*, at II-94.

Section 42(g)(2)(D)(i) provides that notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under § 42(g)(1), the unit will continue to be treated as a low-income unit if the income of the occupants initially met the income limitation and the unit continues to be rent-restricted.

Section 42(g)(2)(D)(ii) provides that if the income of the occupants of the unit increases above 140 percent of the income limitation applicable under § 42(g)(1), the unit ceases to be treated as a low-income unit if any available or subsequently available residential rental unit in the building (of a size comparable to, or smaller than, the unit) is occupied by a new resident

whose income exceeds the income limitation (the “available unit rule”).

Under § 1.42-15(a), a low-income unit in which the aggregate income of the occupants of the unit rises above 140 percent of the applicable income limitation under § 42(g)(1) is referred to as an “over-income unit.”

Section 1.42-15(c) provides that a unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law (for example, a unit is not available if it is subject to a preliminary reservation that is binding on the owner under local law prior to the date a lease is signed or the unit is occupied).

Q-8. On July 1, 2003, an income-qualified household (Household) initially occupied a rent-restricted residential rental unit in Building 1 of Project. On October 31, 2003, the property manager moved Household (and transferred Household’s lease) to a similar rent-restricted unit in Building 2 of Project that was not previously occupied. Household occupied the Building 2 unit at the end of 2003. The unit Household vacated in Building 1 was unoccupied during November and December. Are both units in Buildings 1 and 2 low-income units at the end of 2003?

A-8. No. While a vacant low-income unit generally retains its character as a low-income unit, where an owner simply moves a tenant from a unit in one building to a unit in another building in the same project, both units may not be treated as low-income units; rather, only the unit that the tenant actually occupies at the end of a month in the first year of the credit period and at the end of each year in subsequent years qualifies as a low-income unit. Thus, in this situation, while the unit in Building 1 vacated by Household was treated as a low-income unit during the months it was occupied by Household, the unit ceased to be treated as a low-income unit when Household vacated the unit. At that time, the vacated unit would be treated as a unit not previously occupied.

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 § 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 § 42(g)(1) and calculation of the applicable fraction under § 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.

In addition, the available unit rule is not violated by rental of the market-rate unit before the low-income units because there are no over-income units in the building.

Q-10. A building has 10 units of comparable size, consisting of 7 low-income units (none was an over-income unit) and 3 market-rate units. All units in the build-

ing were occupied except for one market-rate unit. A low-income unit became vacant on March 15, 2004. Between March 15, 2004, and March 29, 2004, the owner made reasonable attempts to rent this unit to an income-qualified tenant. The vacant low-income unit became subject to a reservation (a contractual arrangement that is binding on the building owner under local law prior to the date a lease is signed or the unit is occupied) on March 29, 2004, under which the owner agreed to rent the unit to A, whose income meets the income limitation elected for the project under § 42(g)(1). Thereafter, the owner ceased any efforts to attempt to rent the unit. On April 30, 2004, A signed a lease for the unit and occupied the unit on May 1, 2004. The vacant market-rate unit was rented to a market-rate tenant on April 15, 2004. Did the owner violate the vacant unit rule?

A-10. No. For purposes of the vacant unit rule, an owner needs to make reasonable attempts to rent an available vacant low-income unit. To determine what constitutes an available unit for purposes of the vacant unit rule, the Internal Revenue Service will adopt the rule under § 1.42-15(c) for when a unit is considered not available. Therefore, a unit is not available for purposes of the vacant unit rule when 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. Thus, in this situation, because the vacant low-income unit was subject to a reservation that was binding under local law prior to the renting of the vacant market-rate unit, the low-income unit was not available when the market-rate unit was rented. Accordingly, the owner no longer needed to make reasonable efforts to rent the low-income unit.

In addition, the available unit rule is not violated by rental of the market-rate unit because there is no over-income unit in the building.

## F. RECORDKEEPING AND RECORD RETENTION ISSUE

### Law

Section 42(m)(1)(A)(i) requires each housing credit agency to allocate low-in-

come housing credits according to a qualified allocation plan. Under § 42(m)(1)(B)(iii), an allocation plan is not qualified unless it contains a procedure that the housing credit agency (or an agent or other private contractor of the agency) will follow in (1) monitoring for noncompliance with the provisions of § 42, (2) notifying the Service of any noncompliance which the agency becomes aware of, and (3) monitoring for noncompliance with habitability standards through regular site visits.

Under § 1.42-5(a)(2)(i)(A), for the procedure to satisfy § 42(m)(1)(B)(iii), the procedure must include the recordkeeping and record retention provisions of § 1.42-5(b). However, a monitoring procedure adopted by a housing credit agency may require additional recordkeeping and record retention provisions beyond those specifically provided in § 1.42-5(b).

Section 1.42-5(b)(1) provides that a housing credit agency must require the owner of a low-income housing project to keep certain specified records for each qualified low-income building in the project for each year in the compliance period. Under § 1.42-5(b)(2), the owner must be required to retain the records described in § 1.42-5(b)(1) for a particular year for at least 6 years after the due date (with extensions) for filing the Federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the Federal income tax return for the last year of the compliance period (as defined in § 42(i)(1)) of the building. Section 1.42-5(b)(3) also specifies that the owner must be required to retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit (as described in § 1.42-5(c)(1)(vi)) for inspection by the housing credit agency.

The general requirements for keeping records for purposes of the Code are in § 6001 and the regulations thereunder.

Rev. Proc. 97-22, 1997-1 C.B. 652, provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optical disk. Rev. Proc. 97-22

provides that records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of § 6001.

Q-11. May a taxpayer comply with the recordkeeping and record retention provisions under § 1.42-5(b) by using an electronic storage system instead of maintaining hardcopy (paper) books and records?

A-11. Yes, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97-22. However, complying with the recordkeeping and record retention requirements of the Service does not exempt an owner from having to satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the housing credit agency. For example, the housing credit agency may require the taxpayer to maintain hardcopy books and records.

For the basic requirements of maintaining records in an automated data processing system, including electronic storage systems, see Rev. Proc. 98-25, 1998-1 C.B. 689.

## G. TENANT INCOME DOCUMENTATION ISSUE

### Law

Section 1.42-5(b)(1)(vi) provides that a housing credit agency must require the owner of a low-income housing project to keep records for each qualified low-income building in the project that show, for each year in the compliance period, the annual income certification of each low-income tenant per unit. Under § 1.42-5(b)(1)(vii), the housing credit agency must require the owner to 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).

Under § 1.42-5(c)(1)(iii), the housing credit agency must require the owner of a low-income housing project to certify at least annually that, for the preceding 12-month period, the owner has received an annual income certification from each low-income tenant, and documentation to support that certification.

Rev. Proc. 94-65, 1994-2 C.B. 798, indicates that an owner may satisfy the documentation requirement of § 1.42-5(b)(1)(vii) for a low-income tenant's income from assets by obtaining a signed, sworn statement from the tenant or prospective tenant if (1) the tenant's or prospective tenant's Net Family assets do not exceed \$5,000, and (2) the tenant or prospective tenant provides a signed, sworn statement to this effect to the building owner. The revenue procedure provides that a housing credit agency's monitoring procedure may not permit an owner to rely on a low-income tenant's signed, sworn statement of annual income from assets if a reasonable person in the owner's position would conclude that the tenant's income is higher than the tenant's represented annual income. In this case, the owner must obtain other documentation of the low-income tenant's income from assets to satisfy the documentation requirement. In addition, the revenue procedure indicates that a housing credit agency's monitoring procedure may continue to require that an owner obtain documentation, other than the signed, sworn statement, to support a low-income tenant's annual certification of income from assets.

Q-12. On reviewing tenant files of a project, the housing credit agency discovered that for purposes of determining the income of certain tenants, the owner had accepted signed, sworn self-certifications in which the tenants stated that they had not received any child support payments. Is a signed, sworn self-certification by a tenant sufficient documentation under § 1.42-5(b)(1)(vii) to show that the tenant is not receiving child support payments?

A-12. Yes. Consistent with the documentation requirements in Rev. Proc. 94-65, a signed, sworn self-certification by a tenant is sufficient documentation under § 1.42-5(b)(1)(vii) to show that a tenant is not receiving child support payments. In addition to specifying that a tenant is not receiving any child support payments, an annual signed, sworn self-certification should indicate whether the tenant will be seeking or expects to

receive child support payments within the next 12 months. If the tenant possesses a child support agreement but is not presently receiving any child support payments, the tenant should include an explanation of this and all supporting documentation such as a divorce decree and court documents to enforce payment. Also, the self-certification should indicate that the tenant will notify the owner of any changes in the status of child support.

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

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

## DRAFTING INFORMATION

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