

Chapter 10
Category 11f
Project Failed to Meet
Minimum Set-Aside Requirement

Definition

This category is used to report projects that have violated the minimum set-aside rules; i.e., the number of qualifying units falls below the minimum requirement.

Under IRC §42(g)(1), a “qualified low-income housing project” means any *project* for residential rental property if the project meets one of the two requirements below, whichever is elected by the owner on Form 8609, line 10c.

1. At least 20% of the available rental units in the development are rented to households with incomes not exceeding 50% of Area Median Gross Income (AMGI) adjusted for family size.
2. At least 40%¹ of the available rental units in the development are rented to households with incomes not exceeding 60% of AMGI adjusted for family size.

The choice of minimum set-aside also establishes the income limit and rent limit applicable to low-income units in the project.

Project Defined

Each building is considered a separate project under IRC §42(g)(3)(D) unless, before the close of the first calendar year in the project period², each building that is, or will be, part of a multiple-building project is identified *as such by checking the “yes” box on line 8b of Form 8609 and attaching the statement described in the instructions for line 8b.* The minimum set-aside documented on Form 8609, line 10c, must be the same for all buildings in a multiple-building project.

Two or more qualified low-income buildings may be included in a multiple-building project only if they:

1. are located on the same tract of land (unless all of the dwelling units in all of the buildings being aggregated in the multiple-building project are low-income units (see IRC §42(g)(7)));
2. are owned by the same person for Federal tax purposes;
3. are financed under a common plan of financing; and
4. have similarly constructed residential units.

Deep Rent Skewing Under IRC §142(d)(4)

In addition to the election of a minimum set-aside, the owner may elect on Form 8609, line 10d, to provide housing to households with incomes of 40 percent or less of the AMGI under IRC §142(d)(4)(B). Under this “deep-rent skewing” set-aside, at least 15% of the low-income units in the project must be occupied by individuals with incomes at 40% or less of the AMGI (adjusted for family size) applicable to the units.

¹ For the boroughs of New York City, 25% is substituted for 40%. See IRC §42(g)(4) and IRC §142(d)(6).

² Defined in IRC §42(h)(1)(F)(ii).

Also, gross rent for each low-income unit cannot exceed (1) 30% of the AMGI applicable to the unit, and (2) 50% of the average gross rent for market rate units of comparable size in the project.

Irrevocable Elections

Once made, the minimum set-aside and deep-rent skewing elections are irrevocable.³ Thus, the applicable minimum set-aside, deep-rent skewing, and the corresponding rent restrictions apply for the duration of the 15-year compliance period.

Assistance Provided Under HOME* and NAHASDA⁴*

For buildings placed in service before July 31, 2008, former IRC §42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnership 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 percent or more of the residential units *in the building* are occupied by individuals whose income is 50 percent or less of the Area Median Gross Income (AMGI).⁵ The units used to satisfy the rules under IRC §42(i)(2)(E)(i) also count toward the project's minimum set-aside under IRC §42(g)(1).

NOTE: IRC §42(i)(2)(E) was removed from the Code under section 3002(b)(2)(C) of the Housing Assistance Tax Act of 2008 and is not applicable to buildings placed in service after July 30, 2008.

Suitability for Occupancy

For purposes of computing the minimum set-aside, the low-income units must be physically maintained in a manner suitable for occupancy under IRC §42(i)(3)(B)(ii). See chapter 6 for complete discussion.

Example 1: Vacant LIHC Rental Unit Suitable for Occupancy at the End of the Taxable Year Within the Compliance Period

The owner of a 100% LIHC building elected the 40/60 minimum set-aside and placed the building in service in July of 2003; 2003 is the first year of the credit (and compliance) period. An income-qualified tenant moved into a unit in October 2003 and moved out in November of 2004. The unit was cleaned and ready for occupancy on December 1, 2004. The unit is in compliance as of the end of the of the owner's 2004 taxable year and is, therefore, included in the count of qualified low-income units to determine whether the minimum set-aside requirement is satisfied.

Vacant Units

A rental unit is considered an LIHC unit beginning on the date that the first qualified tenant moved in and continues to be eligible for the LIHC even though it is vacant if the character of the last household to inhabit the unit qualified as a low-income household. Unless a specific noncompliance issue is identified for the unit, qualifying units that are vacant at the end of the owner's taxable year of the credit (and compliance) period are included in determining that the minimum set-aside has been met.

³ In rare circumstances the IRS has granted an owner an extension of time to make the correct election. The owner must request a private letter ruling and receive express permission to do this.

⁴ See Rev. Rul. 2004-82, Q&A #6.

⁵ The designation is shown on Form 8609 (beginning with the Nov. 2003 revision. Line 6f is completed by the state agency.

Example 1: Qualified LIHC Rental Unit Vacant at End of the Taxable Year of the Compliance Period

An income-qualified tenant moved into a unit on April 15, 2003, but the owner did not reduce the rent to account for a utility allowance, resulting in the unit not being rent restricted. The tenant moved out on November 15, 2003. The unit was not rented again until February 2004. At that time, the owner correctly accounted for the utility allowance.

The unit was out of compliance beginning on April 15, 2003 and remains out of compliance until February 2004, when the utility allowance is correctly accounted for. Assume that the close of the first year of the credit (and compliance period) is December 31, 2003. Since the unit is out of compliance on December 31, 2003, the unit is not included in the count of qualified low-income units to determine whether the minimum set-aside requirement is satisfied for the 2003 taxable year.

In Compliance

A property is in compliance if the elected minimum set aside requirement (20/50 or 40/60) and the elected deep-rent skewing requirement (15/40) is met by the end of the first year of the owner's credit (and compliance) period and continues to be met each year throughout the compliance period. The LIHC residential units must also be rent-restricted.

Out of Compliance

The initial analysis of compliance with the minimum set-aside requirement is generally based on a sample of tenant files. In the event that the sample does not meet the minimum set-aside, the owner must be given the opportunity to demonstrate that the minimum set-aside is met in the project. Noncompliance should be reported only if the owner cannot demonstrate compliance for the minimum number of units. The burden is on the owner to show that the minimum set-aside was met.

Noncompliance with the minimum set-aside should also be reported if systemic errors affecting all the LIHC units are identified; e.g., using incorrect income or rent limits for all the units.

Example 1: Single Building Project

20 units in a 100 unit building with a 40/60 minimum set-aside were reviewed. To satisfy the minimum set-aside test, 8 of the selected units must be in compliance.

If there are multiple buildings, and the owner elects to treat them collectively as one project, then combine the samples for each building to determine whether the minimum set-aside has been met.

Example 2: Multi-Building Project

A project consists of three buildings with 75 units in each building. The owner elected a 40/60 minimum set-aside. In total, there are 225 units and at least 90 must be qualified LIHC units to meet the minimum set-aside. The state agency must review 45 files. To satisfy the minimum set-aside test, 18 of the selected units must be in compliance.

Date of Noncompliance

In the event that noncompliance results in the failure to meet the minimum set-aside for the first year of the credit period, the taxpayer is prohibited from ever claiming the LIHC; the date of noncompliance is the last day of the taxable year of the first year of the credit period.

Example 1: First Year Lease Up

The owner did not lease the minimum number of units to income eligible tenants by the end of the first year of the credit period.

The date of noncompliance is the last day of the first year of the credit period. The state agency should issue Form 8823 indicating Category 11f, Project failed to meet minimum set-aside requirements, and Category 11p, Project is no longer in compliance nor participating in the program, if Form 8609 has been filed with the IRS.

If the project meets the minimum set-aside by the end of the first year, but fails to meet the minimum set-aside at the close of a subsequent taxable year in the compliance period, the entire credit is lost for that year. The date of noncompliance is the last day of the taxable year for which the minimum set-aside was not met.

Back in Compliance

First Year of the Credit Period

If a project failed the first year minimum set-aside requirement *at the close of the first taxable year of the credit period*, the noncompliance cannot be corrected and the owner is prohibited from ever claiming the LIHC. The date of noncompliance is the last day of the first taxable year of the credit period for that project. The state agency should issue Form 8823 indicating Category 11f, Project failed to meet minimum set-aside requirements and Category 11p, Project is no longer in compliance and is no longer participating in the program.

Years Subsequent to the First Year of the Credit Period

If the minimum set-aside violation occurs *after* the first taxable year of the compliance period, the project is back in compliance for the taxable year in the compliance period in which the minimum set-aside is met, determined as of the close of that taxable year.

Example 1: Fees for Assisted Living Services

The first taxable year of the credit period ended December 31, 1998 for a 100 percent LIHC building. The units were all rented to income qualified households. Subsequently, in 2003, the owner charged all households a fee for mandatory assisted-living services. This fee, when

added to the rent, exceeded the gross rent limitation for all the units and resulted in a violation of the minimum set-aside requirement for year 2003. The state agency conducted a review on February 2004 and noted the violation of the rent rules. The owner stopped charging the fee on March 1, 2004.

The owner did not meet the minimum set-aside *as of the close of 2003* and should not claim any credit for 2003. The date of noncompliance with the minimum set-aside requirement is December 31, 2003. The owner will be back in compliance at the end of the taxable year in the compliance period in which the minimum set-aside is again met.

The submission of a Form 8823 identifying noncompliance with the minimum set-aside should not be delayed even if the taxpayer demonstrates that the minimum set-aside will be restored by the end of the taxable year in the compliance period. State agencies should file Form 8823 within 45 days after the end of the correction period. A second Form 8823 should be filed after the end of the first taxable tax year in which the minimum set-aside is restored.

**Documentation
of Corrected
Noncompliance**

Documentation of corrected noncompliance with the minimum set-aside requirement will be specific to the noncompliance issue resulting in failure to satisfy the set-aside.

Example 1: Rental to Ineligible Tenants Violates Minimum Set-Aside Requirement

Upon inspection, it is determined that the number of units qualifying as LIHC units did not satisfy the minimum set-aside requirement during a year following the first year of the credit period because the owner rented to ineligible tenants. To correct the minimum set-aside violation, the owner must rent units to IRC §42 eligible income-qualified households until the minimum set-aside is restored.

At a minimum, documentation should include the tenant's application/eligibility questionnaire, income verifications, tenant income certification, and student verification, if necessary.

References

1. IRC §42(g).
2. Rev. Rul. 90-89, 1990-2 C.B. 8.
3. Rev. Rul. 2004-82, 2004-35 I.R.B. 350.