

## Part III - Administrative, Procedural and Miscellaneous

### Physical Inspections Pilot Program

Notice 2012-18

#### **PURPOSE**

Under § 1.42-5(c)(2) of the Income Tax Regulations, State housing finance agencies are required to conduct certain physical inspections and other building reviews. In connection with inspections that are conducted under the Physical Inspection Pilot Program described below, this notice informs those State agencies of an alternate manner for satisfying these review requirements. This notice also solicits comments generally on § 1.42-5 and, in particular, on the review requirements of § 1.42-5(c)(2).

#### **BACKGROUND**

Section 42 of the Internal Revenue Code sets forth rules for determining the amount of the low-income housing credit, which is allowed as a credit against income tax pursuant to § 38. Section 42(a) provides that the amount of the low-income housing credit determined under § 42 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. A qualified low-income building is defined in § 42(c)(2) as any building that is part of a qualified low-income housing project.

A qualified low-income housing project is defined in § 42(g)(1) as any project for residential rental property if the project meets one of the following tests elected by the taxpayer: (A) At least 20 percent of the residential units in the project are rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income; or (B) at least 40 percent of the residential units in the project are rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. A low-income unit is a residential unit that is rent-restricted and its occupants meet the applicable income limit elected by the taxpayer as described in § 42(g)(1)(A) or (B). Section 42(i)(3)(B)(i) provides that a low-income unit shall 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(i)(3)(B)(ii) provides that the suitability of a unit for occupancy shall be determined under regulations prescribed by the Secretary taking into account local health, safety, and building codes. Failure of the project to meet the requirements for the test elected by the taxpayer may result in ineligibility for the § 42 credit, reduction in the amount of the credit, and/or recapture of previously allowed credits.

Section 1.42-5 provides monitoring procedures that a State housing finance agency (or its Authorized Delegate within the meaning of § 1.42-5(f)(1)), hereafter referred to as "HFA," must follow in monitoring for compliance with the provisions of § 42. As part of their compliance-monitoring responsibilities, HFAs must perform physical inspections and review annual low-income certifications.

In particular, § 1.42-5(c)(2)(ii) requires that, for each low-income housing project, and within prescribed time periods, the HFA must conduct an on-site inspection of each building in the project and, for at least 20 percent of the project's low-income units, inspect the units and review the annual low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in those inspected units.

Section 1.42-5(c)(2)(iii) requires the HFA to randomly select which low-income units will be inspected and the records reviewed.

Section 1.42-5(c)(5) requires the HFA to report its compliance monitoring activities annually on Form 8610, "Annual Low-Income Housing Credit Agencies Report."

In 2010, the White House Domestic Policy Council (DPC) established the Rental Policy Working Group (RPWG) to explore ways to improve existing Federal rental policies. The RPWG consists of representatives from the DPC, the National Economic Council, the Office of Management and Budget, and the U.S. Departments of Housing and Urban Development (HUD), Agriculture, and the Treasury.

The RPWG solicited from a cross section of affordable-rental-housing developers and managers and State and local officials (Stakeholders) suggestions for more efficiently achieving Federal rental objectives, including the coordination of programmatic rules between the various Federal rental programs. Stakeholders identified many areas where administrative changes could increase overall programmatic efficiency and reduce burdens on the public. For example,

many projects benefit from more than one Federal source (e.g., both Federal funding and low-income housing tax credits). The rules associated with these different programs may require physical inspections of the same project that use different inspection protocols. As a result, these project owners and managers must now spend significant time preparing for, and responding to, multiple physical inspection visits for the same project.

Using input from Stakeholders, the RPWG prepared specific, actionable proposals for coordination. One such proposal is to avoid duplicative physical inspections by conducting one coordinated inspection. The Physical Inspection Pilot Program (Pilot Program) is testing the feasibility of this proposal in six states (Michigan, Minnesota, Ohio, Oregon, Washington, and Wisconsin).

Under this proposal, the HFAs in these six states may satisfy their property-inspection responsibilities under § 1.42-5(c)(2)(ii) by using either their current property-inspection protocol or the inspection protocol of HUD's Real Estate Assessment Center (REAC).<sup>1</sup> The RPWG hopes to ascertain through the Pilot Program whether this sort of coordinated effort will generate savings for property owners and managers, as well as reduce cost burdens on local, State, and Federal governments.

If the participating HFA chooses to use the REAC inspection protocol for a particular project, HUD (or its agent) will conduct a physical inspection of the project using the REAC inspection protocol on behalf of the HFA. To achieve the desired efficiencies, these inspections must satisfy the HFA's physical inspection

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<sup>1</sup> Information on the REAC inspection protocol can be accessed electronically through the following link:  
[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/public\\_indian\\_housing/reac](http://portal.hud.gov/hudportal/HUD?src=/program_offices/public_indian_housing/reac)

responsibilities under § 1.42-5(c)(2)(ii). As described above, however, § 1.42-5(c)(2)(ii) requires that at least 20 percent of the low-income units in a project be physically inspected and that the records for those same units be reviewed. In some cases, the number of low-income units physically inspected under the REAC inspection protocol may not satisfy the 20 percent requirement. Absent an exception, an HFA would need to perform inspections and certification reviews for any shortfall of inspected units in these projects to meet the minimum standard under § 1.42-5(c)(2). That necessity would undermine the Pilot Program's objective of minimizing duplication of effort and reducing burdens on the public. Also, if HUD completes the physical inspections late in the year, the HFA may not be able to perform its review of the annual low-income certifications for those units timely.

#### **SATISFACTION OF CERTAIN PROVISIONS OF § 1.42-5(c)(2)**

The Internal Revenue Service recognizes the potential inconsistency between the REAC inspection protocol and certain review provisions of § 1.42-5(c)(2) and the potential administrative burdens caused by those differences. Accordingly, for the HFAs in States that are participating in the Pilot Program, and during the time period of the Pilot Program (scheduled for November 7, 2011, through December 31, 2012), if a project is physically inspected by HUD (or its agent) under the REAC inspection protocol, then, for that project—

(1) The HFA is deemed to satisfy the minimum 20 percent low-income unit physical inspection requirement and the requirement to conduct on-site inspections of all buildings in a project under § 1.42-5(c)(2)(ii); and

(2) The HFA may satisfy the certification review requirement under § 1.42-5(c)(2)(ii) by reviewing the annual low-income certifications, the documentation supporting the certifications, and the rent records for the tenants in at least 20 percent of the low-income units in the project, regardless of whether any of the units whose files are reviewed are among the units that are physically inspected by HUD (or its agent).

Use of the REAC inspection protocol does not supersede or preempt any other requirements under § 1.42-5. In particular, under § 1.42-5(d)(2), low-income buildings and units must be suitable for occupancy, taking into account local health, safety, and building codes. Thus, if a participating HFA becomes aware of any violation of these codes, the HFA must report the violation to the Service.

## **REQUEST FOR COMMENTS**

The Service and Treasury Department invite taxpayers to submit written comments on issues relating to this Notice and § 1.42-5 generally. In particular, the Service and Treasury Department encourage taxpayers to submit written comments regarding:

(1) Whether the 20 percent rule under § 1.42-5(c)(2)(ii)(A) and (B) for both physical inspections and certification review is appropriate, including—

- Whether this percentage appropriately balances the Service's compliance concerns against the desirability of reducing the inspection burden on HFAs, tenants, and building owners;

- Whether the percentage should vary depending on the type of inspection the HFA is performing (i.e., physical inspection or annual low-income certification review);
- Whether the percentage should vary with the number of low-income units in a project (that is, the size of the population from which the units that will be inspected are to be randomly drawn); and
- Whether the percentage should vary depending on whether the inspection is the initial inspection performed under § 1.42-5(c)(2)(ii)(A) or the on-going inspection performed under § 1.42-5(c)(2)(ii)(B).

(2) Whether permitting reviews of the annual low-income certifications for a sample of units different from the units physically inspected would simplify the inspection process under § 1.42-5(c)(2)(ii)(A) and (B), and whether the use of a different sample would impair the value of the data obtained.

(3) Whether the Service should amend the current regulations to provide an exception from the inspection provisions of § 1.42-5(d) for inspections done under the REAC protocol, similar to the exception under § 1.42-5(d)(3) for inspections performed by the Rural Housing Service under the section 515 program.

Comments should be submitted by May 31, 2012. Comments may be mailed to:

Internal Revenue Service  
Attn: CC:PA:LPD:PR (Notice 2011–XX)  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

or hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m.

to:

Courier's Desk  
Internal Revenue Service  
Attn: CC:PA:LPD:PR (Notice 2011–XX)  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Alternatively, persons may submit comments electronically via e-mail to the following address:

*Notice.Comments@irscounsel.treas.gov.*

Persons should include "Notice 2012-18" in the subject line. All comments submitted by the public will be available for public inspection and copying in their entirety.

#### **DRAFTING INFORMATION**

The principal author of this notice is Julie Hanlon Bolton of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, please contact Ms. Hanlon Bolton at (202) 622-3040 (not a toll-free call).