Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.103-8(b): Qualified residential rental projects
Also: sections 142(d) and 145(d)

Rev. Proc. 2004-39

## SECTION 1. PURPOSE

This revenue procedure provides guidance to States and local governments that issue bonds to which section 142(d) of the Internal Revenue Code applies. It sets forth procedures for determining whether a residential rental project is in compliance with the applicable set-aside requirements contained in section 142(d) during the qualified project period (as defined in section 142(d)(2)(A)).

## SECTION 2. BACKGROUND

.01 Section 103(a) provides that except as provided in section 103(b), gross income does not include interest on any State or local bond.

.02 Section 103(b)(1) provides that section 103(a) does not apply to any private activity bond that is not a qualified bond (within the meaning of section 141).

.03 Section 141(e)(1)(A) and (G) provides that an exempt facility bond or a qualified 501(c)(3) bond may be a qualified bond.

.04 Section 142(a)(7) provides that the term “exempt facility bond” includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified residential rental projects.

.05 Section 142(d)(1) provides that the term “qualified residential rental project” means any project for residential rental property if, at all times during the qualified project period, such project meets the requirements under section 142(d)(1)(A) or (B) (the “set-aside requirements”), whichever is elected by the issuer at the time of the issuance of the issue with respect to such project.

.06 A project meets the requirements of section 142(d)(1)(A) if 20 percent or more of the residential units in the project are occupied by individuals whose income is 50 percent or less of area median gross income.

.07 A project meets the requirements of section 142(d)(1)(B) if 40 percent or more of the residential units in the project are occupied by individuals whose income is 60 percent or less of area median gross income.  Under section 142(d)(6), in the case of a project located in a city having 5 boroughs and a population in excess of 5,000,000, section 142(d)(1)(B) is applied by substituting “25 percent” for “40 percent”.

.08 Section 142(d)(2)(A) provides that the term “qualified project period” means the period beginning on the first day on which 10 percent of the residential units in the project are occupied and ending on the latest of (i) the date that is 15 years after the date on which 50 percent of the residential units in the project are occupied, (ii) the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding, or (iii) the date on which any assistance provided with respect to the project under section 8 of the United States Housing Act of 1937 terminates.

.09 Section 142(d)(3) contains rules for purposes of determining whether an increase in the income of individuals that occupy a residential unit will cause the individuals to no longer qualify as low-income tenants.  For this purpose, section 142(d)(4) contains special rules for deep rent skewed projects.  Section 142(d)(4)(B)(i) defines the term deep rent skewed project as a project in which, among other requirements, 15 percent or more of the low-income units in the project are occupied by individuals whose income is 40 percent or less of area median gross income.

.10  In the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 519-575 (the "1986 Act"), Congress reorganized sections 103 and 103A of the Internal Revenue Code of 1954 (the "1954 Code") regarding tax-exempt bonds into sections 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. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686.  The regulations promulgated pursuant to section 103(b)(4)(A) of the 1954 Code (the predecessor to section 142(d)) continue to apply for purposes of section 142(d) except as otherwise modified by the 1986 Act or subsequent law.

.11 Under § 1.103-8(b)(7)(ii) of the Income Tax Regulations, if the issue date of the bonds occurs after the first day on which at least 10 percent of the residential units in the project are occupied, then the qualified project period begins on the issue date of the bonds.

.12 Under § 1.103-8(b)(6)(i), if a project does not comply with the set-aside requirements continuously during the qualified project period, the project will not be a qualified residential rental project (as of the issue date of the bonds that financed the project), unless the noncompliance is corrected within a reasonable period. Under § 1.103-8(b)(6)(ii), a reasonable period is at least 60 days after the noncompliance is first discovered or would have been discovered by the exercise of reasonable diligence. Section 1.103-8(b)(6)(i) provides that if noncompliance is not corrected within a reasonable period, subsequent compliance does not alter the taxable status of the bonds that financed the project.

.13 Section 145(a) provides, in general, that the term "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if (A) 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying section 513(a), and (B) sections 141(b)(1) and (2) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

.14 Section 145(d)(1) provides, in general, that a bond that is part of an issue is not a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units. Section 145(d)(2) provides, in part, that section 145(d)(1) shall not apply to any bond issued as part of an issue if the portion of such issue that is to be used directly or indirectly to provide residential rental property for family units is to be used to provide qualified residential rental projects (as defined in section 142(d)).

.15 The IRS and Treasury Department have received comments requesting guidance regarding the application of the set-aside requirements during the qualified project period. For example, guidance has been requested regarding whether residential units in a newly-constructed project may only be leased to low-income tenants until low-income tenants occupy the required percentage of all residential units in the project, or whether a project complies with the set-aside requirements if low-income tenants occupy the required percentage of occupied residential units. Moreover, guidance also has been requested regarding whether the set-aside requirements apply when an existing project is acquired, or whether there is a transition period before the project must comply with the set-aside requirements. The comments indicate that the lack of guidance on these questions and the resulting uncertainty may be limiting the development of low-income rental housing.

SECTION 3. DEFINITIONS

.01 *Available units* means residential units in a residential rental project that are actually occupied and residential units in the project that are unoccupied and have been leased at least once after becoming available for occupancy, provided that (a) in the case of an acquisition of an existing residential rental project, a residential unit that is unoccupied on the later of (i) the date the project is acquired or (ii) the issue date of the first bonds is not an available unit and does not become an available unit until it has been leased for the first time after such date, and (b) a residential unit that is not available for occupancy due to renovations is not an available unit and does not become an available unit until it has been leased for the first time after the renovations are completed.

.02 *First bonds* means the first issue of bonds to which section 142(d) applies issued to finance the acquisition of an existing residential rental project.

.03 *Low-income tenants* means individuals occupying a residential unit whose income satisfies the applicable income limit under section 142(d)(1)(A) or (B) and, if applicable, section 142(d)(4)(B)(i).

.04 *Set-aside requirements* is defined in section 2.05 of this revenue procedure.

SECTION 4. SCOPE

This revenue procedure provides guidance to States and local governments that issue bonds to which section 142(d) of the Internal Revenue Code applies. It sets forth procedures for determining whether a residential rental project is in compliance with the applicable set-aside requirements during the qualified project period.

SECTION 5. APPLICATION

.01 *General rule for set-aside requirements*. Beginning on the first day of the qualified project period (*i.e.*, the later of the first day on which at least 10 percent of all of the residential units in the project are occupied or the issue date of the bonds), the set-aside requirements apply to the total number of available units.

.02 *Special rule for certain existing projects.* This section 5.02 applies to the acquisition of an existing residential rental project unless more than 90 percent of the residential units in the project are not available units (for example, because residential units are not available for occupancy due to renovations) at any time within 60 days after the later of (1) the date the project is acquired or (2) the issue date of the first bonds. For a period of 12 months beginning on the issue date of the first bonds (the "transition period"), the failure to satisfy the set-aside requirements as described in section 5.01 will not cause the project to not be a qualified residential rental project. If the set-aside requirements are not satisfied on the last date of the transition period, such failure will cause the project to not be a qualified residential rental project as of the issue date(s) of the bonds issued to finance the project unless all bonds issued to finance the project are redeemed as soon as possible, but in no event later than 18 months after the issue date of the first bonds.

SECTION 6. EFFECTIVE DATE

This revenue procedure is applicable to bonds sold on or after July 19, 2004 that are subject to section 142(d). In addition, subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply this revenue procedure to any bonds (1) sold before July 19, 2004 that are subject to section 142(d), or (2) subject to section 103(b)(4)(A) of the 1954 Code.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Rose M. Weber, Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of this revenue procedure. For further information regarding this revenue procedure contact Ms. Weber on (202) 622-3980 (not a toll free call).