



Back to Basics: Verification

by Scott Michael Dunn, CEO of Costello Compliance

In this series, we cover the basics of tax credit compliance and how to research answers to questions tax credit professionals have in their daily practice. This Basics article will focus on the verification of household information for tax credit properties. Proving household eligibility for units is one of the fundamental requirements of tax credit housing, so it is crucial to understand this topic.

As covered in earlier articles of this series, household income and student status must be determined to support the claiming of tax credits for a unit. State agencies (and perhaps the IRS) will periodically review resident files. During their visits, the agencies will look to ensure that the files contain sufficient documentation to establish household income, student status and other eligibility factors. To ensure this outcome, good verification procedures must be followed prior to a household's move-in and at annual recertification, as applicable. As we will see, state agencies have most of the authority when it comes to deciding how an owner/agent will conduct the verification process. Understanding the options that a state may choose from, however, makes tax credit professionals better informed to work with state requirements. This article will provide context to the subject of verification.

Step 1: Understand federal tax credit verification requirements.

For government programs, the federal statute and then the regulations are the legal authority. These are followed by other official publications, such as IRS Revenue Procedures or the HUD handbook 4350.3. For the tax credit program, the regulations provide the legally binding verification rules. Treas. Reg. §1.42-5(b) requires that taxpayer maintain:

“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. In the case of a tenant receiving housing



assistance payments under section 8, the documentation requirement is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit.”

For voucher holders, the public housing authority (PHA) can verify the income of the household. Additionally, Rev. Proc. 94-65 allows that, if the total assets for a household are \$5,000 or less, the applicants may satisfy the asset verification requirement by signing a statement attesting to the total value of the assets and any income. Generally, state tax credit HFAs that allow this provision will provide a form for this use.

Step 2: Review HUD and tax credits verification rules 1986-2013.

Documentation provided by a household (such as tax returns or W-2s) is among the examples of verification legally acceptable under the regulation. However, prior to the tax credit program, the other major housing agencies — the Department of Housing and Urban Development (HUD) and Rural Development — had long-standing rules about verification. They mandated the use of verifications that come directly from third parties, if possible. This verification was never to go through any household members’ hands. Documentation provided by a household was the second-best option, allowed only when third-party verification failed after multiple attempts and significant time (such as two weeks). As verifications of income from third parties were among the allowed types in the tax credit regulation, HUD’s model became the best practice for the tax credit program. This promoted consistency among housing programs. Years later, the IRS restated HUD’s verification guidance in the 8823 Guide, Chapter 4, as a best practice.

For years, state agencies generally followed the HUD model of requiring, in order of preference:

1. Verification directly from a third party,
2. Documentation provided by the household, and
3. Household self-certification.

This went beyond the basic legal requirements of the program, as stated in Reg 1.42-5 above, but it worked across housing programs and was the model most state tax credit agencies chose to adopt. Notably, some states allowed or required employed household members to supply paystubs. These were required along with — or instead of — traditional “third party”



verification. These states knew that this also fits the legal requirements of the regulations and were comfortable allowing this type of verification.

Step 3: Review HUD and tax credits verification rules from 2013 to the present.

Change 4 of the HUD 4350.3 handbook, Chapter 5, changed HUD's rules with respect to verification for HUD programs. In IRS LIHC Newsletter 54, the IRS clarified that HUD guidance, although not **required** to be used by the tax credit regulation, was "sufficient for IRC §42 purposes."

The IRS' summary of HUD's new rules followed in this LIHC Newsletter:

1. *"A document generated by a third-party source **provided by the tenant is still considered "third party" verification** because the document originated from a third-party source. For example, a tenant may provide **pay stubs or a W-2** prepared by the tenant's employer. When evaluating the documents, consider:*
 - *Is it current? The tenant's circumstances may have changed since the document was created.*
 - *Is it complete? For example, pay stubs can be used to verify income. Actual paychecks (or copies) are not acceptable because deductions are not identified on the paycheck.*
 - *Is it the original document? If the document is a copy, it may have been altered by using high-quality copying equipment. Documents with original signatures are the most reliable.*
2. *Written documentation sent directly by the third party may be received by mail, fax, or e-mail. If received by fax, the fax should include the company name and fax number of the third party. If received by e-mail, the e-mail address should be for the third party and include the name of the party sending the email.*
3. *Information verified on the Internet is considered third-party verification if the information is from a reliable source. A printout from the Internet is adequate verification.*
4. *Third-party verification may be made over the telephone. To ensure that the person on the telephone is the right party, it is best to call the verification source rather than accepting verification from a third party initiating the telephone call."*



Step 4: Check state agency requirements.

LIHC Newsletter 54, cited above, concluded: “The state housing agencies can require taxpayers to obtain specific documentation of income based on local practices and circumstances. Taxpayers are advised to consult with the state housing agency regarding documentation requirements for income certifications.”

The above history lays out the options that states generally choose from: pre- and post-2013 HUD rules. Some retain the pre-Change 4 method of requiring full direct third-party verification. However, an increasing number of agencies allow documentation provided by the household, especially paystubs, per recent HUD guidance. Some states simply allow owner/agents to make informed decisions and choose between options, as long as the owner/agent is consistent in his or her processes.

Another factor many states may consider is that the 2013 HOME Funds housing regulation revision requires at least two months of “source document” wage history documentation to verify employment income. Many HOME participating jurisdictions (PJs) have interpreted this to mean that paystubs must be collected and that the verification forms completed by a third party are optional for HOME purposes. If these HOME PJs are also tax credit agencies, reconciling the programs by moving toward requiring or allowing paystubs to be used to verify employment makes sense and limits the paperwork burden on households and owners. Some years, up to 30% of tax credit allocations have HOME funding, so this represents a significant burden reduction.

Why do states lean one way or the other when creating verification rules? There are many possible reasons. For instance, allowing paystubs as verification reduces delays that sometimes result when a third party responds slowly. Some states believe that more efficient paystub verification (which is acceptable to the IRS and within the tax credit regulations) helps reduce vacancy loss for properties that are often financially strapped, and is beneficial to the properties and program. States must balance this with what some believe to be greater accuracy afforded by forms completed by a third party, especially for anticipated future changes that may not show up in wage history. Of course, these states may have noted that most employers will not commit to future changes in wages on the forms anyway. Clearly this issue is not of primary concern to



the IRS or HUD, but it is a factor some states prioritize. States in favor of using paystub verification also point out the reality that third parties do not always complete the forms accurately. They may not understand the program rules, may make mistakes, or may fill it out in a way that they believe will benefit their employee. They also often refuse to commit to factors like overtime that are clearly part of the ongoing wage history of the job. The paystubs demonstrate hard wage history and are not subject to these inaccurate tendencies. Upon examination, no system of verification is 100% perfect, but the IRS considers either approach “sufficient.”

In summary, verification of eligibility factors for households is required by IRS regulation. The exact legal requirements for verification are very broad. Considering this lack of specific direction for verification, the IRS puts the primary rule-making authority on state agencies. Best practices developed based on HUD guidance were almost universally accepted in the past. HUD recently changed these, and state agencies may or may not have adopted the adjustments. Knowing this history helps tax credit professionals be prepared to adopt whichever version of the verification rules their state implements. Many states or compliance professionals firmly claim that they use the “right” method. However, higher-level professionals understand the nuances and why multiple states may have developed different methods.

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