Applegate & Thorne-Thomsen
ATTORNEYS AT LAW

BREAKING NEWS BULLETIN

IRS ISSUES PROPOSED REGULATIONS ON THE AVERAGE INCOME SET-ASIDE

Published November 3, 2020

Written by: Glenn A. Graff

On October 29, 2020, the IRS released a notice of proposed rulemaking Reg-119890-18 which proposed regulations to address the Section 42(g)(1)(C) Average Income minimum set-aside test for low-income housing tax credits ("LIHTCs") which was added in 2018. While the new regulations will not become effective until they are published as final regulations, the proposed rules answer some unknowns and should provide some guidance as to how to safely structure LIHTC projects that use the average income method. Serious consideration will be given to comments on these Proposed Regulations as to whether they are overbroad or have taken approaches which are less beneficial than other options. This Bulletin provides an Executive Summary, Background and Detailed Analysis of the Proposed Regulations.

EXECUTIVE SUMMARY

1. **Fixed Designation of Units** - The Designations for units have to be made by the end of the first year of the Credit Period and cannot be changed. Income Designations do not appear to float. Only units that qualify for LIHTC during the year at issue are included in the Average Income calculation.

    a. Comment – there was hope that the designation of an out of compliance unit would not prevent from using that unit's designation for purposes of the 60% Average Income Calculation. The Regulation does not allow this thus increasing the risk of failure of the 60% Average Income requirement. Mitigation provisions are created to lower this risk.

2. **Mitigation Options to Avoid 60% Test Failures** – If a unit fails to qualify as a LIHTC unit and such failure would cause the Project to fail to meet the requirement for units to have an average income of 60%, then either of two mitigation options can be used within 60 days of the end of the year. Mitigation will prevent failure of the Average Income Minimum set-aside.

    a. Market Rate Units - can be converted to LIHTC units.

    b. Other Units - An additional LIHTC unit can be designated a "Removed Unit" such that the unit is no longer a credit-generating unit thus allowing the Project to meet the 60% Average Income requirement. Basically, if one unit fails and that would cause a failure of the 60% Average Income Requirement, then another LIHTC unit at 70% or 80% AMI can be sacrificed to make sure the 60% requirement is met.

c. Comment – Buffer is Good –The IRS approach means that a failure on one unit could end up costing credits on two units. This is better than an all-out failure of Average Income set-aside, but can still be expensive. It will be interesting to see if Investors look for Projects to have some room under the 60% requirement such that a failure of one or two units will not cause other units to be removed and cost additional LIHTC.

d. Comment – Act Quickly after the End of a Year - Mitigation actions need to be taken within 60 days of the end of a year. That means that prompt review of compliance issues and deciding how to mitigate will be very important.

3. **Next Available Unit Rule Flexible, But Questions**– when multiple units go over-income, there is no prescribed order by which an owner has to fill vacant units with low-income tenants to meet the applicable income designation. This is helpful. However, it is unclear if the Proposed Regulation require that if an Average Income unit goes over-income, the NUAR rules would apply to any subsequent LIHTC rentals and not just market rate rentals.

4. **Comments on Regulations** – Comments must be received by December 29, 2020. Applegate & Thorne-Thomsen works closely with the American Bar Association Forum of Affordable Housing and Community Development law, the Affordable Housing Tax Credit Coalition and the Novogradac LIHTC Working Group. We will be working with these groups to provide comments on the Proposed Regulations. If you have particular concerns, please contact Glenn Graff at ggraff@att-law.com.

Applegate & Thorne-Thomsen
ATTORNEYS AT LAW

BACKGROUND ON INCOME AVERAGING

What Is Income Averaging?

Income averaging was added to Section 42 in 2018 as part of the Consolidated Appropriates Act of 2018. The provision allows Projects to take LIHTCs on units which have designated imputed income limitation that allows tenants with incomes at 70% or 80% of Area Media Gross Income ("AMI") as long as there are additional units with designated imputed income limitation at 30%, 40%, 50% or 60% AMI such that the overall average for all units does not exceed 60% AMI. The designated low-income units must comprise at least 40% of all residential rental units in the building. Once the Average Income minimum set-aside is elected by a Project, such election is irrevocable.

Example: 20 unit building with 9 low-income units and 11 market rate units as shown below

Market Rate	Market Rate
Market Rate	Market Rate
Market Rate	Market Rate
Market Rate	Market Rate
Market Rate	Market Rate
Market Rate	80%
80%	80%
70%	70%
40%	30%
30%	30%

Average Income Computation

30% + 30% + 30% + 40% + 70% + 70% + 80% + 80% + 80% = 510%
510% ÷ 9 low-income units = 56.67% average income

Minimum Set-Aside Computation: 9 LIHTC Units ÷ 20 Total Units = 45%. Minimum set-aside is met.

If this Project has used the more traditional 40%@60% minimum set-aside, that would require 40% of the Project to be rented at 60% AMI. The above Project would not qualify for LIHTC because only 4 units out of 20 units (25%) are at 60% or less. The Average Income method allows the renting of some higher income units that are offset by lower rents on other Projects.

Why Have Income Averaging?

Income Averaging has several benefits. First, some Projects may be in situations where it is difficult to have all units be at 60% AMI or less but where there is demand for 70% or 80% AMI units. This could be areas without as deep a demand for 60% or less AMI. It is also helpful for projects with Public Housing Authority ("PHA") assistances because such assistance can be used with tenants up to 80% AMI. Without the Average Income method, a 70% or 80% PHA-assisted unit would not qualify for LIHTC and thus would reduce the amount of LIHTC that a Project could generate.

Second, the Average Income method can lead to higher revenue for a Project thus allowing it to carry more debt and require less LIHTC. At first it would seem because the average income must not exceed 60% AMI that there would not be a rental revenue benefit to a Project. However, many Projects have governmental assistance such as Section 8 and often those units may be targeted at an especially low-income units, such as 30%, 40% or 50% AMI. Those units qualify for LIHTC by charging the tenant rents at 30%, 40% or 50% AMI, but the subsidy allows for rent on top of the tenant-paid rent. Thus, the Section 8 subsidy on that lower-income unit means that even with a deeply targeted unit, the Project rent for the unit can be at the Section 8 rate (which approximates fair market rental). In turn, the presence of 30%, 40% or 50% units allow for some 70% or 80% units which can also deliver higher rents even if such units don't have a subsidy. Thus the 30%-50% units don't hurt revenue, but they allow the higher 70% or 80% units which can add revenue. That added revenue can help keep projects feasible or allow them to carry a little more debt.

THE PROPOSED AVERAGE INCOME REGULATIONS

The proposed regulations come in two parts. There is a brand new Proposed Regulation 1.42-19 which provides basis rules for the average income method. The notice also proposes changes to the existing Regulation 1.42-15 which addresses the "Next Available Unit Rule".

A. Regulation 1.42-19 Average Income Test

Designation of Units To Follow Forthcoming IRS and Credit Agency Rules – The Proposed Regulation provides that the income limitations for units are designated (i) in any manner prescribed by the IRS in forms, instructions or other published guidance, and (ii) any procedures used by state or local credit agencies, so long as such procedure does not conflict with IRS guidance.

Timing of Designation End of First Credit Year, Fixed – Units must be designated by the end of the First Year of the Credit Period. Through the Mitigating Action provisions discussed below, the IRS seems to have decided that a unit loses its designation if doesn't qualify for LIHTC during a year. Whether designations could be lost was not addressed in the Code and some practitioners had thought that a designation should continue even if a unit were to fail to meet its designation.

No Changes to Income Designation – Once the income level of a unit is designated, no change to that designation is allowed. If the income designation is removed, the unit then ceases to be a low-income unit.

This lack of ability for income designations to float is a disappointment for many practitioners. When using the 20% @ 50% or 40% @ 60% minimum set-aside, the low-income units can float within a Project. But the IRS seems to have chosen not to allow this when using the Average Income minimum set-aside. It appears the IRS may have sided on simplicity over Project flexibility.

Converting Market Rate Units – A market rate may be converted to a low-income unit as long as such designation is made within 60 days after the unit is to be treated as a low-income unit.

Mitigating Actions – a risk exists with the Average Income Method that if a designated low-income unit fails to qualify for LIHTC, then that unit would not count for that year when determining whether the remaining low-income units will meet the 60% requirement of the Average Income test.

Failure to meet the test could be catastrophic resulting in loss of all LIHTC for the entire year and recapture. This is a risk not usually present for a 20%@50% or 40%@60% Minimum Set-Aside where the disqualification of one unit would not cause a failure of the minimum set-aside as long as the remaining LIHTC units are at least 40% of the Project.

To reduce this disproportionate risk, the IRS allows for two types of "Mitigating Actions" to be taken. These actions may be taken where (1) at the end of the year, one or more units have ceased to qualify as LIHTC unit(s), and (2) the failure of such units causes the Project to fail the requirement for the average income of the designated units not to exceed 60% of AMI.

1. **Mitigation - Conversion of a Market Rate Unit** – a non-LIHTC unit can be converted to a LIHTC unit, if immediately prior to the conversion such unit is either vacant or occupied by an income-qualified tenant.

2. **Mitigation - Removing a LIHTC unit from the Average Income Computation** – to avoid failing the 60% Average Income minimum set-aside, the owner can choose to identify a qualifying LIHTC unit as a "Removed Unit". A Removed Unit is not included in the 60% Average Income Test. In this way, a 70% or 80% AMI unit can be removed thus improving the 60% Average Income test computation.

    a. Must Meet the 40% Minimum Set-Aside Without Removed Unit - However, if identifying a unit as a Removed Unit means that less than 40% of the Project will be LIHTC, then the Project will fail to be a Qualified Low-Income Housing Project causing a loss of credits and recapture.

    b. No Recapture on Removed Units – A Removed Unit is still included in the Applicable Fraction for recapture purposes, thus it will not cause recapture.

    c. No LIHTC on Removed Units- A Removed Unit will not generate LIHTC.

Mitigation Example:

Assume a Project is 100% LIHTC as shown below. The Projects Average Income is (80% + 80% +60% + 40% + 40%) ÷ 5 = 300% ÷ 5 = 60% exactly.

Unit Number	Imputed Income Limitation of Unit
1	80%
2	80%
3	60%
4	40%
5	40%

Assume that in Year 2, Unit 4 becomes uninhabitable, but in Year 4 it is repaired and returned to service. Without Unit 4, the Project's average income would be (80% + 80% +60% + 40%) ÷ 4 = 260% ÷ 4 = 65%. The Project fails the 60% Average Income Requirement. Without mitigation, the Project would fail the minimum set-aside and not be eligible for LIHTC in Year 2 and would have recapture.

Within 60 days of the end of the Year, the Project identifies Unit 2 as a removed unit. Without Units 2 and 4, the Project's average income would be (80% + 60% + 40%) ÷ 3 = 180% ÷ 3 = 60%. The

Project now satisfies the 60% average income requirement. In addition, 3 out of 5 units (60%) are LIHTC units. As a result, more than 40% of the Project is LIHTC and thus the 40% minimum set-aside requirement is met. The Project will deliver credits on 3 units in Years 2 and 3 rather than 5 units that had originally been expected. Because Unit 2 is uninhabitable, recapture would exist on that Unit. Unit 4 as a removed unit would not cause recapture. In Year 4, Unit 2 is repaired, and the Removed Unit status of Unit 2 is removed. The Project now can deliver LIHTC on all 5 Project units in Year 4.

B. Regulation 1.42-15 Next Available Unit Rule ("NAUR")

What is the Next Available Unit Rule? - The Next Available Unit Rule has been a long-standing rule that provides that if rules where a tenant that initial met the income requirement for a unit has their income go above the applicable income limitation. If the income rises to more than 140% of the applicable limitation, such unit can continue to be a low-income unit if the next available unit of comparable size or smaller is rented to a low-income tenant. For projects using the 20%@50% or 40%@60% minimum set-aside, this rule continues to apply in the same manner as before the Proposed Regulations.

Application of NAUR Was Unclear for Average Income Projects - Prior to the Proposed Regulation, there was uncertainty as to how NAUR would apply, especially in situation where there could be multiple over-income LIHTC units with different income designations. For example, would projects have to fill vacant units with tenants whose income matched the income for the first over-income unit?

IRS Provides Flexible Solution, but Questions Exist–

1. No Prescribed Order - There is no requirement to follow the NAUR rule in any specific order. Thus if a 30% unit goes over income first and then a 50% unit goes over income at a later date, the Owner can fill the next vacant unit with a person at either 30% or 50% of AMI.

2. Vacant Units – If a LIHTC unit becomes vacant, the imputed income limitation is the one that the unit previously had.

3. Other Units - For other units, the income limitation is the highest one that could be used but allow the Project to meet the 60% Average Income Requirement. It is unclear how this language applies to Average Income units. For example, assume (i) a 30% unit went over income by more than 140%, (ii) an 80% unit opened up, and (iii) that the Project would not satisfy the 60% Average Income Test without the 30% unit. Does the rental of that 80% unit need to be at a lower income level sufficient to satisfy the 60% Average Income test. If the 80% unit was vacant, then the foregoing Vacant Unit rule should apply. But what if it is never vacant and a person moves in the same day a unit is vacated. Hopefully clarification can be obtained that this rule only applies to market rate units.

For additional information, please contact Glenn Graff, Becca Hartstein, Sara Langan, Matt McKay, Eric Mittereder, Lisa Pekkala, Ben Swartzendruber or any of your contacts at Applegate & Thorne-Thomsen.