LETTERS TO REGULATORS

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December 28, 2020

Dillon J. Taylor
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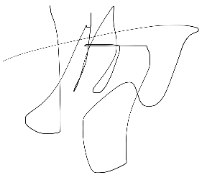
Re: Comments on Notice of Proposed Rule Making, Section 42 Low-Income Housing Credit Average Income Test Regulations REG-119890-18, RIN: 1545-BO92

Dear Mr. Taylor:

Thank you for promulgating the proposed regulations addressing the average income test (the "***Average Income Test***") for low-income housing tax credit (***"LIHTC"***) projects provided in Section 42(g)(1)(C). In response to the Internal Revenue Service (the ***"IRS" or "Service"***) and the Department of Treasury (***"Treasury"***) request for comments on the proposed regulations, we submit this letter. The persons signing below are the primary authors of this letter. We would also like to acknowledge the assistance of Judy Crosby of Kutak Rock LLP, Nicholas Anderson of Lathrop GPM LLP and Angela Christy of Faegre Drinker Biddle & Reath LLP. While we are all active members of the Tax Credit and Equity Financing Committee (the "***Committee***") of the American Bar Association's Forum on Affordable Housing and Community Development Law (the "***Forum***"), and while we have consulted with other members of the Committee and the Forum, this request is not made on behalf of the Forum and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the position of the Association.



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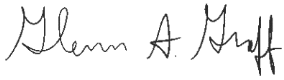

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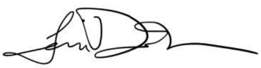

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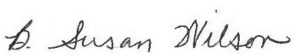

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Overview

We wish to thank the Department of Treasury and the Internal Revenue Service for promulgating the proposed regulations addressing the average income minimum set-aside for the low-income housing tax credit. This provision was added in 2018 and guidance will help remove uncertainty with respect to how the provision should be used and applied. As discussed below, we think that there are a number of alternative approaches and considerations that should be reviewed before the proposed regulations are finalized.

Part I—Comments Regarding the General Approach of the Proposed Regulations

We include comments and suggestions on specific provisions of the proposed regulations in Part II of this letter. Prior to discussing those specific points, however, we respectfully request that the Service reconsider two aspects of the approach taken in the proposed regulations. These two aspects are at the heart of two principal concerns that we have about the proposed regulations: (i) the proposed regulations create the possibility of a complete loss of credits that was never intended, and (ii) the proposed regulations do not provide the flexibility necessary to practically administer a low-income housing project for which an average income election has been made. We believe that reconsidering the general approach of the regulations will allow the reconciliation of the Service's tax policy concerns with the need for certainty and flexibility in the administration of the LIHTC.

A. Calculation of the Average of the Imputed Income Limitations

The proposed regulations require that the average of the imputed income limitations of *the low-income units* in the project not exceed 60% of area median gross income ("***AMGI***"). We respectfully submit that this is contrary to the statute, which requires that the average of the imputed income limitations *designated* shall not exceed 60% of AMGI. IRC 42(g)(1)(C)(ii)(II). That statute further states that "[t]he taxpayer shall designate the imputed income limitation of each unit taken into account under such clause." See IRC 42(g)(1)(C)(ii)(I).

The difference between the proposed regulations and the statute is significant. First, the proposed regulations approach is based on averaging ***actual rentals*** of units. While this may be a worthy intention, the language of the statute simply refers to the units ***designated*** by the taxpayer. Second, the interpretation in the proposed regulations potentially results in a project losing all of its credits as a result of the failure of a single unit to qualify as a low-income unit.

Example 1 The taxpayer owns a 100-unit project and designates imputed income limitations as follows: 90 units at 60% of AMGI, 5 units at 40% of AMGI and 5 units at 80% of AMGI. All units are rented in compliance with their imputed income limitations (and rent restrictions) except that one of the units designated at 40% of AMGI is leased to a tenant with an income equal to 45% of AMGI. In accordance with the statute, imputed income limitations have been designated for 100 units and the average of the imputed income limitations *designated* is 60%. 99 units satisfy the limitation applicable to that unit and the minimum set-aside is met. Under the proposed regulations, there are only 99 low-income units and the average of the imputed income limitations *of the low-income units* is 60.2% and the requirement of the average income set-aside is not met and the project does not qualify for LIHTC on any unit.

As the preamble recognizes, this result cannot possibly be intended by the statute. Accordingly, the proposed regulations propose various mitigation actions. The preamble discusses, and the proposed regulations give an example of, a situation in which a unit is out of service or uninhabitable. If that is the sole concern of the Service, we believe it can be addressed in an alternate manner, as discussed below. But by describing the test as requiring the average of *the low-income units* to be 60%, the proposed regulations encompass other failures to qualify as low-income units for which the mitigation provisions are inadequate, including, most importantly, the failure to satisfy income limitations and rent restrictions.

The minimum set-aside election contained in Section 42(g) establishes the income limitations for determining if a unit is a low-income unit. The income limitation applicable to a unit is then used to determine the rent restriction. A residential unit can qualify as a low-income unit only if it meets the applicable income limitation and rent restriction. Thus, the determination of whether a unit is a low-income unit can only be made once the applicable income limitation is known.

Compare how the other set-aside tests work. Can a unit leased to a tenant with income at 55% of AMGI qualify as a low-income unit? No, if the 20-50 set-aside has been elected, but, yes, if the 40-60 set-aside has been elected. In other words, the income limitations exist before, and apart from, a determination of whether the limitations are satisfied. A unit that does not satisfy its limitation is subject to a limitation; it is circular to argue otherwise. In the example above, 100 units, not 99, have imputed income limitations *designated* and the average of those designated limitations is 60%.

The possibility of a total failure of credits is extremely unattractive to investors and will put projects using the average income election at a disadvantage to projects using the 40-60 set-aside election. In practice, we expect that investors will demand a "buffer" so that the average of the designated limitations will be below 60%. In a situation similar to Example 1, investors will likely insist that 3 or 4 units be designated at 80% of AMGI, rather than 5 units. As a result, rather than allowing an average income project to be on equal footing with a project making the 40-60 set-aside election, the average income project will have aggregate rent restrictions that are more onerous than a 40-60 project. See Example 13, for an illustration of how a buffer might be expected to work.

As noted above, the income limitations determine the rent restriction. Given the manner in which income restrictions are determined (see Revenue Ruling 2020-4), the maximum LIHTC rent that may be collected on 2 units subject to a 60% AMGI limit is the same as the rent that may be collected on 2 units with designated imputed income limitations that average to 60%. Requiring a buffer so as to assure that the failure of a small number of units will not result in the average AMGI rising above 60%, yielding a catastrophic loss of credits, will have the ironic effect of reducing the total rental income of those projects for which the flexibility offered by the average income election is most critical. By reducing the rental income of such projects, they can support less commercial debt and thus will be less feasible.

We think that by focusing on the language chosen by Congress, the preceding problems can be avoided. Section 42(g)(1)(C)(ii)(I)-(II) provide the following:

> 42(g)(1)(C)
>
> (ii) Special rules relating to income limitation
> For purposes of clause (i)-
>
> (I) Designation
> The taxpayer shall designate the imputed income limitation of each unit taken into account under such clause.
>
> (II) Average test
> The average of the imputed income limitations designated under subclause (I) shall not exceed 60 percent of area median gross income.

Based on the plain language of the Section 42(g)(1)(C(ii)(I) and the preceding discussion, we believe that the better reading of this provision is that the 60% average is computed based on the ***designations*** made by the taxpayer rather than having the ***actual rental*** of a unit possibly result in that unit not being included in the computation.

To be clear: units not in compliance would not generate current tax credits and would be subject to recapture. However, ***solely*** for purposes of assuring that the 60% average test had been passed, the plain wording of Section 42 providing that the taxpayer's designations should be used.

It may be that certain theoretical policy issues regarding the application of the average income set-aside may concern the Internal Revenue Service and the Department of Treasury, but we believe that such issues can be adequately addressed by application of the statute as written. We discuss these below.

First, there may be a concern that the average income set-aside could be subject to abuse. A taxpayer could ignore restrictions on units designated with income limitations below 60%, charging market rents and foregoing credits on those units while claiming credits on units designated with income limitations above 60%. This situation could be addressed with a general anti-abuse provision allowing the Service to disregard designations made in bad faith and/or requiring an annual certification made to the Service or the State Housing Credit Agency ("State Credit Agency") that the taxpayer believes, in good faith, that all designated units are in compliance with their applicable income limitations. See the discussion below for further discussion of a such an approach. A determination that designations would not be respected absent good faith attempts at compliance would provide a powerful deterrent to abusive behavior. We also note that there are enforcement mechanisms contemplated by the statute other than the loss of credits, including the restrictions in the extended use agreement that may be enforced by the State Credit Agency or any tenant.

And, we note that the market provides an alternate enforcement mechanism through the tension between interests of developers and investors in a LIHTC project—tax credits accrue to the benefit of investors while cash flow from higher rents accrues primarily to the benefit of developers.

Second, as described in the preamble and the proposed regulations, there are situations in which units could be taken out of service as a result of casualty or otherwise. Once it is determined that a unit is no longer in service or otherwise not habitable, it should be appropriate to allow re-designation of units as well as mitigation of the type described in the proposed regulations. If the regulations require an annual certificate, the instructions could provide that it would be bad faith to certify that designated units are in compliance if those units are not in service unless appropriate re-designations or mitigation has been put in place. As described below, we think it is appropriate to provide mitigation similar to the next available unit rule for casualty losses and similar events that are outside the control of the taxpayer. Another alternative discussed below would be to allow the income designations to be used for units suffering a casualty solely for the purpose of determining the average of such designations. Such units would not count for meeting the 40% minimum set-aside and standard rules relating to casualty losses would apply for the purpose of determining current tax credits or the applicability of recapture.,

Third, there appears to be an assumption in the proposed regulations that the quid pro quo for taking LIHTC on a unit with a limitation above 60% AMGI is the actual compliance of a unit that has a limitation below 60% of AMGI, so that if a unit with a limitation below 60% AMGI fails to qualify as a low-income unit, a corresponding unit (or units) with limitations above 60% AMGI must also fail to qualify for credits. We do not see any indication in the statute that is the case and we respectfully submit that the policy arguments that we provide here outweigh the policy arguments that appear to have motivated the proposed regulations. It seems unlikely that Congress intended that the consequence of noncompliance on one unit was the loss of all credits. Instead, we respectfully submit that the legislature more likely expected that regulations would be drafted to avoid total credit loss and instead substitute credit loss on one or two additional units.

Consider a simple example in which all units have designated imputed income limitations of 60% except for one unit designated at 40% AMGI and one unit designated at 80% AMGI. We contend that the quid pro quo for taking LIHTC on the 80% unit is agreeing to the lower imputed income limitation, and the corresponding rent restriction, on the 40% unit.

1. Assume that the 40% unit was rented to a tenant at 45% of median income. The 40% unit has a rent restriction based on the income limitation of 40%, so there is no economic incentive or benefit to the taxpayer of leasing the unit to an over-income tenant, while there is a significant economic loss because that unit doesn't qualify for LIHTC. Loss of credit on the 80% unit is not required to further punish the owner.

2. What if the rent restriction was not met? Why would the result be different if the owner collected an additional $10 of additional rent from the 40% tenant (loss of credits on 2 units), as opposed to collecting an additional $10 of additional rent from the 80% tenant (loss of credits on 1 unit)? In either case, the applicable restrictions have been breached as to one unit and the economic benefit of that breach is $10—why should the penalty be double in one situation as compared to the other?
3. Treating a violation of the restrictions on a 40% unit differently than a violation with respect to an 80% unit can only be justified by reference to the 40-60 set-aside as a baseline. The argument must be that the 40% unit would qualify under the 40-60 test but the 80% unit would not qualify under the 40-60 set-aside without the linkage to the 40% unit. However, the statute establishes the average income set-aside as a separate set-aside, not a subset of the 40-60 set-aside. Moreover, if that is the baseline, then a 40% unit rented to a tenant at 45% of AMGI would qualify for credits under the 40-60 set-aside. Under this view, it seems that credits shouldn't be lost on two units only if only one unit would have failed to qualify under the 40-60 set-aside.

In summary, we do not believe that the statute supports the interpretation of the minimum set-aside set forth in the proposed regulations. Concerns about abuse of the provision can be addressed directly with anti-abuse or good faith provisions such as the good faith test we describe in the following section. Changes in facts, such as destruction of units can be addressed by changes in designations which, as described below, we believe should be allowed in many circumstances. In almost all cases, violations of the applicable income limitations, and the associated rent restrictions, will be inadvertent and made in good faith and will be subject to penalty through the loss of credits on those units that do not qualify as low-income units. We do not believe the statute intended, or tax policy requires, that failure to qualify one unit as a low-income unit results in the draconian remedy of loss of all credits, or even the loss of credits on one or more additional units that have qualified as low-income units.

B. Good Faith Reliance on Taxpayer's designations allowed and can avoid need to mitigate

As described above, we believe that Section 42(g)(1)(C) provides that, for purposes of testing compliance with the 60% average requirement of Section 42(g)(1)(C)(ii)(II), the income designations used would be those made by the taxpayer. To address policy concerns, including potential abuse of the provision, we propose that the designations made by the taxpayer would not be respected unless the taxpayer certifies and establishes that it made a good faith effort to comply with the designations. We would propose a rule as follows:

> If, during a taxable year, there is a determination that the rental of a unit does not comply with the income designation assigned to such a unit or the unit did not otherwise meet habitability or other requirements to be eligible for tax credits, for purposes of Section 42(g)(1)(C)(ii)(II) such determination shall not apply to any period before such year and Section 42(g)(1)(C)(ii)(II) shall be applied without regard to such determination if (1) the taxpayer certifies and establishes a good faith effort to comply with Section 42(g)(1)(C) and other requirements of Section 42, and (2) the failure is corrected within 1 year from the date of the determination.[1] The good faith of a taxpayer may be established by showing that the Project complies with the Available Unit Rule of Regulation 1.42-5(c)(1)(ix) and the General Public Use Rule of Regulation 1.42-9 or other criteria in the judgment of the State Housing Credit Agency. A taxpayer attempting to rely on a designation for which it purposefully did not comply would be deemed abusive and such designation would then be disregarded for purposes of determining if the project complies with the 60% average requirement of Section 42(g)(1)(C)(ii)(II).

The foregoing rule would provide for the certainty as to designations by taxpayers as prescribed in Section 42(g)(1)(C)(ii)(I), prevent taxpayers from abusing such designation and also allow for a reasonable time where such designations could be relied on while errors are corrected. Importantly, a unit not following the designation will not generate tax credits and can cause recapture even though a good faith effort was made to comply with Section 42 requirements, but the satisfaction of the minimum set-aside will not be unknowingly threatened.

Examples of the foregoing rule are below:

> **Example 2**: Building owner designated Unit X to be a 40% unit. Subsequently, owner and tenant knowingly enter into a lease for unit X for market-based rents that are clearly in excess the applicable low-income rents for a 40% unit. The taxpayer cannot establish a good faith effort to comply with the 40% designation. As a result, the designation of the unit as a 40% unit would not be respected and the unit would not be included in the average income computation as provided in Section 42(g)(1)(C)(ii)(II). If the absence of that 40% unit caused the Project to not meet the 60% average income requirement, then the minimum set-aside would not be met unless the taxpayer timely elected to mitigate. In addition, the out of compliance unit would be subject to existing rules regarding non-qualification for credits in the current year and for recapture in prior years.

> **Example 3**: In 2021, taxpayer places in service a new a 100-unit building which has 50 units designated at 40% and 50 units designated at 80%. On February 1, 2024 Taxpayer leases a 40% unit to a tenant that the Taxpayer

1. The one year approach is patterned after Section 42(h)(6)(J) which provides that if an extended use agreement is determined not to be in place during a taxable year, such determination does not apply to the current or prior years if the failure is corrected within one year. This approach is superior to something similar to the 90 days provided for in Regulation 1.42-5(e)(4) because tenant leases are generally 1 year in length and therefore it may not to be possible to correct non-compliance in less than a year.

believes is an appropriately income qualified person. The unit was properly designated in the first credit year as a 40% unit in compliance with applicable IRS and State Credit Agency requirements. In compliance with rules established by the State Credit Agency, the Taxpayer certifies to the State Credit Agency for 2024 its good faith belief that 100% of the Project units qualified as low-income units. Unknown to the taxpayer, it had incorrectly computed the tenant's income because it had misunderstood that the tenant was paid twice a month (24 pay periods) rather than every other week (26 pay periods). As a result, the tenant's correctly computed income would have been slightly higher than the 40% income limit. On October 15, 2025 a tenant file review by the State Credit Agency discovers the error. When the tenant's lease expires on January 31, 2026, the tenant vacates the unit and is replaced with an income qualified tenant. Because the Taxpayer had made a good faith effort to insure that the tenant's income did not exceed the 40% designation in 2024, solely for purposes of calculating the 60% requirement in Section 42(g)(1)(C)(ii)(II), the 40% designation on the unit may be used and the building would not fail to meet the average income minimum set-aside. For 2025, the error was known by the end of the year, however, the noncompliance was corrected within 1 year of the determination of non-compliance and thus the taxpayer's 40% designation may be used in 2025. However, the out of compliance unit would be subject to existing rules regarding non-qualification for credits in the current and prior year and for recapture in prior years.

Example 4: On April 1, 2021 taxpayer rents a unit in a newly constructed building to a tenant that meets the 40% income requirement and the rents are within those allowed for 40% units. The unit was properly designated in the first credit year as a 40% unit in compliance with applicable IRS and State Credit Agency requirements. The architect had certified as to the completion of the unit and compliance with the project's approved plans and specifications. Unknown to the taxpayer, the unit failed to meet a State Credit Agency's accessibility requirement and thus is not considered habitable under the State Credit Agency's requirements. On February 2, 2023, the Taxpayer is notified by the State Credit Agency that the unit did not meet the accessibility requirement. Taxpayer corrected the unit on April 1, 2023. Taxpayer also establishes to the State Credit Agency its good faith belief that the unit had meet the applicable requirement. Because the Taxpayer established its good faith effort and because the unit was repaired within one year of the determination of lack of habitability, the unit's 40% designation can be included as a 40% unit for purposes of testing whether the 60% average was met in 2024 and 2025.

Example 5: On December 25, 2021 a 40% unit suffers a fire and is not habitable as of December 31, 2021. The taxpayer timely contacts the State Credit Agency and the State Credit Agency provides for a 6-month period in which to repair the unit. The taxpayer expects that it will be able to repair the unit within the time period allowed by the State Credit Agency. Because the taxpayer has arranged a reasonable repair period with the State Credit Agency and is proceeding forward on such repairs, the taxpayer has established a good faith effort to comply with the requirements to be a low-income unit and solely for purposes of Section 42(g)(1)(C)(ii)(II), the unit's designation as a 40% unit would be allowed be used for 2021. Existing rules would apply in determining the unit's qualification for tax credits in the current and prior years and for recapture in prior years. The taxpayer then repairs the unit by June 25, 2022 and the unit is then occupied by an income eligible tenant at 40% rents for the remainder of the year. As a result, the unit's 40% designation can be used for the balance of 2022 for purposes of Section 42(g)(1)(C)(ii)(II).

C. *Floating Units*

The proposed regulations require that unit designations be made by no later than the end of the first year of credit period, and once made, no changes to such designations are permitted. Prop. Reg. 1.42-19(a)(3). Permanently fixing unit designations is inconsistent with other provisions of Section 42, policies and procedures of State Credit Agencies, and statutory tenant protections in a low-income housing project. For the reasons discussed below, we believe the better approach would be to allow State Credit Agencies to set policies and procedures providing for how unit designations can be changed.

i. Section 42: Section 42 does not preclude modification of unit income designations, including in connection with the 20-50 or 40-60 set-asides. Introducing a fixed designation requirement when the average income set-aside is used imposes an additional layer of compliance and management complexity for owners which we do not believe was intended by the statute. In connection with the vacant unit rule, Rev. Proc 2004-82 (Question 8) states that "where an owner simply moves a tenant from a unit in one building to a unit in another building in the same project . . . the unit that the tenant actually occupies at the end of a month at the end of each year in subsequent years qualifies as a low-income unit." Based on this IRS guidance, LIHTC unit designations were not intended to be fixed to a physical unit; instead, low-income tenants should be able to move to another unit and retain the same designation for purposes of the minimum set-aside test.

ii. Next Available Unit Rule: Proposed Regulation 1.42-15 itself contemplates changes in income designation in connection with the next available unit rule. It would not be possible to implement the next available unit rule without a change in the designation of the unit. Further, the preamble to the guidance provides in the "Alternative Mitigating Action Approach" discussion that a taxpayer may take the mitigating action of *re-designating* the imputed income limitation of a low-income unit to return the average test to 60 percent or lower in certain circumstances.

iii. State Credit Agency Guidance: In the absence of federal guidance following the passage of the Consolidated Appropriations Act, nearly every State Credit Agency has developed average income set-aside guidance and policies on income averaging in the absence of federal guidance. Most, if not all, states' policies either (i) expressly permit units to float or (ii) are silent as to whether units could float or are be required to remain fixed. State Credit Agencies are now in the awkward position of having to adjust guidance going forward, or worse, amend existing LURAs which currently allow units to float. In the latter case, the State Credit Agency may find itself in a difficult position given that amending existing LURA's in a manner that could adversely impact tenants (see discussion below re: tenant protections) and could run afoul of tenant third party beneficiary rights under the LURA. In addition, State Credit Agency policies pertaining to the traditional 20-50 and 40-60 set aside tests have permitted units designated at different income levels to allow for the type of flexibility in the cases we have discussed below. State Credit Agencies work with developers and projects on a day to day basis and understand the need in certain cases to change unit designations in manner that does not frustrate the purposes of the LIHTC program.

iv. Tenant Protection Statutes: Various federal and state tenant protection statutes would conflict with proposed regulation's fixed designation requirement

A. ***Fair Housing Act***. Fixed unit designations may in some cases create conflicts with fair housing rules. The Fair Housing Act requires that reasonable accommodations be made to allow a disabled person an equal opportunity to rent and reside in a LIHTC building unit.

Example 6: A tenant lives in a 60% fixed AMGI unit on the third floor of a building with no elevator. The tenant experiences an unexpected severe injury, requiring the tenant to be in a wheelchair. The building has a vacant accessible unit on the first floor, but the units on the first floor are only 50% AMGI units. Does the owner violate the fixed income designation rule under the average income set-aside and lose the unit as a low-income unit, or does it decline to move the tenant and risk running afoul of fair housing rules? .

B. ***Violence Against Women Act*** ("***VAWA***"). Similarly, the Violence Against Women Act may necessitate a quick unit transfer for a victim of sexual assault, domestic violence, stalking or similar crime by statutory requirement if the tenant reasonably believes they are at risk of imminent harm if they remain in their unit.

Example 7: A tenant in a 70% unit in such circumstances notifies the property manager that the tenant has been receiving threatening abusive calls and requests a switch in units under VAWA, and the only vacant units in the building are 50% units.

In either such case, the owner is stuck with the difficult choice of complying with either the average income set-aside rule or Federal tenant protection statutes. We are aware of many LIHTC projects which are targeted entirely to either disabled populations or victim of sex trafficking or violence. In the examples illustrated above, the owner cannot comply with both. The dilemma is clear.

v. Other Issues

Tenant protection concerns are most compelling as to why fixed unit designations are impractical, if not adversely impactful, for owners and tenants. However, other important challenges exist.

A. ***Inability to Accommodate Reasonable Tenant Requests***. Property managers will not be able to grant certain customary tenant requests which they would otherwise be able to afford under any other LIHTC set-aside.

Example 8: A 70% AMGI tenant has signed a lease. The tenant tells the property manager that the tenant is averse to living on the first floor of a building based on prior experiences and requests a unit on the second floor. The only vacant units over the first floor are 30% units. The tenant's request is not protected by statute, but a property manager naturally wants to accommodate its tenants and seek to ensure that they are happy with their housing choice to the extent they are able. In this example, the tenant will either have to take a unit on the first floor against its strong preference or move to a different building. The proposed regulations should permit one unit to be swapped for the other.

B. ***Casualty Events.*** When a casualty event occurs, the unit is required to be restored and back in service by the end of the calendar year to avoid credit disallowance. If the casualty event occurs on December 30, there is no practical way that the unit will be restored by the end of the calendar year. The owner will find itself having to remove the unit to avoid credit disallowance. This seems a harsh penalty for a no-fault event. Further, what if the owner needs to relocate the tenant for a period of time over a year (if it requires that amount of time) while the unit is restored? If the only vacant unit in the building has a lower AMGI, then does the owner relocate the tenant entirely in that circumstance until the unit is restored? Or if the only open unit is a market unit, we recommend allowing the tenant to move into the market unit and have that unit be designated a low income unit with the unit that suffered the casualty becoming the market rate unit going forward. In both situations, it would seem better for the tenant to remain in the same building if possible.

C. **Adding/Removing Designations.** It is unclear under the rules as to whether designations can be added and removed. Proposed Regulation Section 1.42-19(b)(3)(i) states "No change to the designated imputed income limitations may be made. . . . If a designation is removed, the unit ceases to be a low-income unit." This proposed regulation clearly seems to allow a designation to be removed with the consequence that the unit is no longer a low-income unit. Does this mean that changes in designations are not allowed, but that owners may remove designations or newly designate units?

Example 9: If a 30% unit has a casualty which does not cause a failure in the minimum set-aside (and therefore mitigation is not allowed under the proposed rules), can the owner simply designate a market rate unit as a new 30% unit and then have the old 30% unit become a market rate unit? This would seem to run afoul of Proposed Regulation Section 1.42-19(b)(3) which states that designations must be made as of the end of the first year of the credit period.

Example 10: Consider Example 2 in Proposed Regulation 1.42-19(g)(2). In this example, a market rate unit is converted to a low income unit as mitigation because of the inhabitability of a low income unit. However, the example states that once the habitability issue is corrected, both the low income unit and the converted market rate unit are low income units.

> Thus, the proposed regulations would cause the project to forever lose a market rate unit. We recommend that the owner be allowed to convert one of the units to market rate when the other noncompliant unit gets back into compliance, or when the formerly market rate unit is vacant, if later.

We do not believe there is any reason not to allow the withdrawal of temporary designations, or modifications to designations as long as the owner follows State Credit Agency procedures as to how this is to be done. We believe that such an ability is an important component of the long established ability of low income projects to float which units are low income and which are not.

We recommend a reasonable middle ground approach, consistent with other Section 42 guidance. Changes to unit designations should be permitted in all events under the tenant protection examples provided above. Outside that scope, changes to unit designations should be permitted where the taxpayer demonstrates to the State Credit Agency reasonable grounds for the requested change pursuant to procedures established by the State Credit Agency. By analogy, Section 42 guidance on other matters including the next available unit rule and recent 8609 guidance/discussions with the IRS indicate that such an approach is supported. Extreme cases of inappropriate use of unit designation changes could be identified by the state State Credit Agency and such requests would be rejected. The anti-abuse rules of the Code can also address "bad-actor" activity. As we have described, there are many other instances in which a change to the unit designations is warranted and if not made, could cause unintended consequences for the owner.

In summary, our recommendations are as follows:

1. The final rule should allow changes in designations so long as (i) the changes are approved by, or made pursuant to procedures established by, the State Credit Agency, and (ii) do not have the effect of increasing the income limitation applicable to any existing tenant.

2. If the IRS is unwilling to provide that level of flexibility, the final rule should allow changes in designation (i) under the tenant protection circumstances described above, (ii) at any time to reduce the income limitations applicable to a unit, and (iii) in the case of an exchange of designations between two units that are vacant or when an existing tenant moves to a vacant unit.

Part II—Determining when mitigation, timing of mitigation and types of mitigation

A. Timing of Mitigation

The proposed regulations allow a taxpayer to elect to take mitigating actions in order to avoid failing the Average Income Test due to a non-compliance event. However, these mitigation actions need to be taken within 60 days after the end of the year when the non-compliance event occurred. This deadline is problematic and will often render such actions ineffective.

Often, a violation is inadvertent and is not detected until after the end of the year. The discrepancy could be discovered during the annual audit, which can frequently take longer than 60 days following year end, or upon the compliance review conducted by the State Credit Agency, which have varying due dates. In either case, discovery of the non-compliance issue is likely to come more than 60 days following the end of the year the non-compliance event occurred.

We believe that the mitigation period should begin upon the discovery of the noncompliance event. The taxpayer could be required to notify the State Credit Agency of the discovery of an instance of noncompliance and the chosen course of mitigation. The notification would then be attached to the taxpayer's subsequent tax return with the average income calculation and tax credits computed reflecting the mitigation action. In addition, we believe that the mitigation period should be longer in order to properly assess and remedy the situation. We suggest that it continue until at least the earlier of the due date of the tax return with extensions or one year from the date the noncompliance event is discovered.

A mitigation period of one year from the date of the discovery is consistent with the cure period provided by Internal Revenue Code Section 42(h)(6)(J) that allows a taxpayer to correct a noncompliance event within one year of the determination of the noncompliance. We think this one-year period could be treated as grant of relief under Treas. Reg. Section 301.9100, and the taxpayer could file for the relief pursuant to and in accordance with Treas. Reg. section 301.9100-2. Such regulation already provides automatic relief for a number of different regulatory elections, and taxpayers would benefit from the implementation under a commonly understood and straightforward process. We recommend a period of one year and not a lesser period such as 90 days allowed in Regulation 1.42-5(e)(4). A period as short as 90 days may be insufficient to allow the market rate conversion mitigation to be useful as an owner may need to wait for a market rate tenant's lease to expire to allow it to then rent that unit to a low-income tenant. Therefore, we believe that the one-year period in Section 42(h)(6)(J) is more appropriate.

In addition, we believe there should be a default action for mitigation if none is elected by the end of the mitigation period. This would prevent the potentially catastrophic loss of all credits due to one unit falling out of compliance without discovery and corrective action being taken during the mitigation period. Our recommendation for the default mitigation action would be to remove sufficient units from the tax credit project in order to bring the average income of the low-income units to or below 60% AMGI. Of course, this automatic mitigation would not be necessary if our request to allow mitigation to be done up until one year after a determination that a unit is out of compliance.

Example 11: Assume that there is a ten-unit project with income designations for each unit as follows:

1 40%
2 40%
3 40%
4 60%
5 60%
6 60%
7 60%
8 80%
9 80%
10 80%

The project owner inadvertently rents unit 1 to a tenant that earned more than 40% AMGI. The taxpayer was not aware of this error and therefore failed to elect a mitigation action within the mitigation period. If the taxpayer did not mitigate within the time period provided by the proposed regulations, the average of the remaining nine units would exceed 60% and the project would fail the average income test. Had the taxpayer known of the noncompliance event, it could have chosen to remove one of the 80% units from the tax credit calculation and only claimed credits on 8 units, resulting in an average of 60%.

If the proposals described in other portions of this letter are rejected, then we recommend that the proposed regulations be revised to by default have a unit removed to reduce the number of units eligible for tax credits to result in a percentage of 60% or less. By doing so, the tax credit project would then consist of 8 units with an average income of 60%, in compliance with the Average Income Test, and no longer putting the taxpayer at risk for ineligibility for the tax credits. This default option should only apply if the owner did not elect to take other mitigating actions by the end of the mitigation period.

B. Types of Mitigation

Mitigation Strategies in the Proposed Regulations. If one of the designated units ceases qualifying as a low-income unit—for example, because it becomes uninhabitable—then the proposed regulations provide mitigation remedies that can be employed to avoid failing the minimum set-aside, and which applies depends upon the specific facts.

i. **Removing the nonqualified unit**: Technically this is not a form of mitigation because under proposed regulation 1.42-19(c)(2), mitigation is only available if necessary to avoid failing the minimum set-aside. However, this is an important mechanic that we think is worth clarifying. Under this approach, the taxpayer can simply eliminate the particular failing, designated unit from the computations, provided the remaining units continue to maintain an average of 60% of AMGI or less and such units represent at least 40% of the units in the Project. For example, if the nonqualified unit is above 60%, or if the average is already sufficiently below 60% so that losing a below 60% unit does not cause the average of the remaining units to rise above 60%, then only the single unit would fail to generate tax credits and be subject to recapture. This is an obvious solution that makes sense.

ii. **Available FMV unit**: The first mitigation approach of the proposed regulation is that if the project has an available fair market value unit, which is either vacant or occupied by a tenant whose income matches (or is less than) the unit that went out of service, then the fair market value unit can become a new designated unit, and thereby keep the average income at the required level. If an appropriate unit is available, this is a sensible way to address the problem. Unfortunately the requirements of either having a vacant unit or a unit that is ***already*** occupied by an appropriately qualified tenant may render this a rarely used remedy, unless the proposed regulations extend the 60-day deadline discussed previously. As discussed above, we believe that the regulations should make clear that this is a ***temporary*** solution, and can be undone, or the restored unit can replace the formerly market rate unit.

iii. **"Removed" units**: The second mitigation approach of the proposed regulations related to removing a unit. Pursuant to the removed unit rule, the project can designate a matching over-60% unit for the under-60% one which no longer qualifies. This companion unit is referred to as a "removed unit," and the computation of future credits will reflect both the loss of the unqualified unit and the removed unit, although for recapture purposes the removed unit is still treated as a low-income unit since it will still need to meet the requirements of a low-income unit. See Prop. Reg. 1.42-19(g)(2) (60% average computation does not consider non-qualified unit or removed unit), Prop. Reg. 1.42-19(f)(2) (removed unit does not cause recapture). As noted previously, the removed unit must be affirmatively identified no later than 60 days after the end of the year in which the test was failed, and we have previously detailed recommendations for extending this period.

As we discussed above, and setting aside the question of whether this remedy goes beyond what is called for in the Code, the removed unit remedy may not be such a useful solution. Eliminating units which are otherwise complying with the original land use restriction agreement and the requirements of the State Credit Agency will reduce the building's applicable basis, thereby reducing annual credits. We acknowledge that it is appropriate to eliminate the nonqualifying unit but adding a removed unit to the computation has at least twice the impact. Further, we agree with the favorable treatment accorded to the units if and when they are reinstated. However, and perhaps most important, if the nonqualified and removed unit (if applicable) cause the building to fail the minimum set-aside, then we can have the catastrophic result of the building no longer qualifying for any credits.

Example 12: Project 1 has five equally sized units, and a total eligible basis of $1 million. All five are at 60% of AMGI, and it uses the "traditional" 40-60 set aside. If unit 1 goes out of service, the applicable fraction falls to 80%, and its applicable basis falls to $800,000.

Project 2 also has five equally sized units, and total eligible basis of $1 million. Project 2 uses income averaging, with two units designated 40%, one designated 60%, and two designated 80%. If a 40% unit goes out of service, then the remaining units are at 65% (40+60+80+80/4), and therefore, the minimum set aside test is not met. Accordingly, further steps must be taken.

The mitigation strategy in the proposed regulations would likely call for an 80% unit to be removed as well as the nonqualified unit, bringing the project back into compliance at 60% (40+60+80/3), but reducing the applicable basis by *two* units to $600,000.

Now, suppose a second 40% unit goes out of service in each project. Then, Project 1 would still have 3 of 5 units in service, and an applicable basis of $600,000. However, Project 2 would lose not just the two *nonqualifying* 40% units, but also the two *removed* 80% units. As a result, Project 2 would "fall off the cliff," since now the project would only have 1 out of 5, or 20% qualifying units, failing the minimum set aside requirement.

As the example illustrates, the removed unit solution is most problematic when there are a relatively small number of units in a project. If, instead of 5 units, a project had 50 units, then it could have 15 nonqualifying 40% units, plus another 15 removed 80% units and still pass the minimum set aside (because 50 less 30 is 20, and 20/50 is 40%). Furthermore, with a larger project, it is possible to have a "buffer"—have enough below 60% units so that it is not necessary to remove any of the above 60% units, even if one or more below 60% units should become unqualified.

Example 13: Project 3 has 100 units. 40 are at 40%, 30 are at 60%, and 30 are at 80%. Using income averaging, this passes the minimum set aside at 58% ((40 × 40)+(30 × 60)+(30 × 80)/100). If eight of the 40% units became unqualified, the project would *still* qualify at 59.6% ((32 × 40)+(30 × 60)+(30 × 80)/92), and all of the 80% units could still be included in computing qualified basis.

The problem is that this solution is plainly not as efficient as is contemplated by the Code section. ***Remember*** the purposes of the low income house tax credit are fully served; in the example, ***100%*** of the units are in compliance with the income averaging test, and yet that is not good enough. The proposed rule would effectively require the inefficient buffer, as if income averaging requires the building to pass a 40% at 58% test. Furthermore, as these examples illustrate, with smaller projects, the numbers are simply not there to provide the required buffer. Finally, the requirement of a buffer has the direct impact of reducing rental revenue of the entire project as compared to a project using the 40% at 60% minimum set-aside. As a result, projects would not be able to support as much debt and would require additional tax credits or other subsidies. We believe that in creating the average income approach, Congress was seeking to allow projects to receive the same economic rents but allow for a broader range of income targeting. We do not think Congress meant to economically penalize such projects.

C. Other Designation Issues

Ability to change unit designations. As noted above, the proposed regulations contemplate designating a formerly fair market value unit as a low-income unit if that can solve a non-qualified unit problem. But they otherwise do not allow a change in designations. These mitigation strategies do not address other potential issues. What about tenants who are forced to relocate, or if another government program requires the designations to be changed? Or suppose a situation in which permitting an over 60% unit to be designated as a lower percentage unit (e.g., 40%) would have a far less adverse effect than removing a companion over-60% unit). Perhaps the proposed regulations did not contemplate "floating units" because the IRS thought they could be difficult to monitor and enforce. However, we observe that State Credit Agencies have been charged with assuring, and successfully addressed, compliance with the set-aside rules throughout the life of the LIHTC incentive, and we see no reason to not trust them with at role here as well.

Accordingly, we recommend that:

(1) The IRS allow and changes in designations so long as (i) the changes are approved by, or made pursuant to procedures established by the State Credit Agency, and (ii) do not have the effect of increasing the income limitation applicable to any existing tenant.

(2) If the IRS is unwilling to allow flexibility to that extent and believes some restrictions are required, then changes in designation should be allowed (i) at any time to reduce the income limitations applicable to a unit, and (ii) in the case of an exchange of designations between two units that are vacant or when an existing tenant moves to a vacant unit.

Part III—Other Issues

A. IRS Proposal for Next Available Unit Type Relief

We agree with the concept of being able to correct an inadvertent violation by using a remedy that would require renting the next available unit to a tenant that would bring the average into compliance.

B. Removed Units Not Low Income Units After the Credit Period

Proposed Regulation 1.42-19(f)(4) states the following:

> (4) Long-term commitment. For purposes of applying section 42(h)(6)(B)(i) to any taxable year after the credit period, removed units are not taken into account as low-income units.

We request clarification on this point, especially how the computation of the applicable fraction would be computed in order to comply with the requirement under IRC 42(h)(6)(B)(i) that the applicable fraction continue to be maintained.

Conclusion

We sincerely appreciate the significant effort of the Department of Treasury and the IRS in writing proposed regulations in this complex area. However, we respectfully believe that modifications are called for. In particular, the proposed regulations create significant potential for projects to inadvertently fail the minimum set-aside, a risk that is much higher than with the other minimum set-asides under Section 42. The proposed regulations also significantly restrict the flexibility owners traditionally have (often with the participation of their State Credit Agency) and will likely create conflicts with other laws. Finally, the proposed regulations negatively impact the economics and financial feasibility of projects, which will cause investors to avoid projects that use income averaging.

We believe that the above issues can be avoided by (i) focusing on the statute's reference to the taxpayer making unit designations and permitting flexibility in such designations, while providing good faith and anti-abuse rules, as well as oversight by the State Credit Agency, (ii) providing for longer mitigation periods which would address real world timing issues, and (iii) continuing the long-standing tradition of allowing which units are low-income units to change or "float" from year to year by allowing the designations of units to change, generally with notice to the State Credit Agency.

Thanks very much for your consideration of these recommendations.