NOW + NEXT

COMMUNITY DEVELOPMENT FINANCE LAW ALERT | NIXON PEABODY LLP

DECEMBER 1, 2020

NP

The IRS issues proposed regulations on income averaging

By Forrest David Milder

The minimum set-aside requirement. For most of the history of the section 42 low-income housing tax credit ("LIHTC"), there have been two tests with respect to the "minimum set aside." These are the "20-50 test," pursuant to which at least 20% of the residential units in a project must be both rent restricted and occupied by tenants whose gross income is 50% or less of area medium gross income ("AMGI"), and the "40-60 test," under which at least 40% of the residential units must be both rent restricted and occupied by tenants whose gross income is 60% or less of AMGI. These are often referred to as "cliff tests," because if a project fails the minimum set aside, then it doesn't qualify for ***any*** credits. In other word, the project has "fallen off a cliff." Of course, once the minimum set aside is met, the actual tax credit computation is based on the building's "qualified basis," that is, its eligible basis multiplied by the ratio of low-income units to total units in the building.

Income averaging becomes law in 2018. The Consolidated Appropriations Act of 2018 ("2018 Act") added a third minimum set aside test, often referred to as "income averaging." It should be noted that the Internal Revenue Service ("IRS") refers to this as the "average income test."

How does income averaging work? Pursuant to income averaging, an LIHTC project can designate units that are a mix of unit percentages, ranging from 20% to 80% of AMGI, and count **all** of them toward meeting the 40-60 minimum set aside requirements, provided (A) the average of these imputed income limitations does not exceed 60%, and (B) 40% or more of the units in the project are both rent restricted and occupied by tenants whose income does not exceed the imputed income limitation provided.

> **Example:** Assume a project has ten 40% units, ten 60% units, five 80% units, and 10 market-rate units, all of equal size. The average percentage for the low-income units is 10 times 40% plus 10 times 60% plus 5 times 80%, divided by 25, or 56%, which is below 60%, and therefore meets the set aside, while the fraction for computing the building's applicable basis is 25 low-income units divided by 35 total units, or 71.4%.

Following adoption of the 2018 Act, the LIHTC community has sought guidance from the IRS on how some of these rules should be applied. In the absence of IRS guidance, some intrepid project

This newsletter is intended as an information source for the clients and friends of Nixon Peabody LLP. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct. Copyright © 2020 Nixon Peabody LLP. All rights reserved.

sponsors, and their corresponding state agencies, have endeavored to fashion rules that they believe comply with the statutory requirements. Of course, they didn't know if the IRS would agree.

The proposed regulations. The IRS has now published proposed regulations, which interpret the income averaging provisions. Presented with a complex statutory regime, the IRS has made a thoughtful and practical response. As proposed regulations, they are not yet considered law, but they do represent the IRS's view of how the law should be applied, and they merit close review. Still, some of the rules have drawn fire and the IRS is accepting comments, on a pretty quick timetable; comments are due by December 29, 2020.

Here are the basic rules:

1. **Initial designation**. Not later than the end of the first year of the credit period, a taxpayer must designate, in accordance with local agency procedures, the percentages, in multiples of 10, ranging between 20% and 80%, for each of the units intended to be "low income." ***Once designated, these percentages are tied to the particular units and cannot be changed***.

2. **Over income units**. If the income of a tenant in one of the designated units goes above the limitation, i.e., it becomes an "over income unit," then a modified next available unit rule applies. If the next available unit is already a designated unit, then it's percentage is already fixed, and no changes are made for that unit. On the other hand, if the next available unit is a fair market value unit, then it must be rented at whatever percentage it takes for the designated units (as a group) to continue to maintain an average of 60% of AMGI or less.

3. **Nonqualifying units.** If one of the designated units ceases qualifying as a low-income unit—for example, because it becomes uninhabitable—then there are more choices to be made. These are referred to as "mitigation" in the proposed regulations, and which strategy applies depends upon the specific facts.

    a. <u>Available FMV unit</u>. First, 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.

    b. <u>Removing the nonqualified unit</u>. Second, 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. For example, if the nonqualified unit is above 60%, or if the average is already sufficiently below 60% that losing a below 60% unit does not cause the average of the remaining units to rise above 60%, then only the single unit is eliminated from tax credit computations.

    c. <u>"Removed" units.</u> Finally, we come to the new rule, which has drawn the most attention with regard to these new regulations. If there is not an available fair market value unit to convert to a designated unit, and removal of the nonqualified unit will not solve the "average is no more than 60" problem, then 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. The removed unit must be affirmatively identified no later than 60 days after the end of the year in which the test was failed.

d. Effect of these rules. The first strategy, changing a FMV unit to a designated unit, is a permanent change; what had been a fair market value unit now becomes a permanent part of the designated low income units. So, it may not be as easy a fix as first appears. Eliminating units also has consequences. First, it will reduce the building's applicable basis, thereby reducing annual credits. Eliminating the nonqualifying unit is bad enough, but adding a removed unit to the computation has at least twice the impact. Second, the nonqualified unit will result in tax credit recapture. Notably, removing the removed unit from the computation of tax credits going forward does not result in recapture of previously claimed tax credits. If and when the unqualified unit is reinstated, the removed unit is also reinstated, and the credit computation returns. Last, and perhaps most important, if the nonqualified and removed unit (if applicable) cause the building to fall below 40% low income, then the cliff test described above can kick in, with the catastrophic result that the building no longer qualifies for any credits.

Examples. A couple of examples will help illustrate the new rules. To illustrate the proposed rules, we'll assume a small 7-unit building. We discuss larger projects below. Assume that we have a project that consists of two 40% units, two 60% units, two 80% units, and one fair market value unit.

Suppose that one of the 40% units becomes uninhabitable. On these facts, the average income test would be failed, because the remaining designated units would average out to 64%, i.e., (40+60+60+80+80/5).

To bring the project back into compliance, the fair market value unit could be designated as a 40% unit in order to replace the one that was no longer habitable. However, remember that this option is only available if the fair market value unit is either vacant or occupied by someone who already meets the 40% requirement. It would not be possible to simply remove the 40% unit from the mix, because this would leave us at 64%, as I described above. So, the only other alternative would be to remove a matching 80% unit. As a result, the project would now be back at the 60% level, i.e., (40+60+60+80/4).

Criticism of the removed unit concept. The removed unit concept has been subject to criticism. Some conclude that once the project has designated units, which together pass the 60% test, the Internal Revenue Code does not require that the project (as a project) continue to meet the averaging test in subsequent years; they see the test as only requiring that each individual unit be designated at a particular percentage, and then that unit must meet the percentage that has been so designated. If a unit fails to meet its percentage, be it 20% or 80% or anything in between, then only that unit would be backed out of tax credit basis. Thus, when a 40% unit is removed from the mix for failing to comply with the LIHTC requirements, critics of the proposed regulations contend that this should be the extent of the impact, and removal of a corresponding 80% unit is beyond the statutory requirement.

A particular source of concern arises when income averaging is compared with a "traditional" 40-60 project. A traditional 40-60 project that is (for example) 100% low income), can lose many units to disqualification before it "falls off the cliff" by dipping below the 40-60 requirements. In comparison, an income averaging project that is 100% affordable will have to take affirmative steps right away, depending on how close its average percentage is to 60 of AMGI.

> **Example.** 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 the 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.** 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% ((40x40)+(30x60)+(30x80)/100). If eight of the 40% units became unqualified, the project would *still* qualify at 59.6% ((32x40)+(30x60)+(30x80)/92), and all of the 80% units could still be included in computing qualified basis.

The bottom line is that we expect the IRS to receive comments on the proposed regulations asking for it to eliminate the removed unit concept, and it remains to be seen how it will respond.

Other Issues. There are other issues in the proposed regulations that are likely to generate comments as well:

1. **Time for designating removed units.** As noted above, the mitigation strategy of designating removed units must be done no later than 60 days after the end of the tax year. It is anticipated that LIHTC advocates will seek a longer period, perhaps till the partnership's tax return is due, including extensions. But more important is whether the designation needs to be done by any specific time. Suppose a situation in which a unit is only discovered to be non-compliant in an audit two years later, well beyond the time to designate a removed unit under the proposed regulations. Presuming that this failure was

"in good faith," is there a reason to not allow the taxpayer to designate a removed unit *at that time* if needed to avoid falling off the cliff?

2. **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. 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). The IRS may have opposed "floating units" because they could be difficult to monitor and enforce. Still, it seems that such changes should be permissible when done in good faith, perhaps with notice to the state agency that otherwise administers the tax credit, after providing such information as the IRS might require in the regulations. After all, these agencies have monitored compliance with the 20-50 and 40-60 tests since 1986.

3. **Grandfathering**. As noted above, there are agencies, sponsors, and projects that have developed their own interpretations of the rules. It's not clear how the IRS would address differences in treatment, if any. For example, if an agency awarded credits based on income averaging in 2019 without including a feature like the removed unit mitigation technique of the proposed regulations, what should be done? Should the arrangement be modified to comply with these proposed rules, or should it be "grandfathered," since the regulations only apply to tax years that begin after the final regulations are published?

4. **Going forward**. At this time, it's not clear what ***any*** project should do in light of the ***proposed*** status of the regulations. It may be that we will see all parties -- sponsors, investors, and agencies – reluctant to apply these proposed regulations unless and until they become finalized. One possible response is to at least apply the buffer strategy, described above. As illustrated above, if the project's average is far enough below the 60% requirement, then regardless of how the rules are finalized, it is likely to be protected from the adverse effects of the mitigating strategies in the current form of the proposed regulations.

Giving comments to the IRS. The IRS has set December 29 as the due date for submitting comments. These can be submitted here, indicating IRS and REG-104591-18 in the comments. We are participating in submissions; let us know if you would like our assistance in submitting a comment.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

— Forrest David Milder at **fmilder@nixonpeabody.com** or 617-345-1055
— Richard S. Goldstein at **rgoldstein@nixonpeabody.com** or 202-585-8730
— Matthew W. Mullen at **mmullen@nixonpeabody.com** or 202-585-8128
— Roger W. Holmes at **rholmes@nixonpeabody.com** or 617-345-1227
— Andrew H. Tripp at **ahtripp@nixonpeabody.com** or 312-977-4374
— Nathan Bernard at **nbernard@nixonpeabody.com** or 617-345-1236
— John M. Marti at **jmarti@nixonpeabody.com** or 617-345-1012

— Thomas A. Giblin at **tgiblin@nionpeabody.com** or 617-345-1102
— David Kavanaugh at **dkavanaugh@nixonpeabody.com** or 617-345-1134