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Final IRS Average Income Regulation Much Improved Over Proposed Regulation

by A.J. Johnson

The IRS released final and temporary regulations on the Low-Income Housing Tax Credit (LIHTC) Average Income Test Regulations on Oct. 7, 2022. The regulation is now in effect for all LIHTC properties.

In general, these substantive final regulations provide significant flexibility with respect to satisfying the average income test, identifying a qualified group of units for use in the average income set-aside test and applicable fraction determinations, and changing the imputed income limitation designations of residential units.

Following is a summary description of the final regulation and the changes it has made from the proposed regulation.

Background

In 2018, Section 42(g)(1)(C) was added to the federal tax code, providing for a third minimum set-aside test option — the average income test. A project meets the requirements of the average income (AI) test if 40% or more of the residential units in the project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the specific unit.

Unlike the two original minimum set-aside tests (20-50 and 40-60), the AI test requires the property owner to designate each units imputed income limitation for purposes of the AI test. The code requires that the average of the imputed income limitations designated not exceed 60% of area median gross income (AMGI). The possible imputed income limitations are 20, 30, 40, 50, 60, 70 and 80.

In October 2020, the Department of Treasury and IRS published a notice of proposed rulemaking, with proposed regulations for the AI minimum set-aside test. The IRS received many comments on the proposed rule, and in March 2021, the IRS held a public hearing on the proposed rule. Since that time, the IRS has been developing this final regulation.

Review of Critical Elements of the Final Regulation

The Available Unit Rule (AUR)

There is no major change to the AUR, but the language specifies that if a low-income resident has income in excess of 140% of the 60%, 70% or 80% limit, and the next available unit in the building that is comparable or smaller in size to the over-income unit is a market unit, it must be designated with an income limit such that the average of all imputed income designations of residential units in the project does not exceed 60% of the of the AMGI.

Also, if multiple units are over-income at the same time, and there is a mix of low-income and market-rate units, the owner need not comply with the AUR in any specific order. Renting any available comparable or smaller vacant unit in the building to a qualified tenant maintains the low-income status of all over-income units until the next comparable or smaller unit becomes available.

Requirements to Satisfy the AI Test

The proposed regulations would have required taxpayers to complete, no later than the close of the first taxable year of the credit period, the initial designation of imputed income limitations for all the units taken into account for the average income test.

Under the proposed regulations, the 60% of AMGI limit on the average of designated imputed income limitations applied to all the low-income units in the project. The proposed requirement did not take into account whether fewer than all of those units could constitute a group of at least 40% of the residential units in the project such that the average of the limitations of the units in that group averaged to no more than 60% of AMGI.

In some cases, this interpretation magnified the adverse consequences of a single unit's failure to maintain low-income status. In light of the potential adverse consequences of the rule, the proposed regulations provided for mitigating actions the taxpayer could take within 60 days of the close of the year for which the AI test might be violated.

In response to the comments on the proposed regulation, and in order to make the AI test comparable to the 20-50 and 40-60 tests in terms of project impact, the final regulation eliminates the "mitigating actions." In the final regulation, the project satisfies the average income test if at least 40% of the building's residential units are eligible to be low-income units and have designated imputed income limitations that collectively average 60% or less of AMGI.

A project satisfying this minimum requirement satisfies the AI test. Thus, the final regulations have been revised so that it is no longer necessary to consider all low-income units in a project for residential rental property when determining whether the AI test is met.

This change has created a new term that operators of LIHTC projects with the AI test will have to become familiar: “qualified group of units.” This means that to qualify as a low-income unit in a project electing the AI test, a residential unit — in addition to meeting the other requirements to be a low-income unit under section 42(i)(3) — must be part of a group of units such that the average of the imputed income limitations of the units in the group does not exceed 60% of AMGI.

Accordingly, under the final regulations, a project for residential rental property meets the requirements of the AI test if the taxpayer’s project contains a “qualified group of units” that constitutes 40% or more (25% or more in the case of a project described in section 142(d)(6)) of the residential units in the project, and the average imputed income of the group does not exceed 60%.

By removing the proposed requirement applicable to all low-income units and thus allowing a project to satisfy the AI test if it contains a qualified group of units meeting the minimum requirements, the final regulations generally avoid the outsized impact that one unit’s loss of low-income status could have under the proposed regulations. In other words, it does away with the “cliff test.”

Determining “Qualified Groups of Units” for Purposes of the Applicable Fraction

The applicable fraction is the percentage of a building occupied by qualified low-income households. It is the lesser of the percentage of low-income units or the percentage of low-income residential floor space, and is determined on a building-by-building basis. Except for the first year of the credit period (where the applicable fraction is determined on a monthly basis), it is determined as of the last day of the tax year.

Under the final regulations, the determination of a group of units to be taken into account in the applicable fractions for the buildings in a project follows the same approach as determining a group of units to be taken into account for purposes of the set-aside test. Essentially, a taxpayer can determine this group of units by including the low-income units identified for the AI test, and any other residential units that can qualify as low-income units if they are part of a group of units such that the average of the imputed income limitations of all of the units in the group does not exceed 60% of AMGI. If the average exceeds 60% of AMGI, then the group is not a qualified group.

For example, if a unit was designated at 80% of AMGI and if including that unit in an otherwise qualified group of units causes the average of the imputed income limitations of the group to exceed 60% of AMGI, then the taxpayer cannot include the 80% unit in the otherwise qualified group. Only the otherwise qualified group of units, without the 80% unit, is a qualified group of units used to determine the applicable fractions for the project's buildings.

Once a qualified group of units in a project has been identified for a taxable year, the applicable fraction for each building in the project is computed using the units that are in both the qualified group and the building at issue. (Although the qualified group of units for a project must have an average limitation no greater than 60% of AMGI, this is not true of the average limitation of the units used to compute the applicable fraction of individual buildings in the project.)

This last provision is critical and confirms that although a "project" must meet the 60% average, individual buildings are not required to do so.

Designation of Imputed Income Limitations and Identification of Units

The final regulations require the initial designation of a unit to be made no later than when a unit is first occupied as a low-income unit. The final regulations revise timing of the designation so that it is no longer required by the end of the first year of the credit period, and instead is based on when a unit is first occupied as a low-income unit. (Owners and managers should note that this may be before or after the beginning of the first year of the credit period).

The designation must also be communicated annually to the housing finance agency (HFA), and the HFA may establish the time and manner in which information is provided to it. This change will allow a taxpayer to make designations after having a chance to evaluate the market for a particular unit.

Changing a Unit's Imputed Income Designation

The proposed regulations did not allow income limitations to be changed after they had been designated.

Under the final regulations, a taxpayer may change the imputed income limitation designation of a previously designated low-income unit in any of the following circumstances:

(1) In accordance with any procedures established by the IRS in forms, instructions or guidance published in the Internal Revenue Bulletin.
(2) In accordance with an HFA's publicly available written procedures, if those procedures are available to all the Agency's projects that have elected the AI test.

(3) To comply with the requirements of the Americans With Disabilities Act of 1990; the Fair Housing Amendments Act of 1988; the Violence Against Women Act; the Rehabilitation Act of 1973; or any other state, federal or local law or program that protects tenants and that is identified by the IRS or an Agency in a manner described in (1) or (2) above. The tenant protections that apply to an AI project and that redesignation may enhance do not necessarily have any specific connection to section 42.

For example, the protections may be ones that apply to all multifamily rental housing, or they may apply to the project at issue because some congressionally authorized spending supported the project with federal financial assistance. Even if a tenant protection does not legally apply to a particular AI project but does apply to analogous multifamily rental housing, the owner of the project may redesignate income limitations to implement the protection for the project's residents.

(4) To enable a current income-qualified tenant to move to a different unit within a project keeping the same income limitation (and thus the same maximum gross rent), with the newly occupied unit and the vacated unit exchanging income limitations.

(5) To restore the required AI limitation for purposes of identifying a qualified group of units either for purposes of satisfying the AI set-aside or for purposes of identifying the units to be used in computing applicable fraction(s). This rule is limited to newly designated, or redesignated, units that are vacant or are occupied by a tenant that would satisfy the new, lower imputed income limitation.

Any new designation of units must be reported to the HFA in a manner required by the HFA.

Applicable Dates

In general, the final regulations apply to taxable years beginning after Dec. 31, 2022. For taxable years prior to the first taxable year to which these regulations apply, taxpayers may rely on a reasonable interpretation of the statute in implementing the AI test for taxable years to which these regulations do not apply.

In essence, this indicates that the provisions of this final regulation may be applied to AI projects that were operating prior to 2023.

Prior to becoming a private developer in August 1983, Mr. Johnson was with K-Mart Corporation, Portsmouth Redevelopment & Housing Authority, and Suffolk Redevelopment & Housing Authority. While with the public housing agencies, Mr. Johnson was responsible for the implementation of a variety of federally funded programs, including public housing, Section 8 housing, housing rehabilitation (single family and multi-family), Community Development Block Grant (CDBG), Urban Development Action Grants (UDAG), Urban Homesteading, and was a

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Section 202 Housing Consultant. As a private developer, Mr. Johnson coordinated the development of over 70 multifamily housing complexes utilizing federal, state and conventional financing, of which more than 40 used the federal low-income housing tax credit.

Currently, Mr. Johnson is a training advisor to the Housing Credit Certification Board of the National Association of Home Builders, which is responsible for implementing the requirements of a national certification examination for tax credit management personnel and carries the designation of Housing Credit Certified Professional (HCCP). Mr. Johnson is a nationally known trainer in affordable housing issues and served as a technical advisor to Congressional staff during the drafting of both the Low-Income Housing Tax Credit Program and the Fair Housing Amendments Act of 1988 and is a certified Fair Housing Specialist through the National Center for Housing Management.