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Affordable Housing Alert

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IRS publishes revised average income regulations for LIHTC

By Forrest David Milder

The IRS has published the long-awaited revisions to its average income test regulations for the low-income housing tax credit.

What's the Impact?

- The new rules eliminate the "cliff test" that troubled sponsors and investors
- Projects may still have to back out units in pairs when computing the actual amount of the tax credit
- The new rules provide great flexibility in changing the percentages associated with units and relocating tenants

One of the requirements to qualify for the Section 42 low-income housing tax credit ("LIHTC") is that a project must meet the "low-income set-aside," i.e., it must have at least a minimum number of units that are rent restricted and occupied by individuals whose income is at or below certain percentage requirements. Prior to 2018 legislation, there were two tests—at least 20% of the units had to be occupied by tenants whose income was at or below 50% of area median (the "20/50" test), or 40% of the units had to be occupied by tenants whose income was at or below 60% of area median (the "40/60" test).

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As part of 2018 legislation, the Internal Revenue Code was amended to include an average income test ("AIT"), as an addition to the 20/50 and 40/60 tests of existing law. The AIT enables a project to have units whose tenants have income at or under a range of percentages, from 20% to 80% of area median income, as an alternative to the 20/50 and 40/60 tests.

In 2020, the IRS issued proposed regulations providing its interpretation of AIT, and these regulations were criticized.

You'll remember that the three biggest complaints about the proposed regulations were (1) loss of even one below-60% unit could potentially cause the entire building to no longer qualify for credits; (2) once designated, a unit was locked in to a specified percentage, regardless of tenant needs or applicable law, like the Americans with Disabilities Act; and (3) designation and correction deadlines meant that building owners might discover that they had failed the law's requirements, but be unable to timely correct the failure. These concerns made many developers and investors reluctant to use the AIT.

In response, the IRS held a hearing and called for written submissions. Now, in October 2022, the IRS has published "Temporary and Permanent Regulations," which modify the proposed AIT regulations and address these complaints.

Note that the bulk of the regulations are now final, although the regulations addressing record-keeping are temporary and may change.

- The final regulations call for the owner to first demonstrate that at least 40% of the units in the building are rent restricted and average out to 60% of area median, both as to designation and occupancy. If this test is satisfied, then (assuming all other Section 42 requirements are met) the ***building*** qualifies as a low-income building for Section 42 purposes. For example, a one-hundred unit building that has forty 40% units and forty 80% units could designate all forty 40% units, or thirty 40% units and ten 80% units, or a broad range of other possibilities, and still qualify. Note that even if twenty of the 40% units went out of service, it would still be possible to pass this test with twenty 40% units and twenty 80% units.
- The credit that the building then generates is based on the portion of the designated units in the building that are ***occupied*** by qualifying tenants, ***provided*** the average income of all such units is not higher than 60%. So, for example, in the one hundred-unit building I described above, 80% of the units would qualify. There can still be adverse consequences if a below 60% unit becomes uninhabitable. If this causes the average of occupied units' designations to be more than 60%, then an above 60% unit may have to be excluded from the computation in order to pass the test. For example, in our same 100-unit building, if a 40% unit became uninhabitable, then we would exclude an 80% unit from the computation, leaving us with 78% of the building qualifying. But note that (as described in the preceding paragraph) since we are still well over 40% of the units in the building meeting the 60% requirement, the building will not be at risk of losing its credits entirely.

- Tenants can be relocated without upsetting the average income test, where it is in accordance with one of the following: (1) guidance published by the IRS; (2) a housing agency's published written policy that applies to all projects; (3) the ADA, VAWA, FHA, the Rehabilitation Act of 1973, or any other state, federal, or local law or program that protects tenants and is designated by the IRS or the housing agency; (4) a tenant relocates and the income designations of the units are swapped; or (5) the owner redesignates units to restore compliance with the AIT percentage requirement.
- While units are normally designated before they are occupied, changes in designation must be made not later than the end of the taxable year.
- An example illustrates that a multiple-building 100% low-income project can pass the tests across the buildings, even if one of the buildings is above the 60% average.
- The temporary regulations provide that designations of units must be done ***annually*** in ***both*** (1) the books and records of the owner, and (2) notice to the agency, as specified by the agency. It is sufficient to simply note changes, if any, from the prior year. The housing agency can waive failure to comply with the record-keeping requirements for up to 180 days after the failure is discovered.
- In general, the final regulations apply to taxable years beginning after December 31, 2022. There are rules for residential units in projects that were already occupied prior to the applicability date. For taxable years prior to 2023, taxpayers may rely on a "reasonable interpretation of the statute." It's also notable that the regulations provide a lot of deference to state agencies in interpreting and applying the rules.

While some had hoped that the IRS would not require the possible removal of a second unit in computing the credit once all the units had been designated, the new temporary and final regulations are a sensible approach to the problem, and the other changes are very helpful to facilitating the implementation of the average income test.

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

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