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A Limited Liability Company
Certified Public Accountants

December 4, 2020

Via Upload to Federal Rulemaking Portal

CC:PA:LPD:PR (REG-119890-18)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044
Attention: Sunita Lough, Deputy Commissioner for Services and Enforcement

Re: Comments on REG-119890-18: Section 42, Low-Income Housing Credit Average Income Test Regulations

Dear Ms. Lough:

We write to submit comments in response to Internal Revenue Service (IRS) notice of proposed rulemaking document number 2020-20221, REG-119890-18: *Section 42, Low-Income Housing Credit Average Income Test Regulations*. We are grateful for the guidance the IRS has provided regarding the average income set-aside under §42 of the Internal Revenue Code (IRC or Code), and we appreciate the opportunity to provide comments on that guidance.

As described in the following comments, the proposed guidance limits the benefits of the new average income minimum set-aside, and discourages taxpayers from using it relative to the pre-existing 20/50 and 40/60 minimum set-asides. While the benefits of the average income set-aside - namely, reaching a larger potential tenant base - are still apparent, the penalties for failure and lack of flexibility to react to changes in the underlying affordable housing market make the implementation of it in practice prohibitive.

Dauby O'Connor & Zaleski, LLC (DOZ) is a nationally-recognized CPA firm concentrating in the affordable housing industry, and has been helping clients navigate the §42 set asides for over thirty years. Thank you for considering the following comments and recommendations.

1. **Final regulations should allow for subsequent changes to imputed income designations as determined by the states.**

Prop. Treas. Reg §1.42-19(b)(3)(i) prohibits owners from changing the designated imputed income limitations over time. This prohibition on changing the designations eliminates a key feature of flexibility in the new set-aside, and therefore, will discourage owners from using it relative to the pre-existing 40/60 and 20/50 set asides.

One of the assumed benefits of electing the average income set-aside is the potential flexibility that it provides. Owners selecting the new set-aside presumed that it would allow owners to adjust income designation to mirror changes in the local tenant-base over time while, provided that the owners' adjusted designations continues to satisfy the parameters of the new set-aside (i.e., at all times 40 percent of the units remain rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the owner, and the average of the imputed income limitation designations would not exceed 60 percent of the area median gross income in any given year). As an example, a designated 20% unit in 20X1 could match the needs of the area, while in 20X8, the make-up of the area could have changed such that finding new tenants making at or below 20% AMI is no longer viable.

Further, low-income housing tax credit projects are subject to an extended use period of at least 15 years following the initial 15-year compliance period. The land use restriction agreement (LURA) between the taxpayer and the State or local housing credit agency generally contains restrictions which are determined by the minimum set-aside election. By disallowing a change in imputed income designations over time, Prop. Treas. Reg §1.42-19(b)(3)(i) would lock the imputed income designations for a period of thirty years or more, extending and exacerbating the negative effects from the prosed regulations limiting the taxpayer's ability to adjust the income limitation designations to meet the underlying needs of the rental market.

In addition to the above, taxpayers with credit periods beginning with the 2019 and 2020 tax years have elected average income and designated all units at 60 percent AMI while awaiting further guidance from Treasury. This was done with the assumption that additional guidance would be provided by Treasury and knowing that by designating all units at 60% imputed income, the taxpayer would pass the minimum set-aside test. By disallowing subsequent changes to imputed income designations, Prop. Treas. Reg §1.42-19(b)(3)(i) has reduced the flexibility of the new set-aside to such taxpayers and discouraged their use, and simultaneously prevented the communities where such projects are located from realizing the benefits and flexibility of the new set-aside.

We would also note that nothing in the plain language of §42 setting forth the new set aside appears to require or support the prohibition against changing designations imposed in the proposed regulations.

For these reasons, we recommend the final regulations provide owners with the ability to change imputed income designations over time, and that the underlying rules for changing designations be determined based on procedures established by the State or local housing credit agencies.

2. **Final regulations should not include a reduction in the applicable fraction for compliant units that are "removed" for purposes of calculating the annual tax credit.**

For projects operating under the most commonly elected 40/60 set-aside, the consequence of non-compliance or units not being suitable for occupancy is a reduction of the applicable fraction only for the units which are non-compliant or are not suitable for occupancy as of the taxpayer's year end.

However, under the proposed regulations, some compliant units may be removed from the applicable fraction, resulting in a reduction of tax credits for the non-compliant units and certain compliant units. Specifically, under Prop. Treas. Reg §1.42-19(f)(3), if a project has a noncompliant unit that causes it to violate the parameters of the new set-aside, the owner can remove certain compliant units needed to bring the project average down to 60%. By removing the compliant unit from the applicable fraction, there is a reduction to the amount of tax credits related to the non-compliant units and the removed compliant units. This treatment results in a "double counting" effect as, in addition to the non-compliant unit, the applicable fraction is further reduced by the removed compliant unit.

This treatment of removed compliant units causes a disparity between the impact of non-compliance for a taxpayer electing a 40/60 or 20/50 set-aside versus electing new average income set aside - again, discouraging use of the new set aside relative to the pre-existing set asides.

This is further detailed in Examples A and B below.

Example A
Taxpayer A received an allocation of low-income housing tax credits for a single building, 20 unit property and has elected the average income set-aside on its IRS form 8609. All units in the property are of equal size. The first year of the tax credit period is 20X1. In 20X1, A designates its imputed income for the units as detailed in Exhibit A-1 for a project average of 60%.

In 20X4, it is determined that the tenant in the 20% imputed income unit was over income at move-in. As a result, this unit is out of compliance and is not considered a tax credit unit for purposes of the applicable fraction. Due to the non-compliance in that one unit, the project average after removing the 20% imputed income designated unit from the calculation is 62% (Exhibit A-2). Absent any mitigation, this would result in failure of the minimum set-aside, and loss of 100% of tax credits.

In order to prevent the catastrophic failure of a 100% loss of tax credits, A uses the mitigating factor allowed by Prop. Treas. Reg §1.42-19(e)(2) and treats the two units designated as 80% imputed income as removed units to bring the project average down to 60% (Exhibit A-3), further reducing the applicable fraction to 85%.

Example B
Assume the same facts in Example A, but Taxpayer B instead elects the 40-60 minimum set-aside on its IRS Form 8609. In 20X4, it is determined that the tenant occupying one unit was over income at move-in. As a result, this unit is out of compliance and is not considered a tax credit unit for purposes of the applicable fraction. The resultant applicable fraction for this buildings in 20X4 is 95% (Example B-1).

In both Example A and Example B above, the project had one non-compliant unit. All other things being equal, the resultant applicable fraction for Taxpayer A was 10% lower than Taxpayer B solely because Taxpayer A elected the average income set-aside on its IRS Form 8609. These two examples highlight the disparate impact caused by Prop. Treas. Reg §1.42-19 as written.

To counteract this potential issue, taxpayers will likely create a "buffer" in their project average in order to prevent unit non-compliance resulting in the need to remove one or multiple additional units to bring the project average back down to 60%. By operating a project using a 55% project average, as an example, the beneficial effects of the average income election - namely the ability to help finance the affordable project through rental operations and to have a larger potential tenant base - have been nullified.

The potential penalties of the application of Prop. Treas. Reg §1.42-19(f)(3) as written make it prohibitive for taxpayers to elect average income. As such, we recommend that the treatment of removed units for purposes of calculating the credit in Prop. Treas. Reg §1.42-19(f)(3) should mirror the treatment of removed units for purposes of calculating recapture pursuant to Prop. Treas. Reg §1.42-19(f)(2).

3. **The "alternative mitigating action approach" described in II-H of the *Explanation of Provisions* should be implemented.**

As noted in #2 above, the mitigating actions in Prop. Treas. Reg §1.42-19(e)(2) create a disparate impact on non-compliance when calculating credits under Prop. Treas. Reg §1.42-19(f)(3) in comparison to the 40/60 and 20/50 set-aside elections. Further, the conversion of a market-rate unit under Prop. Treas. Reg §1.42-19(e)(1) will only be available as a mitigation strategy in the event that (1) the project has market rate units, and (2) either (A) a market rate tenant made less than the AMI permitted by the non-compliant unit's designation or (B) the market rate unit comes vacant within 60 days of the taxpayer's year end. Properties having no market-rate units do not have access to this mitigation strategy.

It is not uncommon for a unit with, say, a 60% imputed income designation to be occupied by a tenant with an AMI of under 40%. By allowing this unit's designation to be changed to 40%, as permitted by the alternative mitigating action approach, it would prevent non-compliance and associated recapture. As such, we recommend the "alternative mitigating approach" be implemented in the final regulations.

4. **The opportunity to take mitigating action should be changed to at least 90 days following the discovery of the issue causing the failure of the minimum set-aside test.**

Prop. Treas. Reg §1.42-19(d) allows the taxpayer 60 days following the end of the failing year to take mitigating action to correct the underlying issue. In many cases, the issue causing the taxpayer to fail the minimum set-aside test is not discovered until the State or local housing agency conducts a compliance inspection of the project. In the event the State or local housing agency discovered an issue which caused the project average to rise above 60% three months after the taxpayer's year end, Prop. Treas. Reg §1.42-19(d) would result in failure of the minimum set-aside test and require 100% recapture of all credits taken at the project to date, and loss of any future credits. This treatment would be detrimental to the project's ability to provide affordable housing going forward, as well as to the guarantor.

We recommend that Prop. Treas. Reg §1.42-19(d) be modified in the final regulations to allow for mitigating action to be taken up to 90 days following the discovery of the issue causing the taxpayer to fail the minimum set-aside test rather than 60 days after year end.

Conclusion

As described in the above comments, the proposed guidance reduces the benefits and flexibility of the new set-aside to project owners and to the underlying communities they serve. The proposed regulations also discourage use of this new set-aside.

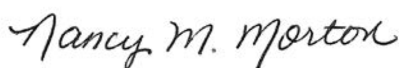
The benefits of the average income set-aside - namely, reaching a larger potential tenant base and financing the cost of affordable housing developments through ongoing rental operations - are still apparent from the proposed regulations. However, the restrictions and the penalties in the proposed regulations discourage taxpayers from using the new set-aside, defeating the intended benefits to project owners and the underlying communities.

Thank you for considering the foregoing comments.

Very truly yours,

Dauby O'Connor & Zaleski, LLC

By



Nancy M. Morton
CPA, Member

By

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By

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Ms. Lough
December 4, 2020
Exhibits

Exhibits

Exhibit A-1

20%	80%	80%	60%
60%	60%	60%	60%
60%	60%	60%	60%
60%	60%	60%	60%
60%	60%	60%	60%

Average	60%
Applicable fraction	100.00%

Exhibit A-2

	80%	80%	60%
60%	60%	60%	60%
60%	60%	60%	60%
60%	60%	60%	60%
60%	60%	60%	60%

Average	62%
Applicable fraction	95.00%

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Exhibit A-3

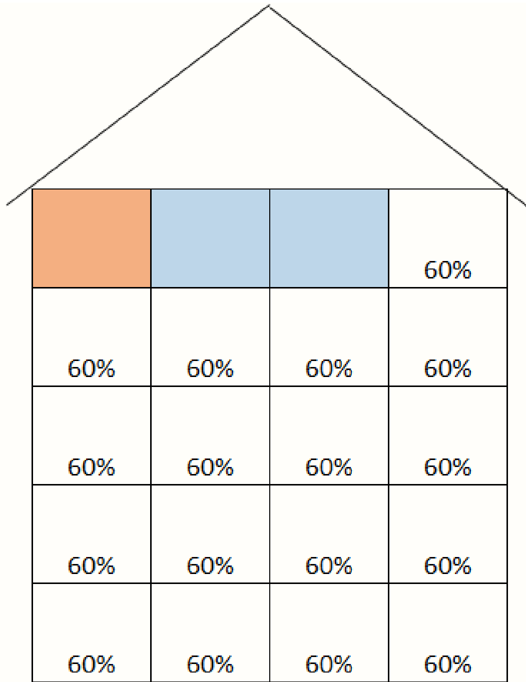

Exhibit B-1