LIHTC WORKING GROUP™
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Dillon Taylor
Office of Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: REG-104591-18, Section 42, Low-Income Housing Credit Average Income Test Regulations
Proposed Treasury Regulation Section 1.42-19 (Guidance)

Dear Mr. Taylor:

We are writing this letter on behalf of the LIHTC Working Group. The members of the Working Group are low-income housing tax credit (LIHTC) professionals who work together to help resolve technical LIHTC program issues and provide recommendations to make the program even more efficient in delivering benefits to help build affordable housing. Our group includes nonprofit and for-profit developers, syndicators, investors, accountants and lawyers.

We appreciate this opportunity to respond to the proposed Treasury regulations and how these regulations, as currently drafted, would interact/conflict with other federal housing programs. We also are alerting the Internal Revenue Service (IRS) to potential consequences it may not foresee.

I. Not Allowing Designation Changes

Agencies and Owners

Other than being done by the taxpayer, Internal Revenue Code (IRC) Section 42 is silent on designations. Therefore, since Congress enacted the average-income set-aside 34 months ago, LIHTC allocating agencies have adopted logical interpretations for their jurisdictions. The approaches are tailored to their specific circumstances, including decades of experience underwriting and monitoring units targeted to multiple area median gross income (AMGI) levels (from qualified allocation plan criteria).

Owners relied on these policies, most of which allow designation changes in various circumstances. The ability to do so was a crucial aspect of the decision to elect average income.

The Guidance imposition of a permanent prohibition on all flexibility is not in keeping with long-standing practices of:

- federal and state partnership in administering the LIHTC, and
- no ex post facto limitations on taxpayers' reasonable actions.

Legal Impossibilities

The rigidity of the Guidance causes the owner to choose between following the average income guidance or possibly violating other federal housing program laws. For example, assume fair housing mandates allow a 68% AMGI household to move from a third-floor unit to the first floor due to a mobility impairment, yet the only units available are designated at 60% or less. There are many other similarly impossible scenarios.

Conflicts between authorities occur. However, knowingly creating a conflict with other federal housing programs should be avoided, especially when a reasonable alternative exists. The IRS can avoid such an outcome by authorizing agencies to determine when a designation change is appropriate, as is the existing practice.

Conflicts with Other Federal Housing Programs
The proposed rule will create significant challenges for properties that are financed with other federal subsidies. Nearly every other major federal housing program has statutory or programmatic rules that require the floating of unit designations to some degree, including Section 8, the HOME Investment Partnerships (HOME) program, the National Housing Trust Fund, Rural Development, and tax-exempt bonds. Fixing the designations would not work with these programs. According to National Council of State Housing Finance Agencies 2019 Factbook, only 12.8% of LIHTC units financed did not also have federal funding sources. This percentage is relatively consistent year over year. Federal guidance should reduce barriers to affordable housing.

Conflict with Existing LIHTC Guidance
Under Treasury Regulation (Treas. Reg.) Section 1.42-15(d), when a current resident moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit. A similar rule applies under Revenue Ruling 2004-82, when a household whose income is no greater that 140% of the applicable AMGI limitation transfers to a different unit with in the same project. The prohibition against changing a unit's designation would eliminate the taxpayer's ability to operate in a manner consistent with the existing minimum set-asides.

II. Average Income Minimum Set-Aside

Section 42
To qualify as a LIHTC project, an owner must provide a minimum number of low-income units. Effectively, the minimum set-aside is a threshold test. If an owner fails to provide at least the required number of *low-income* units, the project does not qualify under the IRC.

The crucial question is how this test works in the average-income context. A first step is to understand Congress redefined low-income to range from 20% to 80% of AMGI (not coincidentally, the Department of Housing and Urban Development uses the term "low-income" for 80%).

IRC Section 42(g)(1)(C)(i) is clear. Just like with the other two minimum set-aside tests, at least a certain percent of a project's residential units must qualify. The difference among the three are the AMGI levels which count as low-income. For example, if an owner elects 20% at 50%, a household at 55% AMGI is over income.

With average income, 40% of units must be

> both rent-restricted and occupied by individuals whose income does not exceed the imputed income limitation designated by the taxpayer *with respect to the respective unit*.

(emphasis added) The AMGI necessary to qualify is each of the units' designations within the range from 20% to 80%.

In other words, so long as four out of 10 units comply with their designations, whatever they may be, the project complies with the minimum set-aside. In this way, average income operates the same as the other two tests: a certain percent of units must qualify at particular AMGI levels.

IRC Section 42(g)(1)(C)(ii) does not stand apart, creating its own distinct requirements. Rather it is "For the purpose of clause (i)." Each statement applies in discrete ways:

- (I) says the taxpayer designates the imputed limitation of each unit;
- under (II), "the average of the income limitations *designated under (I)* shall not exceed" 60% (emphasis added).

Clause (ii)(II) expressly and specifically governs (ii)(I), nothing else. No words apply it in other ways. The average is only of the designations themselves. The IRC does not anticipate, let alone require, ever recomputing the average. Furthermore, nothing in (g)(1)(C) contemplates a unit losing its designation for any reason.

Noncompliance is relevant when claiming LIHTCs and assessing whether at least 40% of a project's units are qualified as low-income, just as happens with the other two minimum set-asides. After excluding any noncompliant units, if 40% are qualified, the minimum set-aside test has been satisfied.

Incorrect Interpretation in the Guidance

The preamble is correct that the IRC does not indicate any intent to create "a stark disparity between the average income set-aside and the existing 20–50 and 40–60 set asides." Despite this understanding, the Guidance being proposed would create that exact outcome.

The problems start with not following the IRC with regard to the required average:

- "the income limitations designated under (I) shall not exceed" versus
- "the imputed income limitations of the low-income units in the project does not exceed."

The former is from IRC Section 42(g)(1)(C)(ii)(II), whereas the latter is in Treas. Reg. 1.42.19(a)(3).

By altering the statutory clause from which the concept originates, and ignoring its surrounding context, the Guidance is proposing to add another test not contemplated or created by Congress. In effect the mandate would be 100% compliance to meet the minimum set-aside, when only 40% is necessary.

Although unstated in the Guidance, presumably units' designations *do count* toward the average before being initially qualified (necessary to conduct lease-up). Yet the designations supposedly *do not count* after a unit stops being "low-income" because of noncompliance. The proposed interpretation seems internally inconsistent.

Practical Realities and Legal Consequences

A fundamental premise of the Guidance is finding noncompliance within 60 days. Indeed, it's how the IRS attempts to resolve the clear relative disadvantages faced by average income under their approach (noted in the preamble).

The unfortunate reality is discovery of an error often occurs more than a year later. In the case of the original two minimum set-asides, this prospect creates a project-wide concern only if the noncompliance is very widespread. By contrast, under the proposed regulation, a single unit being out of compliance could prevent the taxpayer from claiming any LIHTCs.

Even extending the period to mitigate is not a solution in all cases. As such, the preamble's notion of resolving the disparity will not happen.

In the meantime, equity providers are insisting on the designations averaging less than 60% as a buffer against failing the minimum set-aside. The result is projects being less financially feasible than if the taxpayer had elected 40% at 60% AMGI instead. This difference between the two elections is yet another demonstration of how the Guidance cannot reflect Congressional intent.

The key to avoiding such disproportionate penalties and effects is adopting the interpretation in this letter. Another benefit is avoiding the need for complex schemes like removed units. Most importantly, it follows the Code.

III. Mitigation

Concerns with Proposed Action
As stated above, so long 40% of the units in the project are low-income, in no case should the minimum set-aside be considered failed. While the idea of mitigating action appears reasonable in theory, it would be impractical in practice

The following example demonstrates why. At the close of the first year of the compliance period, the owner designations units in the manner below, creating a project average of 58%.

A- 70%	F- 30%
B- 60%	G- 50%
C- 70%	H- 60%
D- 80%	I- 60%
E- 30%	J- 70%

In year 5 the agency discovers that the income for the household in unit E, who moved into the project in the first year, was miscalculated and the household was not income eligible at the 30% designation.

A- 70%	F- 30%
B- 60%	G- 50%
C- 70%	H- 60%
D- 80%	I- 60%
~~E- 30%~~	J- 70%

Without the 30% designation associated with unit E, the project average is 61.11% and project fails to be a qualified low-income housing project.

The proposed regulations provide for mitigating actions; in this example, Unit J is removed and the project average is now 60%. Unit E remains designated at 40% and unit J remains designated at 70%.

Yet by removing unit E from the project average (under the guidance), the project fails first-year minimum set-aside requirement at the close of the first taxable year. The noncompliance cannot be corrected and the owner is prohibited from ever claiming LIHTCs.

Based on the preamble, the mitigating action is provided for *because there is no indication that the statute intended such a stark disparity between the average-income set-aside and the existing 20-50 and 40-60 set asides*. However, neither the existing 20-50 and 40-60 set asides have this type of stark consequence to noncompliance.

Relying on Unit Designations
In the absence of egregious noncompliance, the taxpayer should be able to reply on the unit's designations. The guidance could define egregious noncompliance as violation of the vacant unit rule under Treas. Reg. Section 1.42-5(c)(1)(ix) or not available to the general public under Treas. Reg. Section 1.42-9.

The ability of the IRS to reasonably rely on a taxpayer's due diligence exists in the application of the available-unit rule as it relates to 100% LIHTC projects. If a unit in a 100% LIHTC project is leased to a nonqualified household, the unit ceases to be a low-income unit and does not qualify for credit. But, for purposes of the available-unit rule, all other households are treated as initially income qualified households, as long as the taxpayer can demonstrate due diligence when completing the initial income certification. In other words, unit noncompliance alone is not a violation of the available-unit rule as the presumption is that the noncompliance was not egregious in nature.

With regard to recalculating the average of designations, the final guidance could distinguish between violating the vacant unit rule or general public use and other forms of noncompliance.

Alternative Mitigating Action

1. Allow the taxpayer to redesignate the imputed income limitation of a low-income unit to restore the 60% project average. In the example above where unit E is occupied by a household with an income greater that 30% but less than 40%, the taxpayer could redesignate unit E to a 40% unit, resulting in a 59% project average, thus meeting the requirement.

2. Until such time that an event of noncompliance is identified, the taxpayer must be able to rely on the unit's designation as compliant. For the taxable year in which the event is known, the taxpayer can take the mitigating action.

   In the above example, the event became known in Year 5. The date of noncompliance is in Year 1, when the household moved into the project. Assuming the event is corrected in Year 6, unit E would be subject to recapture for all accelerated credits since Year 1 and disallowance of annual credit in Year 5. Unit J would be removed for purposes of meeting the project average in Year 5, resulting in its disallowance of the LIHC in Year 5. Because of not being egregious noncompliance (vacant unit rule or general public use), the taxpayer can rely on the unit's designations to evidence that the project average was satisfied in Years 1, 2, 3 and 4; no further mitigating action is required.

Either approach would both allow the minimum set-aside to function as the current 20-50 or 40-60 tests, while accommodating for the effect of unit noncompliance on the project average.

Opting Out
If the proposed regulations are adopted as is, the final regulation must give taxpayers an opportunity to change what was otherwise an irrevocable election. The allowance would include a transition period to convert units from their existing designations to 60% or 50% AMGI upon turnover. Third-party beneficiary

rights to enforce recorded extended-use commitments would be a limiting factor, but those provisions do not carry the threat of ending all LIHTCs.

IV. Conclusion

If at the close of a taxable year of the compliance period, 40% of the units are occupied with households that meet the units' designations, the project meets the minimum set-aside test. The punitive nature of how unit noncompliance can impact the minimum set-aside creates the unintended stark difference between the existing minimum set-asides.

Thank you in advance for your time and careful consideration of these issues. Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

THE LIHTC WORKING GROUP

Very truly yours,
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