What's News in Tax

Analysis that matters from Washington National Tax

IRS Issues New Proposed Regulations on the Average Income Test

November 9, 2020

by Katherine Breaks and Susan Reaman, Washington National Tax*

The IRS recently issued proposed regulations providing clarifying rules on one of the tests housing developers can use to determine if a building is a qualifying low-income building for purposes of the low-income housing tax credit. The regulations also provide rules on how these developers can mitigate potential non-compliance issues when applying the test.

The low-income housing tax credit is claimed by owners of qualifying low-income buildings. The credits are allocated by state housing agencies and the credit may be claimed over a 10-year period beginning with the year the qualifying building is placed in service. To be a qualifying low-income building, a certain percentage of the building's tenants must be low income. For this purpose, the owner of the building must satisfy one of three tests to satisfy this requirement:

— Under the 20-50 minimum set aside test,[1] at least 20 percent of the residential units of the building must be both rent-restricted and occupied by tenants whose gross income is 50 percent or less of the area median gross income ("AMGI").

---

* *Katherine Breaks is a principal and Susan Reaman is a director with the Tax-Incentivized Transactions, Leasing, & Energy (TITLE) group of KPMG's Washington National Tax.*

[1] Section 42(g)(1)(A). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

- Under the 40-60 minimum set-aside test,[2] at least 40 percent of the residential units in the building must be both rent-restricted and occupied by tenants whose gross income is 60 percent or less of AMGI.
- In 2018, Congress[3] passed a third minimum set aside test,[4] the average income test, which provides that at least 40 percent or more (25 percent or more in the case of a project located in New York City) of the residential units in the building must be both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation[5] designated by the taxpayer for that unit.

The average income test allows the project owner to designate the imputed income limitation for each low-income unit at 20, 30, 40, 50, 60, 70, or 80 percent of AMGI but the average of the designated imputed income limitations may not exceed 60 percent of AMGI.

The income limits are computed based on the Department of Housing and Urban Development's income limits for very low-income families under Section 8, as adjusted by family size.[6]

Proposed Regulations under the Average Income Test

Next Available Unit Rule

During the compliance period for claiming the low-income housing tax credit, it is likely that some tenants will move out and others will move in. There are rules under the low-income housing tax credit to ensure that the mix of low-income units remains roughly the same when there is turnover. These rules are often referred to as the "next available unit" rules.

The proposed regulations update the existing next available unit rules [7] for units designated under the average income test.[8] according to the average income next available unit rule, a unit *ceases* to be a low-income unit if:

- The aggregate income of the occupants of a low-income unit increases above 140 percent of the greater of (1) 60 percent of AMGI, or (2) the designated imputed income; and
- If any other residential rental unit in the building that is of a size comparable to, or smaller than, that unit is occupied by a new tenant whose income exceeds the applicable imputed income limitation.

If the new tenant occupies a unit that was a low-income unit prior to becoming vacant, the applicable imputed income limitation is the limitation designated for that unit. If the new tenant occupies a market-

---

[2] Section 42(g)(1)(B).

[3] Consolidated Appropriations Act of 2018, Pub. L.115-141, 132 Stat. 348 (2018).

[4] Section 42(g)(1)(C).

[5] Section.42(g)(2). The rent paid by low-income households must be restricted such that the rent cannot exceed 30 percent of the imputed income limit for that unit, which is based upon the number of bedrooms in a unit.

[6] Rev. Rul. 2020-4.

[7] Section 1.42-15.

[8] Section 42(g)(2)(D)(iii), (iv), and (v).

rate unit, the applicable imputed income limitation is the limitation that would have to be designated for the building to continue to maintain an average of 60 percent of AMGI or lower.

If multiple units are over-income at the same time in an average-income building that has a mix of low-income and market rate units, then the proposed regulations provide that a taxpayer need not comply with the next available unit rule in a specific order. Instead, renting any available comparable or smaller vacant unit to a qualified tenant maintains the status of all over-income units as low-income units until the next comparable or smaller unit becomes available.

Average Income Test Imputed Income Designations

The proposed regulations[9] allow taxpayers to designate the imputed income limitation of units in accordance with state housing agency procedures relating to those designations, provided that the agency procedures are consistent with any IRS guidance. The designations must occur as of the close of the first year of the credit period. Once the building owner designates a unit, no change to the designated imputed income limitation is allowed.

Mitigating Actions to Avoid Project Disqualification

The proposed regulations also provide certain mitigating actions a taxpayer may take to avoid failing the average income test if the failure of one or more unit to be treated as a low-income unit would cause total disqualification of the project as a low-income project.

For example, if a nonqualifying unit had a designated imputed income limitation of less than 60 percent of AMGI, and the average of all low-income units' imputed income limitations without that unit was more than 60 percent, the building would no longer qualify under the average income minimum set aside.

In that situation, in the absence of some relief provision under the average income test, the entire project would fail because a building must continuously satisfy its elected minimum set aside[10] to be considered a qualified low-income building. Moreover, the taxpayer would be subject to a correspondingly large recapture amount of low-income housing credits.[11]

Consequently, the proposed regulations describe two possible mitigating actions. First, the taxpayer may convert one or more market-rate units to low-income units. Immediately prior to becoming a low-income unit, that unit must be vacant or occupied by a qualified low-income tenant whose income is not greater than the new imputed income limitation of that unit (or units).

The second mitigating action allows the taxpayer to identify one or more low-income units as "removed" units. A unit may be a removed unit only if it complies with all the requirements to be a low-income unit.

A removed unit is not included in computing the average of the imputed income limitations of the low-income units under the 60 percent or lower average income test. Consequently, if one or more removed units from the computation causes fewer than 40 percent (or, if applicable, fewer than 25 percent) of the

---

[9] Proposed section. 1.42-19.

[10] *See* section 42(c)(2)(A) and 42(g).

[11] Section 42(j).

residential units to be taken into account in computing the average, the project will fail to qualify as a low-income housing project.

In addition, a removed unit is *not* treated as a low-income unit (or units) for purposes of credit calculation or under the building's extended low-income housing commitment. However, for purposes of recapture, a removed unit *is* treated the same as a low-income unit. Identifying a removed unit does not trigger recapture unless the identification reduces the low-income units below 40 percent of the project.

In most situations, if the taxpayer takes a mitigating action within 60 days of the close of a year for which the average income test might be violated, the taxpayer may avoid total disqualification of the project and corresponding recapture. However, if no mitigating actions are taken, the project will fail to qualify as a low-income housing project.

Treasury and the IRS requested comments on an alternative mitigating approach. Under the alternative mitigating approach, in the event that the average income test rises above 60 percent of AMGI as of the close of a tax year, due to a low-income unit or units ceasing to be treated as a low-income unit or units, the taxpayer may redesignate the imputed income limitation of a low-income unit to return the average test to 60 percent of AMGI or lower. If, under this approach, a redesignation causes a low-income unit to become an over-income unit, the taxpayer would be required to apply the next available unit rule.

Proposed Applicability Date

The amendments to the next available unit regulations for the average income test are proposed to apply to occupancy beginning 60 or more days after the date those regulations are published as final regulations in the Federal Register. The average income test regulations are proposed to apply to tax years beginning after the date those regulations are published as final regulations in the Federal Register.

Taxpayers, however, may rely on the proposed amendments to the next available unit rules for occupancy beginning after October 30, 2020, and on or before 60 days after the date those regulations are published as final regulations in the Federal Register, provided the taxpayer follows the rules in proposed rules in their entirety, and in a consistent manner. Taxpayers may also rely on proposed average income test regulations for tax years beginning October 30, 2020, and on or before the date those regulations are published as final regulations in the Federal Register, provided the taxpayer follows the rules in their entirety, and in a consistent manner.