Commonwealth of Massachusetts

DEPARTMENT OF HOUSING & COMMUNITY DEVELOPMENT

Charles D. Baker, Governor ◆ Karyn E. Polito, Lieutenant Governor ◆ Jennifer D. Maddox, Undersecretary

December 29, 2020

Internal Revenue Service
Attn: CC:PA:LPD:PR (Reg-119890-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments on Reg-119890-18, Low Income Housing Tax Credit Average Income Test Regulations

To Whom It May Concern:

On behalf of the Massachusetts Department of Housing and Community Development ("DHCD"), which administers the Low Income Housing Tax Credit ("LIHTC") in the Commonwealth of Massachusetts, I am offering the following comments on Internal Revenue Service (IRS) notice of proposed rulemaking entitled *Section 42, Low-Income Housing Credit Average Income Test Regulations* (the "Proposed Rule").

In our view, and for the reasons stated below, the Proposed Rule creates an unnecessary and excessive risk of violating the minimum set-aside for LIHTC investors and developers. It also prohibits state agencies from allowing owners to modify unit designations, which is essential for practical implementation of the average income test ("AIT"). Prohibiting changes in unit designations also creates potential conflicts with fair housing- and accessibility-related laws.

Background

Section 42 of the Internal Revenue Code (the "Code") establishes a minimum affordability threshold, or "minimum set-aside test," to determine whether a housing development constitutes a "qualified low-income housing project" eligible to receive LIHTC. Failure to satisfy the minimum set-aside test during the initial 15 year compliance period may render a project ineligible for the LIHTC. This, in turn, may prevent the project's investors from receiving any credit not yet claimed for the project, and trigger recapture of credits previously received by the investors, as well as preventing the investors from receiving future credits.

For more than 30 years, for a project to qualify for LIHTC, it had to meet one of two minimum set-aside tests: the "20-50 test" (under which 20% or more of the residential units in the project must be both rent-restricted and occupied by individuals whose income is 50% or less of area median income ["AMI"]) or the "40-60 test" (under which 40% or more of the residential

units in the project must be both rent-restricted and occupied by individuals whose income is 60% or less of AMI).

Over time, it became apparent that the 40-60 test and 20-50 tests were not flexible enough to fully support the use of LIHTC in projects to preserve existing housing. To provide additional flexibility, the Consolidated Appropriations Act of 2018 created the AIT as an alternative minimum set-aside test. Under the AIT, a project can now be considered a "qualified low-income housing project" if 40% or more of the residential units are both rent-restricted and occupied by individuals whose income does not exceed the imputed income limitation[1] designated by the taxpayer with respect to the unit, so long as the *average* of the imputed income limitations does not exceed 60% AMI.

Since the creation of the AIT, DHCD has financed 15 LIHTC properties, collectively containing more than 500 units, for which the sponsors have either already chosen the AIT minimum set-aside or have indicated their intent to do so. Most of these projects resulted in the preservation of existing affordable housing, while the remainder elected the AIT minimum set-aside in order to serve a broader range of low-income applicants. These projects are located across the Commonwealth of Massachusetts.

<u>Concerns with the Proposed Rule</u>

1. <u>The proposed rule imposes an excessive and unnecessary risk of violating the AIT minimum set-aside test.</u>

Under the 40-60 test and the 20-50 test, failure to satisfy income and rent restrictions in the *required percentage of units* results in the loss of all credits for the entire project until the minimum set-aside is restored (or forever, if the violation occurs during the first year of the credit period). However, if a project contains additional low-income units—for example, if 100% of the units in the project are income- and rent-restricted at 60% of AMI—and one or more of the *additional* units fail to satisfy income and rent restrictions, that will not cause the project to fail the minimum set-aside test. An owner (and its investors) will lose credits for the non-compliant units while they remain non-compliant, but the project will retain its status as a qualified low-income housing project.

In contrast, the proposed rule would require *all* low-income units in an AIT project to average no more than 60 % of AMI as a condition of meeting the AIT minimum set-aside. As a result, even a single noncompliant unit in an AIT project could result in a violation of the minimum set-aside if the loss of that unit causes the overall average unit designation across the entire project to go above 60 % of AMI. This catastrophic failure of credits would occur even if

[1] The statute allows designated imputed income limitations in 10% increments from 20% AMI to 80% AMI, inclusive. DHCD's AIT policy limits taxpayers to four permitted income levels: 30% AMI, 50% AMI, 60% AMI and 80% AMI.

the project maintained far greater affordability overall than would be required under the 40/60 test or the 20/50 test.

Example:

40/60 test project – 100 2-BR units, all @ 60% AMI	AIT project – 100 units with: 80 units @60% AMI 12 units @80% AMI 8 units @ 30% AMI Average of designated income limitations is 60%
Even if 50 of the units were non-compliant, the project would continue to meet the minimum set-aside test, and investors could continue to receive credits on the remaining units, because more than 40% of the units would still be income-and rent-restricted at 60% AMI	If **one** of the designated 30% units is non-compliant, the average of the designated income limitations would increase to 60.3%. Under the proposed rule, even though the project would still have 80 of the project units compliant at or below 60% AMI, 12 of the project units compliant at or below 80% AMI, and an additional 7 of the designated 30% units compliant at the dramatically reduced income level of 30% AMI, the project would fail the minimum set-aside test.

In this respect, the Proposed Rule is far more restrictive than the statute, which at Section 42(g)(1)(C)(i), requires only that 40 % of the units in the project be 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 to achieve the minimum set-aside requirements.

The unnecessary and excessive risk the proposed rule creates is likely to significantly reduce investor interest in AIT properties, which would make AIT useless in practice. From an investor perspective, AIT properties would be far riskier than properties that opt to satisfy either the 40-60 test or the 20-50 minimum set-aside tests. This risk would be exacerbated in smaller deals, such as those in rural areas, where a single unit makes up a greater proportion of the total units.

In addition, the treatment of AIT in the Proposed Rule is inconsistent with that of the other minimum set-aside options. If a unit is out of compliance in a 40-60 project, so long as 40 % of the units in the project are in compliance, the project does not fail the minimum set-aside; whereas under the proposed rule, a single unit out of compliance in an AIT property could jeopardize the minimum set-aside, even if 40 % of the low-income units still have an average income limitation at 60% AMI less.

In recognition of the minimum set-aside violation risk, the proposed rule would allow a taxpayer up to 60 days after the end of the calendar year in which a violation occurred to take a mitigating action in order to avoid violating the minimum set-aside. However, the risk is still disproportionate for AIT properties as compared to the other minimum set-aside options. Moreover, in many cases an owner may not even know that there is a violation of the average until well after the 60-day mitigation period is over, depending on when the violation occurs and when the state Agency's compliance monitoring is scheduled for that property. DHCD conducts compliance monitoring across the entire Massachusetts LIHTC portfolio annually—twice as often as is required under IRS regulations—but it is not feasible to conduct all compliance monitoring within 60 days after the end of the calendar year, and a violation of the average might remain undiscovered until after the end of the mitigation period. Similarly, even the most rigorous internal auditing and other due diligent measures on the part of an owner may not discover noncompliance until after the mitigation period.

The negative impact of the Proposed Rule is exacerbated by the IRS's policies related to casualty loss. When a casualty occurs, with the exception of cases in which the casualty is in relation to a major disaster declaration, the owner has only until the end of the calendar year to fix the casualty to avoid having the damaged units deemed noncompliant. This policy can be problematic depending on the timing of the casualty and the extent of the damage. For example, damage from a late December casualty typically could not be remedied before January 1. The AIT proposed rule would create a new level of risk because a noncompliant unit could create a violation of the minimum set-aside. The mitigating action most likely to be available to an owner in such a circumstance would be to remove a higher income unit from the credit calculation. This is an unreasonable penalty, especially where the noncompliance resulting from a casualty is beyond the control of the owner.

2. <u>The Proposed Rule will have serious negative practical implications.</u>

Section 42 of the Code does not prohibit owners from modifying income designations, and there is no indication that it was Congress's intent to do so. The "next available unit rule" in section 42(g)(2)(D) of the Code allows an owner to continue to "count" a unit as LIHTC-compliant if an existing tenant's income increases to the point where it exceeds the applicable income limitation, so long as the next available unit of comparable size is rented to an income-qualified tenant. Clearly, Congress anticipated that, at least in projects that have market-rate units, an owner would need to be able to modify income designations by converting a market-rate unit to a LIHTC unit, and treating the unit with the over-income tenant as a market-rate tenant.

The proposed rule, in keeping with Section 42(g)(2)(D), modifies the existing regulations at 1.42-15 relating to the next available unit rule. However, the proposed new regulation at 1.42-19, which prohibits modification of income designation, contradicts these proposed provisions of 1.42-15. This change would prevent an owner from complying with the "next available unit" rule by conversion of a market-rate unit to a LIHTC unit, where the sole reason for the existing LIHTC unit's noncompliance is the existing tenant's increase in household income. When

coupled with the provisions of the rule requiring all low-income units in a project to average no more than 60% of AMI as a condition of meeting the AIT minimum set-aside, this rule could have the absurd result of causing the loss of all credits on the project for reasons entirely beyond the control of the taxpayer.

3. The Proposed Rule creates potential conflicts with fair housing laws

Moreover, by prohibiting the taxpayer from changing the designated imputed income limitation of individual units once made, the Proposed Rule sets up the potential for conflicts with the Fair Housing Act, Section 504 of the Rehabilitation Act of 1973 ("Section 504"), and the Violence Against Women Act ("VAWA"). Any conflict with federal laws such as the Fair Housing Act creates the distinct possibility of litigation, creating unnecessary liabilities for state LIHTC allocating agencies and property owners.

In certain circumstances, the proposed rule may create conflicts with the Fair Housing Act because it could prevent an owner from making a reasonable accommodation upon request of a tenant with a disability. Specifically, the Fair Housing Act makes it unlawful for any person to refuse "to make reasonable accommodations in rules, policies, practices, or services when such accommodation may be necessary to afford... person(s) [with disabilities] equal opportunity to use and enjoy a dwelling."[2]

In certain circumstances, the proposed rule may create conflicts with Section 504 and numerous state laws, which provide accessibility protections for persons with disabilities.[3] Additionally, if such units house households who do not need the features of the unit, they agree to transfer to an appropriate unit if a household that does need the features of the unit applies. The proposed policy would limit the accessible units to set income levels and also the units to which households who do not need the features can transfer.

In certain circumstances, the proposed rule may create conflicts with VAWA. Since the reauthorization of VAWA in 2013, LIHTC has been a covered program for purposes of the law. VAWA provides that victims/survivors of domestic violence, dating violence, sexual assault, or stalking may request an emergency transfer to a different unit or property if the person reasonably believes there is a threat of imminent harm from further violence if they remain in their unit or if a sexual assault occurred on the premises 90 days before the transfer request is made.[4] A LIHTC owner may not be able to accommodate an emergency transfer request if they are unable to modify unit designations.

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[2] 42 U.S.C. §3604(f)(3)(B).

[3] While Section 504 does not directly apply to LIHTC, it does apply to federally subsidized housing, and the vast majority of LIHTC properties have some other federal subsidy in the capital stack and/or a rental assistance contract.
[4] See 42 U.S.C. §14043e-11.

4. <u>The Proposed Rule will create significant challenges for properties that are financed with other federal subsidies in addition to LIHTC equity.</u>

Nearly every other major federal housing program has statutory or programmatic rules that require in practice the floating of unit designations to some degree. These notably include Section 8, the HOME Investment Partnerships (HOME) program, Public Housing, Section 8, the Housing Trust Fund, and Rural Development housing programs. Fixing the AIT designations would not work with these programs and uniquely disqualifies the AIT minimum set-aside from the majority of LIHTC properties for this reason.

5. <u>State allocating agencies have ample experience and capacity to monitor compliance in properties with floating unit designations.</u>

State allocating agencies have extensive experience in successfully monitoring affordable rental properties with floating units, and are committed to the sustainability of these properties. Household situations may change over time, often demonstrating improved economic circumstances. The federal HOME program has long recognized the importance of allowing the option to "float" HOME-assisted units. Applying this approach provides an ongoing path to sustain programmatic compliance and offers a tool to help avoid stigmatizing particular affordable units. Floating HOME-assisted units within a HOME project does not adversely affect the ongoing number, size, and income band of that project's HOME-assisted units. The same can be said of floating units within a LIHTC project: the ability to modify unit designations can facilitate ongoing compliance and give owners the flexibility to address accommodations that are needed under VAWA, Section 504 or the Fair Housing Act. Based on DHCD's experience in monitoring compliance at approximately 500 HOME rental projects, nearly all of which have floating HOME units, we believe that flexibility has been successful in contributing to sustained compliance.

DHCD recognizes that AIT compliance presents additional challenges for LIHTC owners, given the likelihood of multiple income tiers at a single project. However, these challenges can best be addressed through the kinds of safeguards that DHCD and many other jurisdictions have adopted in AIT guidance, such as additional third-party monitoring and enhanced training and qualification requirements for property managers.

6. <u>The proposed rule should not be applied retroactively to existing projects.</u>

As written, the proposed rule would apply to existing AIT projects that were approved, financed, and in many cases developed and placed in service. In the absence of IRS regulations, all of these projects relied on the plain language of the Consolidated Appropriations act of 2018 as well as guidance from state allocating agencies. Investors have committed capital to these projects assuming that units could float and that only 40% of the units in the project must be rent restricted and occupied by income-eligible individuals to meet the AIT. Imposing these proposed changes on these projects, which no longer have the option to select an alternative minimum set-aside test, would unfairly defeat investment-backed expectations.

Proposal for the Final Rule:

DHCD respectfully requests that the IRS incorporate the following revisions when issuing its final rule with respect to the AIT:

- The AIT minimum set-aside should be considered met so long as 40 % of the units in the property have an average of 60 % or less of AMI. In addition, the property should have an overall average of no more than 60 % of AMI across all low-income units, but if a unit goes out of compliance causing the property-wide average to go above 60 % of AMI, this should be considered noncompliance for that unit, and not a violation of the minimum set-aside, so long as 40 % of the units still meet the 60 % average.

- The final rule should allow owners to modify unit designations, so long as the state Agency policy allows for such modifications, and the state Agency consents to the change. Unit designation changes should always be allowed if needed to adhere to the Fair Housing Act, the Violence Against Women Act, Section 504 of the Rehabilitation Act of 1973, or any other federal statute. The final rule should specifically permit two types of unit designation changes:

    - Floating units in which the overall property average does not change. For example: Unit 1A, previously a 40 %-designated unit, becomes an 80 %-designated unit; provided that Unit 2A, previously an 80 %-designated unit, becomes a 40 %-designated unit.

    - Modifying individual unit designations even if it changes the average in the property, so long as the average remains below 60 % of AMI. For example: Unit 1A was a 40 %-designated unit in a property that averaged 56 %. Unit 1A becomes a 50 %-designated unit, raising the property average to 58 %.

If, however, the IRS does not make significant changes to the Proposed Rule, given that many projects elected the AIT in good faith reliance on statutory language and DHCD guidance, DHCD believes that at a minimum the IRS should put in place reasonable transition language, as follows:

- If the Proposed Rule is made final without significant changes, IRS should provide owners of AIT projects an opportunity and a reasonable period under the circumstances to choose a different minimum set-aside and grandfather existing residents who have been allowed occupancy in good faith in accordance with the statute and state Agency policies without reduction in qualified basis.

- If any element of the Proposed Rule's policy on violation of the minimum set-aside is retained, IRS should modify the time period provided for taking mitigating actions. State allocating agencies should be able to set a reasonable time period for taxpayers

to take the necessary mitigating actions, and that time period should not start until the state identifies the noncompliance.

- If any element of the Proposed Rule's policy on violation of the minimum set-aside is retained, the rule should provide an exception when noncompliance results from a casualty loss. For example, if there is a fire in a unit, the owner should not have to remove another unit from the credit calculation to account for noncompliance associated with the casualty loss.

For more than 30 years, the LIHTC has played a critical role in the production and preservation of affordable housing nationwide. This program has created or preserved more units than any other construction and preservation program operating today. The strong partnership between the IRS and state allocating agencies has been instrumental in the success of the program, ensuring that units receiving LIHTC are built and preserved. DHCD is offering these comments in the spirit of that partnership, to help assure that LIHTC projects utilizing the AIT remain stable and affordable.

Thank you for your consideration of these comments.

Respectfully submitted,

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