THE AFFORDABLE HOUSING TAX CREDIT COALITION

December 29, 2020

Department of the Treasury
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

RE: IRS Notice of Proposed Rule Making:
Section 42 Low Income Housing Credit
Average Income Test Regulations
Reg-119890-18

The Affordable Housing Tax Credit Coalition ("AHTCC")[1] appreciates the opportunity to comment on the Section 42 Low-Income Housing Tax Credit Average Income Test Regulations proposed by the Internal Revenue Service (the "Proposed Regulations"). Established in 1988, the AHTCC is a leading trade association of nearly 200 organizations and businesses that advocate for affordable housing financed using the Low-Income Housing Tax Credit ("Housing Credit"). AHTCC membership represents the full spectrum of those involved in the nation's affordable housing delivery system, including syndicators, developers, investors, state allocating agencies, and affiliated organizations, and together have financed or developed well over half of all nearly 3.5 million Housing Credit apartments.

The AHTCC strongly supports the 'income averaging' flexibility, which has been widely used to make more types of affordable housing developments possible since enactment in 2018. However, we are concerned that the Proposed Regulations will severely limit utilization of the income averaging flexibility, and we propose mitigation remedies to ensure that income averaging remains a viable option.

<u>The Benefits of 'Income Averaging'</u>

The AHTCC was an active proponent of the amendments made by the Consolidated Appropriations Act of 2018 (the "2018 CAA") to Section 42(g) providing for an Average Income Test, in addition to the two other previously existing minimum set-aside tests. This Average Income Test was originally incorporated into the proposed Affordable Housing Tax Credit Improvement Act of 2017 (the "2017 AHCIA"), which was originally sponsored by Senators Orrin Hatch and Maria Cantwell in the Senate and Representatives Patrick Tiberi and Richard Neal in the House of Representatives.

The AHTCC supported an Average Income Test because it would make more types of affordable housing financially feasible and allow the program to serve a broader range of low-income tenants. For example, where the tenant base is relatively shallow, such as in rural communities, a broader range of eligible income levels provides more flexibility for initial lease-up as well as more stability for continued occupancy, while allowing the development to reach a broader segment of the population. In higher-cost areas, it provides more affordable housing options for low-income renters in the 60 to 80 percent

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[1] Our comments do not represent the views of any individual member organization but are supported by the AHTCC as a coalition in our mission to support affordable housing investment.

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of area median gross income (AMGI) range, for whom affordable housing may be unavailable but market-rate rents are still out of reach. Additionally, it allows the Housing Credit to serve more extremely low-income tenants, whose lower rents can be offset by higher rents from higher-income tenants in the same development. Having been heavily involved in the drafting of the 2017 AHCIA, we believe the bill's sponsors shared these views, and did not intend for the average income set-aside test to be more restrictive than the other two existing set-aside tests.

The Background section of the explanatory introduction to the Proposed Regulations summarizes the Average Income Set-Aside in two sentences as follows:

> First Sentence (the "**General Rule**"):
>
> "Section 42(g)(1)(C)(i) provides that, a project meets the minimum requirements of the average income test if 40 percent or more (25 percent or more in the case of a project described in section 142(d)(6)) of the residential units in the project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit."
>
> Second Sentence (the "**Special Rules**"):
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> "Section 42(g)(1)(C)(ii)(I) and (III) provides that the taxpayer must designate the imputed income limitation for each unit and the designated imputed income limitation of any unit must be 20, 30, 40, 50, 60, 70, or 80 percent of AMGI. Section 42(g)(1)(C)(ii)(II) provides that the average of the imputed income limitations designated by the taxpayer for each unit must not exceed 60 percent of AMGI."

<u>Alternative Interpretations of the Average Income Set-Aside Test</u>

We understand that there is some ambiguity in interpreting how the Average Income Test should be applied, and that there are alternative ways to interpret Section 42(g)(1)(C), listed below. **The position of the AHTCC is that either the Alternative Interpretation or the Second Alternative Interpretation are more closely aligned with the policies expressed in the original two set-aside tests and the risks that the investment community has accepted in making Housing Credit investments**.

- The "**Proposed Regulation Interpretation**" adopts an interpretation that Section 42(g)(1)(C)(i) (the "General Rule") and Section 42(g)(1)(C)(ii) (the "Special Rules") are both operative provisions that must be read together – that at least 40 percent of the units must have tenants meeting the maximum income levels and rent levels designated for such units, and that all designated units which are qualified units (whether 40 percent of all units or more) must have an average income of at most 60 percent of AMGI. This is tested annually, and if in any year any combination of the designated units are leased to tenants having incomes or are charging rents in excess of the amount designated for such unit or are not available to be leased to such tenants, and as a result the average assigned AMGI of all designated units is more than 60 percent of AMGI, the minimum set-aside would not be met. Under the Proposed Regulations, even if substantially more than 40 percent of the units are designated units and in compliance, but the average income of those units is greater than 60 percent of AMGI, no Housing Credits are available to be

claimed, and a recapture of previously claimed credits would be required, absent the availability and election of a mitigating action.

- Another interpretation (the "**Alternative Interpretation**") shared by many members of the affordable housing community is that Section 42(g)(1)(C)(i) (the "General Rule") is the operative provision and that Section 42(g)(1)(C)(ii) (the "Special Rules") is a procedural provision that must be satisfied in order for the operative provision to be effectuated. Under the Alternative Interpretation, the procedural requirement is that at least 40 percent of the units are designated units having an average income designation of 60 percent of area median. The operative provision is that if 40 percent of all units are leased to tenants having incomes and rent restrictions that meets the designations for such units, the minimum set aside is met. The procedural requirement enables the owner, Housing Credit agency and prospective tenants a procedure to determine which units are available to be leased to tenants at the various AMGI levels and to enable the state allocating agencies to determine whether the proposed project meets the needs of potential tenants seeking affordable housing and the amount of Housing Credits that are needed to make the project feasible. If 40 percent of the units are leased as designated, any unit which is not leased or available to be leased to a tenant at such designated income and rent level would not be eligible for Housing Credits in the year it fails to satisfy that condition, and may be subject to recapture to the same extent as a non-complying unit under the two other set-aside elections. However, the minimum set-aside would be met.

- A variation on the Alternative Interpretation (the "**Second Alternative Interpretation**") proposes that the procedural requirement is the same as under the Alternative Interpretation. The operative provision is that if 40 percent of all units are leased to tenants having incomes and rent restrictions that meet the designations for such units and which have designated average incomes of not more than 60 percent of area median, the minimum set aside is met. The difference between the Proposed Regulation Interpretation and the Second Alternative Regulation Interpretation is that for the latter, testing is done on any 40 percent of the designated units, and so long as the average income for any 40 percent of the units is 60 percent of AMGI or less, the minimum set-aside has been met. Therefore, if a development has substantially more than 40 percent of the units as designated units, it would take substantial non-compliance to fail to meet the average of 60 percent of AMGI.

We have attached to this letter examples of the application of the proposed and alternative interpretations depending upon different scenarios.

<u>Discussion of the AHTCC Position on Interpretation of the Average Income Test</u>

The AHTCC supports either the Alternative Interpretation or the Second Alternative Interpretation for the following reasons:

- The Proposed Regulation Interpretation provides for **substantially greater risk** than either of two existing set-aside tests, with **drastic and punitive consequences** that would likely serve as a deterrent to using the income averaging option. The minimum set-aside test has normally not been seen to provide substantial risk in Housing Credit transactions to date, because violating the existing set-aside tests would mean a systematic failure to lease units to qualified tenants. Under

the Proposed Regulation Interpretation, only a very small number of units leased to higher-income tenants would threaten the tax credits for the entire development. Recapturing these credits would disproportionately impact lower-income tenants who are in the greatest need of affordable housing.

- We believe that the Proposed Regulation Interpretation **unduly penalizes serving tenants between 60 and 80 percent of AMGI**. Tenants below 80 percent of AMGI are considered low-income for nearly all other affordable and assisted housing programs, and by enacting the income averaging flexibility Congress recognized the value of serving the full range of low-income tenants through the Housing Credit program. Temporarily serving a higher proportion of tenants between 60 and 80 percent of AMGI until the original income mix can be restored should not cause a total failure of the development to qualify for the Housing Credit program.

The **Alternative Interpretation** is more consistent with the precedent set by the existing set-asides allowed through the Housing Credit program, and provides a comparable level of risk. If the Alternative Interpretation is not accepted, we propose that consideration be given to the Second Alternative Interpretation which would require that 40 percent of the designated units meet the 60 percent average income requirement. The risk in that circumstance would be more similar to the risk of a transaction choosing a 40/60 set aside, where substantially greater than 40 percent of the units are intended to be qualified low-income units for households with incomes no greater than 60 percent of AMGI.

If either the Alternative Interpretation or the Second Alternative Interpretation is accepted, there could be added to the regulation an anti-abuse provision which could be put in place if there is a continuous disregard for making the designated units available to qualified tenants. This has been used by the Internal Revenue Service in certain circumstances where there has been substantial non-compliance with the failure to relet to tenants who have become over-income or whose leases have otherwise been terminated without cause.

Ability to Change Unit Designations

The Proposed Regulation would prohibit the change in designation of the units once made, which creates several compliance issues. It does not provide for an exception for satisfaction of the next available unit rule, even though the revisions to Section 42(g) specifically require the application of the next available unit rule and provides for a variation on the application of the rule if the Average Income Set-Aside is elected. At a minimum there would have to be a change in designation of units should a market rate unit be made available to a qualified tenant to satisfy the next available unit rule. Since the operation of the next available unit rule would require a change in designations, it seems as though Congress did not require that the designations could not change, once made.

There are additional legal requirements that could require a change in unit designations, such as Violence Against Women Act, Americans with Disabilities Act and Fair Housing Act requirements. If a tenant that is protected under these laws does not meet the income requirements for an available unit, it is not clear whether there can be a substitution of units so that compliance with the laws can be met while preventing economic consequences to the project.

There also may be changes in the needs of a community over the course of the minimum thirty-year

compliance period. For example, new businesses may open or other housing in the community may become uninhabitable. Discretion should be given to the state housing agencies which initially approved the designation to vary it to meet either existing or future changes in demand, and in general the IRS should trust state housing agencies to manage the process of designation changes. In the scenario given in our example there should also be flexibility to allow families to remain, while keeping the overall designation plan.

Mitigation Remedies

If a determination is made that neither of the Alternative Interpretations is consistent with the statute, we request consideration of mitigation remedies that can be met by diligent owners and operators. As discussed, many developments are fully committed to having all units restricted, with no market rate units available. Even if there are a limited number of market rate units in a project, there must be a vacant unit at the time that non-compliance occurs to take advantage of the first proposed mitigant. Similar to the next available unit rule, there should be a time period to comply that is well beyond the proposed sixty-day period. This should be similar to the next available unit rule, and should be applicable when the violation is discovered. Again, if there is a pattern of abuse the mitigant should not be available.

The second proposed mitigant would avoid the disastrous effect of not meeting the minimum set-aside, but still provides an overly punitive result of disqualifying two units for the violation of one unit. It would provide for a time period that is required to be acted upon within 60 days of the violation first occurring, even if there is no knowledge of the violation at that time. This would create a situation where a penalty which is twice the amount of the ordinary damage is imposed without a requirement that there be a showing of intent to disregard the commitment. Such penalties are not ordinarily used where there has not been a showing of malice or intentional disregard for compliance. At a minimum, we suggest allowing the ability to make the removed unit designation at the time the tax return for the development is filed or required to be filed.

We also recognize that there is a limited economic incentive to lease units to higher income, albeit low income, tenants, since the maximum rent that can be charged for higher income tenants is greater. As a potential mitigant, the taxpayer could be required to pay a penalty equal to the additional income received from the rental to the higher income tenants or, if necessary, the excess rent plus a percentage of that amount if there is determined to be an intentional disregard of the Proposed Regulation Interpretation. That penalty can either be applied as a general revenue source or required to be reinvested in the development or used to reduce rents to tenants. This could be in lieu of or in addition to the other proposed mitigants, and could be made available only in those situations where there is not a pattern of disregard for compliance.

The introduction to the Proposed Regulation itself states that the remedy of failing the minimum set-aside has drastic consequences. Mitigants should be available that can be complied with upon notice and that provide a reasonable ability to cure the problem. Again, an anti-abuse provision could be added that either eliminates the ability to mitigate or imposes a deemed notice of violation to repeat offenders.

The AHTCC appreciates the opportunity to comment on the Proposed Regulation. As a strong advocate for the adoption of the Average Income Set-Aside it is our belief that this provision could make affordable housing available to more people that are in severe need for affordable housing. We would hope that a

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public hearing can be held to further express the views of our constituent members and the affordable housing community in general.

If you have any questions regarding these comments, please contact Emily Cadik, Executive Director, at emily.cadik@taxcreditcoalition.org or 202.935.1217.

Sincerely,

Emily Cadik
Executive Director
Affordable Housing Tax Credit Coalition

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Examples of Outcomes by Utilizing Various Interpretations

The following example illustrates the operation of the Proposed Regulation, the Alternative Interpretation and the Second Alternative Interpretation:

Assumed Facts: Project A is 100-unit apartment complex comprised of 25 townhouse buildings with 4 units per building, having one 1-bedroom unit, two 2-bedroom units, and one 3-bedroom unit. Each 1-bedroom unit is designated for an adult relative of another occupant of the development that has a disability that qualifies them for rental support, since the disability impedes their income raising capacity but they have the ability to live independently with some assistance.

- Nine of the 1-bedroom units are designated as 20 percent of AMGI, 8 units are designated at 60 percent of AMGI and 8 units are designated at 80 percent of AMGI. While it is anticipated that the subsidy would be available to pay substantially all of the rent on these units, the designations of incomes at the various levels would allow for as broad a population of such tenants with disabilities together with their spouses to have access to these units.
- Twenty-five of the 2-bedroom units are designated at 50 percent of AMGI and the other 25 are designated at 70 percent of AMGI.
- Twelve of the 3-bedroom units are designated at 40 percent of AMGI and 12 are designated at 80 percent of AMGI. One 3-bedroom unit is reserved for an on-site manager and superintendent.

The designation of the 2-bedroom and 3-bedroom units are made to maximize the ability to have 1-bedroom unit tenants located in the same building as the related party. The development makes a project election rather than a building election, so all of the 99 units that are designated units are included in determining the Average Income Set-Aside. The average income of the designated units is 58 percent of AMGI.

	20% AMGI	30% AMGI	40% AMGI	50% AMGI	60% AMGI	70% AMGI	80% AMGI
1-bedroom 25 units	9				8		8
2-bedroom 50 units				25		25	
3-bedroom 24 units			12				12

Scenario One: Assume in the second year of the credit period there is a fire or other casualty that makes one entire townhouse with one 20 percent of AMGI 1-bedroom unit, two 50 percent of AMGI units and one 40 percent of AMGI 3-bedroom unit that makes the building at the end of the year of the casualty uninhabitable. Assume all of the other units are leased to tenants at the designated AMGI for the respective units. The units are restored within 24 months following the casualty pursuant to a plan approved by the credit agency.

Proposed Regulation Interpretation:

- Under the Proposed Regulation, the average income of all units in the development would be more than 60 percent of AMGI, even though 95 of the 99 units are in compliance. Without a

mitigant the Project would breach the Average Income Set-Aside. Since all units are designated units there is no opportunity to lease a market rate unit, if one is available. Therefore, the only way under the current proposed regulation to continue to claim the Housing Credit would be to designate three additional units as removed units to bring the average to 60 percent of AMGI. There would be a total reduction of seven units until the affected townhouse was restored. Assuming that the development elected a 60 percent set-aside, only 4 of the units would be temporarily impaired.

Alternative Interpretation:

- Under the Alternative Interpretation, there would be no breach of the Average Income Set-Aside since more than 40 percent of the units are leased to tenants meeting the designations for those units. Only four units that were subject to the casualty would be unable to claim the Housing Credit until the units were restored.

Second Alternative Interpretation:

- Under the Second Alternative Interpretation there would be no breach of the Average Income Set-Aside since more than 40 percent of the designated units whose incomes average 60 percent or less of AMGI are leased to tenants meeting the designations for those units. Only four units that were subject to the casualty would be unable to claim the Housing Credit until the units were restored.

Scenario Two: Assume there is a fire or other casualty that makes one entire townhouse with one 20 percent of AMGI 1-bedroom unit, two 70 percent of AMGI units and one 80 percent of AMGI 3-bedroom unit that makes the building at the end of the year of the casualty uninhabitable. Assume all of the other units are leased to tenants at the designated AMGI for the respective units.

Proposed Regulation Interpretation:

- Under the Proposed Regulation, the Average Income of all units would be less than 60 percent of AMGI. There would be no breach of the Average Income Set-Aside. The same would be true under the Alternative Interpretation or the Second Alternative Interpretation.

Scenario Three: Same as Scenario One but local zoning regulations prohibit the reconstruction of the destroyed building.

Proposed Regulation Interpretation:

Under the Proposed Regulation, the result would be the same but the mitigant would have to be applied to each of the seven units through the end of the credit period. In such a situation there would be a recapture of one-third of the previously claimed Housing Credits and all future Housing Credits unless the mitigant is chosen for all remaining years of the Credit Period.