December 28, 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 Regarding Low Income Housing Tax Credit Average Income Test Regulations

To Whom It May Concern:

We appreciate the opportunity to provide comments on the Internal Revenue Service (IRS) notice of proposed rulemaking to establish regulatory guidance on the Low Income Housing Tax Credit (LIHTC) Average Income Test (AIT) minimum set-aside. For over half of a century, the Costello Companies have been involved in all aspects of the development and management of thousands of multifamily housing units. We are also the owners of a consulting firm with clients who are state LIHTC allocating agencies and have worked directly for 60 percent of the state LIHTC agencies. We are active affiliates of the National Council of State Housing Agencies (NCSHA). We also assist all interested parties in developing compliance systems to meet the regulations of various housing programs. From this broad perspective, we feel strongly that modification of the proposed guidance is necessary for it to meet the intent of the AIT and also to work in practical terms. Although we have elected the AIT for several of our projects that are now in operation, we will not do so in the future if the terms of the proposed regulation are finalized and do not anticipate that any of our clients will either. We also now have serious concerns about our current AIT portfolio, which we have run in good faith according to what we believe the AIT statute and our state agencies have directed.

Before its enactment in 2018, we were involved in several industry attempts to create the AIT provision. We shared the goal of using the AIT to benefit higher income households than were allowed in the past, while at the same time making LIHTC properties more affordable to lower-income households who do not receive rental assistance. Preservation of existing affordable housing projects with HUD, Rural Development, and other federal financing by introducing LIHTC equity to the project for rehabilitation purposes was also a strong incentive for the housing industry to work with Congress to create the AIT option. The AIT as it exists in the statute would also allow for decreased displacement of existing higher-income households at these rehab projects. We believe that Congress intended these same benefits, as there is very little reason to implement the AIT if these are not the result. The AIT serves no other significant purpose.

We have deep concerns that most of the intended benefits from the AIT will be stripped away if the proposed AIT policy is made permanent, subverting what we believe was the congressional intent. Although the policy seeks to enforce the 60% *Average Test* required in the statute, it creates significant additional risk that investors and developers will be unable to assume.

Additionally, the proposed rule's rigid application of unit designations without the flexibility of being able to move these among other units in a project or changing the designations, while maintaining the statutory *Average Test,* unnecessarily hampers the practical implementation of the AIT to the point that it will be practically impossible. This is especially true for properties that utilize other programs, either to finance the property or provide rental assistance to tenants. The proposal would also impede the application of other important federal civil rights laws that relate to housing, including the Fair Housing Act and the Violence Against Women Act (VAWA). These laws apply to all LIHTC properties. Also, Section 504 of the Rehabilitation Act of 1973 applies to a large portion of properties, including those with Section 8, Rural Development and HOME funding.

Here we will review some of the reasons that we see issues with the proposal, but will propose alternatives that we believe meet the parameters of the statute and will also work based on decades of tried and true affordable housing and state LIHTC allocating agencies' procedures.

Issue #1: the proposed rule imposes a minimum set-aside standard that appears to be at odds with the statute and creates much more risk to the tax credits for similar noncompliance when compared to the other minimum set-aside options.

My reading of the proposed rule is that it requires that the average of all low-income units in a project not exceed 60 percent of area median income (AMI) *as a condition of meeting the AIT minimum set-aside*. It is easy to propose many scenarios where the loss of even a single noncompliant unit could result in a violation of the minimum set-aside if the loss of that unit causes the overall average to exceed 60 percent of AMI. A violation of the minimum set-aside is existentially problematic for a property, as it results in the loss of all credits on the property for at least a year, and forever if the violation occurs during the first year of the credit period. It seems that this is a conflation of two separate provisions of the statute. We agree that the *Average Test* dictates which units can claim credits and that all units used to claim credits must be designated and that these designations must average 60 percent. If a unit is out of compliance with its designation, it cannot support tax credits. We note that the statute at §42(g)(1)(C)(ii)(II) lays out the terms of the designating of units. It requires that "the average of the imputed income limitations ***designated*** under subclause (I) shall not exceed 60 percent of area median gross income." (emphasis mine) It is the *designations* that average 60 percent to meet the *Average Test*, not the actual incomes of the households. However, the Average Test is only a component of meeting the minimum set-aside. The clauses of §42(g)(1)(C)(ii), including the *Average Test*, are all established as such in the introduction to that section. Once those designations are established in the *Average Test*, the actual minimum set-aside test is *then* explicitly met per §42(g)(1)(C)(i), which requires that "40 percent… of the residential units in such project are 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."

As long as 40% of the units in a project meet the designations established in the *Average Test,* it would seem that the minimum set-aside is satisfied. This is consistent with the other minimum set-asides codified in §42(g)(1) – 20-50, 25-60, and 40-60. In those cases, the designation of units is solely determined by the minimum set aside (all units are designated at 50 or 60 percent AMI) and the minimum set-aside is met if at least 40 percent of the units meet that designation. Until that level of noncompliance occurs, the implication of a unit not meeting its designation is the loss of credits on that unit. The way the statute is constructed for the AIT seems to me to replicate this same basic arrangement. The only difference is that, rather than a set designation of 50 or 60 percent of AMI, there is a range established in the *Average Test*. Still, noncompliance with its designation in one unit results in loss of credits in one unit until less than 40 percent of the units in the project are compliant, then the more catastrophic minimum set-aside loss is invoked.

Some commentators in the industry have indicated that the proposal requiring the *Average Test* be met by *households* and not just the *designations* dictated by the statute, is designed to encourage compliance with an admittedly more complex rule. However, the penalty for noncompliance—potential loss of credits and/or recapture on a specific unit(s) has always been sufficient to encourage program compliance. Imposing further restrictions and jeopardy to the credit only serves to discourage the use of the AIT at all. Extensive surveys we have done of our investor clients indicate that every single one of them cannot justify the additional risk posed by the proposed regulation and will instead elect the 40-60 minimum set-aside in the future. No amount of "cushion" by lowering the overall *Average Test* can truly remediate the increased risk, and such cushions penalize AIT property revenue in ways that it is hard to imagine congress intended (we see no reason to conclude that the statute envisions a revenue stream based on less than a 60 percent average rent limit). This contrasts starkly with the general approach before the release of the proposed rule, where most indicated that the AIT was, and would continue to be, the most preferable election.

Suggested alternative #1: the minimum set-aside should be applied per §42. An owner must designate units, and these units must average no more than 60 percent. Individual units that do not meet these designations will not support tax credits, but a violation of the minimum set-aside will not occur until less than 40 percent of the units in a project fail to meet their designation.

Issue #2: The mitigating actions for correcting a minimum set-aside violation allowed in the proposed rule will provide little benefit in actual practice.

To offset the extreme risk created by the proposed rule, two mitigating actions are then offered to prevent a minimum set-aside violation in a case when noncompliance would cause the *Average Test* of a project to go above 60 percent.

First, if a property has market-rate units, the owner could convert one or more of the market-rate units to low-income units to reestablish the average, but only if the market-rate unit(s) is vacant or occupied by an otherwise eligible tenant. Most LIHTC properties are 100 percent LIHTC properties. Additionally, as state allocating agencies did not predict the proposed approach, most have required that projects implementing the AIT be 100% LIHTC. For these reasons, this mitigation action is of limited benefit for current and any future AIT projects.

The second option is for the owner to remove a unit from the credit calculation. This penalizes the owner with loss of credits on more units than are noncompliant similar to the disproportionate way the proposed minimum set-aside test does, as discussed above.

The proposed rule provides a taxpayer up to 60 days after the end of the calendar year in which a violation occurred to take a mitigating action to avoid having the violation result in loss of credits. Unfortunately, this provides only a slim chance to resolve the extreme risk of investing in an AIT property. Likely, the owner may not know there is a violation of the average until after the mitigation period is over. Even the most rigorous internal auditing and other due diligence measures on the part of an owner or syndicator may not discover noncompliance until after the mitigation period.

Suggested alternative #2: as this provision appears to be wholly created to mitigate issues created by the proposed interpretation of issue #1 discussed above, the suggestion on that issue will remove the need for these mitigation actions. However, we do note that the proposed mitigations do seem to indicate a willingness on the part of the IRS to open the door for the redesignation of units, which we entirely endorse, as explained below. State Housing Credit Agencies should be able to set a reasonable period for owners to take the necessary mitigating actions, and that period should not start until the state identifies the noncompliance. Moreover, if the IRS does not make substantial changes to this policy, the rule must provide an exception when noncompliance results from a casualty loss, which is beyond an owner's control.

Issue #3: the proposed prohibition on modifying income designations makes the AIT essentially unusable, is inconsistent with existing IRS guidance, and sets up an unnecessary conflict with important civil rights and other housing laws.

The new AIT statutory provision in §42 does not prohibit modification of income designations, and there is no indication that Congress intended to do so. In fact, the available unit rule in §42(g)(2)(D) was adjusted with the introduction of the AIT with the expectation that, at least in projects that have market-rate units, an owner would need to be able to modify income designations to address over-income tenants. Moreover, the proposed rule, in keeping with §42(g)(2)(D), modifies the existing regulations at §1.42-15 relating to the next available unit rule and provides excellent flexibility within the statutory parameters in applying this rule. However, the proposed change to §1.42-15 seems at odds with the proposed new regulation at §1.42-19, as §1.42-15 allows for modifications of income designation, and §1.42-19 prohibits such modifications.

The proposed rule also conflicts with long-standing IRS policy concerning transfers of households between units within a project. IRS Revenue Procedure 2004-82, section E, *Vacant Unit Rule Issues*, in answer to question #8, established that the low-income qualified status of a unit moves with a qualified household if the household transfers from one unit to another. In contrast, the AIT proposed rule would lock the qualifying designations down by unit far more rigorously and would make management and compliance relating to transfers for AIT projects far less flexible than is allowed for the other minimum set-asides. The flexibility allowed in this policy has always provided a vital safe harbor for compliance at Housing Credit properties with other relevant housing laws and regulations.

The Fair Housing Act, the Violence Against Women Act (VAWA), and Section 504 of the Rehabilitation Act of 1973 all contemplate times when transfers of tenants between units or providing a specific unit to a new applicant may be necessary to accommodate immediate risk to life or the needs of persons with disabilities. Locking designations will limit the choices that victims of violence or persons with disabilities would otherwise have. None of these may be outright violations of the programs, but they do hamper the free application to all, as intended. It is interesting to note that not adhering to VAWA at a property covered by the VAWA statute (including LIHTC properties) can also be determined by HUD's Office of Fair Housing and Equal Opportunity (FHEO) to be a violation of the Fair Housing Act, under HUD FHEO's disparate impact doctrine, which doctrine has since been affirmed by SCOTUS (see February 9, 2011 MEMORANDUM FOR FHEO Office Directors and FHEO Regional Directors. Assessing Claims of Housing

Discrimination against Victims of Domestic Violence under the Fair Housing Act and the Violence Against Women Act). Although nothing in VAWA requires violating §42 to satisfy VAWA, not following it could still be a disparate impact Fair Housing violation and subject a property to tax credit noncompliance under general public use provisions of §42.

Throughout §42 and related historical IRS guidance, Congress and the IRS have always shown considerable efforts to allow the combination of other federal programs with the LIHTC. The need for this is evident when you look at the national LIHTC portfolio. According to the National Council of State Housing Agencies (NCSHA), only 12.8 percent of Housing Credit units financed in 2019 were financed without other federal sources. This is relatively consistent year over year. However, the AIT proposed rule will create significant challenges for properties that are financed with other federal subsidies with LIHTC equity, making combining programs impractical.

Every other major federal housing program that we are aware of has statutory or program rules that require or allow the floating of units or modification of income designation in certain circumstances. These include Public Housing, Project-Based Section 8, the HOME Investment Partnerships (HOME) program, the Housing Trust Fund, and the U.S. Department of Agriculture Rural Development programs. Fixing the AIT designations would not work with these programs for various reasons and, thus disqualifies the AIT minimum set-aside from the majority of Housing Credit properties. We assisted a team in the development of the NCSHA comments on the AIT proposed rules, and we refer to their excellent research and examples used in their comments that amply demonstrate many of these specific issues.

One of the primary benefits hoped for in the creation of the AIT was the ability to better align the LIHTC with other programs that have income limitations up to 80 percent of AMI to make the LIHTC a tool for the preservation of federally subsidized housing. This includes housing originally financed using public housing, Section 8, HOME, and Rural Development programs. In all these cases, the AIT would allow the Housing Credit to be used for preservation while significantly limiting the displacement of households whose incomes fall between 60 and 80 percent of AMI. The proposed rule, by barring unit designation modifications, makes preservation of these properties using AIT impractical.

We understand that there are always conflicts between housing programs that an owner may choose to use at a property, and it is the owner's responsibility to arrange for compliance with all programs they use. However, unnecessarily implementing barriers to the free application of other important housing programs and civil rights protections will discourage owners from electing the AIT option congress granted. By prohibiting the taxpayer from changing the designated imputed income limitation of individual units once made, the proposed rule could lead to denial of tenant rights otherwise available and possible litigation, creating liabilities for state agencies and property owners.

The prohibition against redesignating units creates many other challenges for the practical implementation of the AIT in actual housing management. This includes impracticalities related to managing resident waitlists and casualty loss where transfers may be necessary to continue housing a household that resided in a damaged unit.

Suggested alternative #3: if the AIT is to be used at all while respecting tenant civil rights, existing IRS policy, and other programs, we strongly believe that owners should be able to modify unit designations if the applicable state allocating agency allows for such designation adjustments. Designations should also be allowed to float among units in a project. Besides a mitigating action to correct noncompliance, this should be allowed for any reason acceptable to the state agency, as long as the adjustment maintains the designation average of the *Average Test* at 60 percent or less. Unit designation changes should certainly always be allowed if needed to adhere to the Fair Housing Act, VAWA, §504 of the Rehabilitation Act of 1973, or any other relevant federal or state statute.

Issue #4: as the proposed rule includes significant departures from the statute that could not be foreseen, state allocating agencies and owners could not have anticipated the proposed limitations on the usability of the AIT. This creates a host of problems for existing AIT properties and state allocating agencies who elected and allowed the AIT in good faith based on the statute.

State LIHTC allocating agencies and affordable housing owners and investors routinely allow units to float to ensure compliance with a host of LIHTC requirements, civil rights issues, and to meet other program needs. For decades most states allocating agencies have had policies that promote income tiering at various levels below 60 percent of AMI. For instance, thousands of properties with a 40-60 minimum set-aside election have units designated at lower income levels than the 60 percent required by the federal set-aside. These policies, to my knowledge, always allow for those units to float. State agencies and owners have invested in buying or designing software that tracks floating units. These multiple set-asides have not been too difficult to implement and they enabled multiple income targeting in addition to the LIHTC minimum set-aside. When the AIT was enacted, it made this option available immediately to owners. Congress did not hold back implementation until the provisions were regulated by the responsible federal agency, as is often done with new laws. To support Congresses apparent intent of immediate implementation of the option, most state agencies established their AIT policies, with the assumption that if IRS were to provide guidance, that guidance would reasonably reflect the language of the statute and practically work with civil rights and other housing laws and regulations. No state LIHTC agency or owner expected that the IRS would prohibit unit designation changes in such a way as to make the election considerably riskier and not work as a housing program. To our knowledge, not a single state Housing Credit Agency that has implemented AIT policies up until this point has prohibited redesignation of units. In fact, in some instances, AIT projects' extended use agreements specifically state that the units may float.

Suggested alternative #4: if the IRS does not modify its proposed policy on the standard for violation of the minimum set-aside, it is unlikely that owners and investors will choose to make the election in the future, or that state allocating agencies will support this election. If the proposed rule is made final without the changes suggested here and by other commenters, the IRS should provide owners of current AIT properties an opportunity and a reasonable period under the circumstances to choose a different minimum set-aside and grandfather existing residents who have been moved in over 60 percent AMI in good faith per the language of the statute and state LIHTC allocating agency policies without a reduction in qualified basis.

We appreciate your consideration of our comments. We respectfully request that the IRS provide the option to further discuss the issues we have raised in this comment letter at a public hearing on the AIT proposed rule.

Please do not hesitate to reach out to me if you have any questions.

Sincerely,

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