December 24, 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 to Reg-119890-18 Regarding Low Income Housing Tax Credit Average Income Test Regulations

To Whom It May Concern:

As the Interim Executive Director of the Ohio Housing Finance Agency (OHFA), which administers the Low Income Housing Tax Credit (LIHTC) in the state of Ohio, I am writing to express my concerns regarding the Internal Revenue Service (IRS) notice of proposed rulemaking to establish regulatory guidance on the Housing Credit Average Income Test. These concerns are outlined below, specifically:

1. Excessive and unnecessary risk of violating the minimum set-aside
2. Inability to modify unit designations
3. Impact on existing properties

<u>1. Excessive and unnecessary risk of violating the minimum set-aside</u>

The majority of concerns outlined in our letter stem from one core issue – the IRS's interpretation of how to meet, and subsequently how to fail, the average income minimum set-aside test. The average income test establishes a third option for a taxpayer to satisfy the minimum set-aside requirement in order to qualify as a low-income housing project. In the notice of proposed rulemaking, the IRS presents language for the average income test that is inconsistent with the other two options- the 40/60 test and the 20/50 test. The language in the proposed rule is also inconsistent with interpretations made by state Housing Finance Agencies (HFAs), developers, and investors who based their interpretations on language in Internal Revenue Code § 42(g)(1). Further complicating the proposed regulations is the introduction of multiple conditions and requirements that are not present in the current law. These additional, unanticipated conditions (i.e., mitigating actions, removed units, the 60-day mitigation period, changing of market units to low-income units) are at best overly complex and complicated and at worst infeasible. Most significantly, these new requirements would be unnecessary if the regulations for meeting the minimum set-aside using the average income test were consistent with the regulations for meeting the minimum set-aside using the 40/60 and 20/50 tests.

As currently written in Internal Revenue Code § 42(g)(1), each of the three minimum set-aside options contain the same basic condition – that a certain percentage of units in the project meet a specified rent and income limitation. What varies between the three options are the percentage required and rent and income limitation used. For the average income test, the requirement is that 40 percent of the units 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. While the average income test contains a subparagraph with special rules relating to income limitation, the method by which a project meets the minimum set-aside appears to be limited to ensuring 40 percent of units in the project meet their designated rent and income limitation.

In contrast, the IRS's notice of proposed rulemaking elevates what are currently defined in § 42(g)(1)(C) as "special rules relating to income limitation" to additional conditions that must be met in order to satisfy the average income test. Furthermore, the wording of these conditions is different from that which appears in the IRC. While § 42(g)(1)(C)(ii)(II) states that the average of the imputed income limitations *designated under subclause (I)* shall not exceed 60 percent of area median gross income, the proposed rule states that the average of the imputed income limitations *of the low-income units in the project* shall not exceed 60 percent of area median gross income (AMGI). This language in the proposed rule creates a requirement not present in the IRC by reframing the 60 percent average as a test to be conducted using the current incomes of all households in a project.

For an owner that utilizes the average income test to meet the minimum set-aside requirement, they risk losing credits for an entire building as a result of one unit being out of compliance – a consequence not present in either of the other two minimum set-aside tests. The proposed rule includes "mitigating actions" that are intended to lessen the devastating financial impact of this scenario. The mitigating actions, however, present a variety of additional challenges and do not represent realistic scenarios for most LIHTC projects. Even with the successful application of a mitigating action, the resulting credits or revenue to the project may be significantly less than projected due to the requirement that both the out of compliance unit and the "removed" unit be subtracted from the credit calculation, or due to the loss of a market rate unit that may now collect only a portion of the rent it originally could.

The result of this interpretation and accompanying mitigating actions will be either an unwillingness to select the average income minimum set-aside, or an extreme financial risk on the part of the owners and investors who do. To address these concerns, OHFA would recommend the IRS revise the proposed rule to incorporate the National Council of State Housing Agencies' (NCHSA) proposal for how the average income test should be considered to have been met – 40 percent of the units meet their designation, and those 40 percent have an average of 60 percent or less of AMI. In addition, the property should have an overall average of no more than 60 percent of AMI across all low-income units, but if a unit goes out of compliance causing the property-wide average to go above 60 percent of AMI, this should be considered noncompliance for only that unit, and not a violation of the minimum set-aside, so long as 40 percent of the units still meet the 60 percent average. Either way, the penalty is limited to potential loss of credits/recapture on the non-compliant unit until the noncompliance is corrected, not the forfeiture of all the credits. Taking this approach would both encourage use of the average income minimum set-aside and minimize the extreme financial risks that not doing so would place on owners and investors who make the average income election.

2. Inability to modify unit designations

The introduction of the limitation put forth in § 1.42–19 (b)(3)(i) is not only inconsistent with current IRS policy regarding unit transfers and the other two minimum set-aside tests, but will likely result in conflicts with the rules of other federal subsidies (such as Section 8, HOME, and National Housing Trust Fund) and federal laws (such as the Fair Housing Act, Section 504, and VAWA). These conflicts will make selection of the average income minimum set-aside both risky and impractical for most affordable housing owners. The inconsistency with the other minimum set-asides and IRS Revenue Ruling 2002-82 regarding unit transfers further dis-incentivizes owners from utilizing the average income minimum set-aside because of the inherent uncertainty that comes with deciding how to comply with an IRS rule and IRS revenue ruling that are in conflict.

When developing OHFA's Average Income Policy, our agency determined that unit designations were to be documented in the Carryover Agreement or 42m Letter of Eligibility, but not be recorded in the restrictive covenant. Further, our average income-specific restrictive covenant contains a general provision to the required average for income and rent designations. OHFA chose this course of action for two reasons: 1) we did not foresee the IRS prohibiting the modification of unit designations and 2) the ability to modify unit designations is a flexible and appropriate mitigating action that properly accounts for tenant attrition, market changes, and other situations beyond the owner's control without fully and irreparably jeopardizing the financial viability of the project by triggering a recapture of the housing credit.

The ability to transfer households to different units, and/or modify the designation of a unit, are a critical part of effectively managing a LIHTC property and the inability to do so will cause undue burden and harm to both tenants and property owners. It is the responsibility of the owner and property manager to ensure the property remains in compliance, i.e. that households remain income-qualified, rent restrictions associated with multiple funding sources are met, and the needs of residents are met in accordance with federal laws. Restricting the owner's or property manager's ability to change a unit's designation in perpetuity makes it extremely difficult, if not impossible, for them to resolve situations in which a tenant may be at risk of physical harm, needs accommodation for a disability, or requires relocation under the Uniform Relocation Act.

In addition to losing the flexibility required to manage these real-life scenarios, the inability to modify a unit's designation would prevent property managers from filling vacant units and serving tenants who desperately need an affordable place to call home. As many LIHTC properties operate on very thin margins, this loss of revenue to a property can have detrimental impacts on the quality of living conditions and services that the property is able to provide to its already-vulnerable residents.

Consistent with the statement on page 8 of the proposed rule, "…the Treasury Department and the IRS agree that Agencies should generally be able to establish designation procedures that accommodate their needs", the final rule must allow owners to modify unit designations if the HFA allows it, and designation changes should always be allowed if adherence to the Fair Housing Act, the Violence Against Women Act, Section 504 of the Rehabilitation Act of 1973, or any other federal statute necessitates it. At minimum, the following two types of modifications should be permitted: 1) Modifying individual unit designations even if it changes the average in the property, so long as the average remains below 60 percent of AMI; and 2) Allowing for floating units where designations can be swapped as needed while maintaining the same overall property average.

3. Impact on existing properties

More than 50 projects in Ohio have indicated their intention to select the average income minimum set-aside since it became law, and at least 15 of those have been placed into service. Because these projects were structured, underwritten, and funded assuming an ability to transfer households to different units, and/or modify the designation of a unit - a very different interpretation than that of the IRS - the industry is now at a stand-still on what to do to resolve what could be catastrophic impacts to their projects.

During the 19-month gap between the average income test becoming law and the release of proposed rules, HFAs, along with affordable housing developers, owners, investors, and attorneys, moved ahead with implementation. Industry professionals held countless conversations on interpretation of the average income test through the lens of existing minimum set-aside tests, compliance practices, and the overall goals of the LIHTC program. Because of the many benefits now possible, housing professionals were eager to incorporate the new minimum set-aside into developments. HFAs across the country issued guidance, published policies, and established expectations for developments seeking to elect the average income minimum set-aside for their developments - many of which were written using the existing minimum set-asides as a guide.

Regardless of how the final rule is written, the IRS will need to clearly state how projects who have selected the average income minimum set-aside prior to the publication of the final rule will be treated. This includes both projects that have received funding commitments but not yet placed in service as well as projects that have placed in service, moved in qualified tenants, and have begun the compliance period. The final rule must provide owners the opportunity to choose a different minimum set-aside, change unit designations, and/or grandfather existing residents who have been allowed occupancy based on the HFA's policy and interpretation of the statute at that time.

Conclusion

When the average income test was created by Congress, the intent was to provide a new option that would allow for deeper rent and income targeting combined with the opportunity to serve individuals and households with moderately higher incomes. NCSHA summarized these benefits as follows:

> *The higher rents that households with incomes in the 61-80 percent of AMI range could pay would have the potential to offset the lower rents for extremely low- and very low-income households living in the property, thereby allowing developments to maintain financial feasibility while providing a deeper level of affordability than is currently possible without other subsidies. Income averaging would thus preserve rigorous targeting to low-income households, while providing more flexibility and greater income-mixing potential.*

This critically important public policy tool isn't available through the other minimum set-asides. If owners are worried about losing their credits with only one unit going out of compliance, the proposed rule will have a cooling effect on utilization of the average income minimum set-aside. Similarly, if owners are worried about going over the 60 percent average with just one unit out of compliance, owners and investors may be inclined to provide so much "buffer" below 60 percent that the intended benefit of providing higher income units through the average income option won't be realized, further straining already seriously constrained resources and budgets. Without effective means to manage the risk of falling out of compliance, the potential for huge consequences will make the average income minimum set-aside an unattractive and problematic option for owners.

The challenges and inflexibility that this proposed rule creates will negate the benefit of the new average income minimum set-aside option and ultimately, owners and investors may choose not to utilize it and consequently, states will not realize the benefits its creation was intended to produce.

Finally, I would like to refer you to the comments submitted by NCSHA, which represents OHFA and all other state Housing Credit administering agencies, which I have enclosed. As noted above, NCSHA has recommended that the IRS provide guidance allowing the average income test to be met so long as 40 percent of the units in the property have an average of 60 percent or less of AMI and for states to establish policies allowing for modifications of unit designations. OHFA strongly concurs with NCSHA's recommendations and hope the IRS will consider them in finalizing these regulations.

Thank you very much for your consideration as you finalize the average income test rule.

Sincerely,

Shawn Smith
Interim Executive Director