SAHF

COLLABORATE. INNOVATE. ACCELERATE.

December 29, 2020

Internal Revenue Service
U.S. Department of Treasury
1111 Constitution Ave, NW
Washington, DC 20224

RE: Docket No. REG-119890-18, Section 42, Low-Income Housing Credit Average Income Test Regulations

To Whom It May Concern:

On behalf of Stewards of Affordable Housing for the Future (SAHF) and National Affordable Housing Trust (NAHT), thank you for the opportunity to provide comments on the Internal Revenue Services' (IRS) proposed regulations on the Average Income Test for the Low-Income Housing Tax Credit (Housing Credit) under section 42(g)(1)(C) of the Internal Revenue Code (Code).

SAHF is a collaborative of thirteen exemplary multi-state nonprofits who collectively own, operate, and manage more than 147,500 affordable rental homes in 2,000 properties across the country. More than sixty percent of these homes have been financed with the Housing Credit. SAHF members use Housing Credit allocations to attract investments in affordable housing serving a wide range of communities in urban, suburban and rural locations. SAHF members often couple Housing Credit investments with state and local programs as well as federal rental subsidies in order to create and preserve quality homes for people with the lowest incomes, including seniors, veterans and the formerly homeless.

SAHF is also an affiliate of the National Affordable Housing Trust (NAHT), a syndicator of Housing Credit investments that connects investors with mission-driven developers, including SAHF members. NAHT has pioneered innovative funds and investments to help finance the construction and preservation of housing across the country. NAHT's portfolio includes a very high percentage of properties with rental assistance or other subsidies that enable properties to serve people with very low and extremely low incomes.

SAHF members and NAHT welcomed the introduction the Average Income Test (AIT) as a valuable tool for helping to create mixed income properties and communities, a viable means for targeting some units to people with extremely low incomes and a necessary flexibility for serving smaller and rural communities. SAHF members are already using AIT in some transactions, but have found some state Agencies and investors hesitant to proceed without regulatory guidance. While we greatly appreciate the IRS' work to develop these regulations and share the IRS's commitment to maintaining property income averages at or below 60 percent, we are very concerned that as proposed the regulations will stymie use of AIT and cause significant concerns for participants in properties already using AIT. We believe that the proposed rule goes beyond what is required by the Code. In particular, the prohibition of modification of unit designations will hinder implementation of AIT, especially for properties financed with rental assistance contracts or other subsidies. This result would undermine AIT's intended benefit of expanding the reach of the Housing Credit.

Stewards of Affordable Housing for the Future

750 9TH Street NW Suite 650, Washington, D.C. 20001-4793 ● P (202)737-5970 ● www.sahfnet.com

Our primary concerns with the proposed rule are outlined below and are generally consistent with comments submitted by the National Council of State Housing Agencies and a wide range of other actors representing developers, investors, syndicators and other partners in the creation and preservation of Housing Credit Properties.

Excessive and unnecessary risk of violating minimum set-aside

The proposed rule requires all low-income units in a property to average no more than 60 percent of area median income (AMI) as a condition of meeting the AIT minimum set-aside. Under this requirement even a single noncompliant unit could potentially result in a violation of the minimum set-aside if the loss of that unit causes the overall average unit designation to go above 60 percent of AMI. Violating the minimum set-aside is the most absolute version of noncompliance because rather than resulting in loss of Housing Credits on the noncompliant unit(s), it results in the loss of all Credits on the project until the minimum set-aside is restored (or forever, if the violation occurs during the first year of the Credit period).

The statute requires only that 40 percent of the units in the property 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 (Section 42(g)(1)(C)(i)). The proposed rule goes much further than the statute and creates significant risk that is likely to reduce investor interest in AIT properties. If investors are not interested in AIT properties or if they significantly reduce the price they are willing to pay for Housing Credits for AIT properties, then AIT becomes unworkable since it won't generate funding for the creation or preservation of affordable homes.

From an investor perspective, AIT properties would be far riskier than properties that opt for either the 40 at 60 or 20 at 50 minimum set-asides. Some investors have already reported that they would respond by not investing in any AIT projects. While some may claim that developers could address the risk by ensuring their properties have an average several points below the 60 percent maximum, this will impact cashflow for properties that are already very challenging to finance. This may be infeasible for some properties. Moreover, smaller deals, such as those in rural areas, would need a far larger cushion than larger deals, as a single unit makes up a greater proportion of the units in a small deal.

The treatment of AIT in the proposed rule is inconsistent with that of the other two minimum set-aside options. For example, if a unit is out of compliance in a 40 at 60 project, so long as 40 percent 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 percent of the low-income units still have an average of 60 percent or less.

If Unit 1 goes out of compliance in the AIT example below, the project's average goes to 62.2 percent. Because of the proposed rule's approach, noncompliance in this one unit is a violation of the minimum set-aside and the taxpayer may not take any credits on the entire project until the minimum set-aside is restored. This is the case even though 40 percent of the units have an average of 60 percent or less (for example, Units 4, 5, 6, and 7 constitute 40 percent of the units in the project and have an average of 60 percent).

750 9TH Street NW Suite 650, Washington, D.C. 20001-4793 ● P (202)737-5970 ● www.sahfnet.com

AIT Example	
Unit 1	30
Unit 2	40
Unit 3	40
Unit 4	60
Unit 5	60
Unit 6	60
Unit 7	60
Unit 8	80
Unit 9	80
Unit 10	80

60% AMI Example	
Unit 1	60
Unit 2	60
Unit 3	60
Unit 4	60
Unit 5	60
Unit 6	60
Unit 7	60
Unit 8	60
Unit 9	60
Unit 10	60

In a 40% of unit at 60 percent of AMI property, if Unit 1 goes out of compliance, the property still meets the minimum set-aside because at least 40 percent of the units are low-income units. Thus, the penalty is limited to potential loss of credits/recapture on the noncompliant unit until the noncompliance is corrected, not the loss of all credits.

In recognition of the significant 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. The owner may not even know that there is a violation of the average until well after the mitigation period is over, depending on when the violation occurs and when the state Agency's compliance monitoring is scheduled for that property. 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. For example, a unit falls out of compliance in 2021. The proposed rule provides the owner until 60 days into 2022 to fix the issue. However, the state agency is not scheduled to inspect the property until April 2022 and the owner does not realize the unit is out of compliance until the state discovers it. Thus, the owner does not have the ability to correct the noncompliance and prevent the violation from resulting in a loss of credits. In fact, the onerous interpretation coupled with a minimal mitigation period could drive operators of AIT properties to invasive income certification and recertification procedures that are burdensome to residents.

Inability to Modify Income Designations

The proposed rule prohibits the taxpayer from changing the designated imputed income limitation of individual units once made. This limitation will not only stymie practical implementation of AIT, but also sets up the potential for conflicts with the Fair Housing Act, Section 504 of the Rehabilitation Act of 1973, and the Violence Against Women Act (VAWA). Any conflict with federal laws such as the Fair Housing Act is a disservice for residents and creates the distinct possibility of litigation, creating unnecessary liabilities for state Housing Credit Agencies and property owners.

Section 42 does not include any prohibition on modifying income designations, and there is no indication that it was Congress's intent to do so. In fact, the Consolidated Appropriations Act of 2018, which enacted AIT, modified the next available unit rule in Section 42(g)(2)(D) 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. 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 change to 1.42-15 contradicts the proposed new regulation at 1.42-19, as 1.42-15 allows for modification of income designation, whereas 1.42-19 prohibits such modification.

Long before AIT existed, many states had policies that promoted income tiering at various levels below 60 percent of AMI. Thus, properties with a 40 at 60 minimum set-aside election have units designated at various income levels. These policies have always allowed for those units to float, and states have built software allowing them to track floating units. State Housing Credit Agencies are very capable of ensuring that units may float while adhering to developer commitments for units designated at various income tiers.

The proposed rule also conflicts with long-standing IRS policy with respect to transfers of households between units within a project. IRS Revenue Ruling 2002-82, in the answer to question #8, established that the qualified status of a unit moves with a qualified household if they are transferred. It is the unit that the tenant actually occupies at the end of a month in the first year of the credit period and at the end of each year in subsequent years that determines the status of the unit. 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 provided a safe harbor for compliance at Housing Credit properties with other relevant housing laws and regulations, some of which are mentioned below.

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."[1] The proposed rule may create unnecessary conflicts with the Fair Housing Act because it could create significant barriers to an owner making an otherwise reasonable accommodation of moving a resident with a disability to a new unit. For example, a household with an income of 55 percent of AMI lives in a 60 percent-designated unit on the third floor of an AIT project. A member of the household becomes disabled and needs a first-floor unit because they are unable to climb stairs. A first-floor unit in the project is available, but the unit is a 40 percent-designated unit. The proposed rule prohibits the owner from switching income designations of the units, thus the owner cannot meet the reasonable accommodation request allowing the household to move to the first-floor unit while maintaining compliance with Housing Credit regulations.

The proposed rule may also create conflicts with Section 504 of the Rehabilitation Act of 1973 and numerous state laws, which provide accessibility protections for persons with disabilities.[2] While Section 504 does not directly apply to the Housing Credit, it does apply to federally subsidized housing, and the vast majority of Housing Credit properties, including most Housing Credit properties owned by SAHF

[1] 42 U.S.C. Section 3604(f)(3)(B).

[2] While Section 504 does not directly apply to the Housing Credit, it does apply to federally subsidized housing, and the vast majority of Housing Credit properties have some other federal subsidy in the capital stack and/or a rental assistance contract.

members, have some other federal subsidy in the capital stack and/or a rental assistance contract. Under Section 504, persons who need the features of such units have statutory priority on wait lists for transfers and new move-ins. Additionally, if accessible units in properties covered by Section 504 are occupied by households who do not need the features of the unit, the households 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 that households who do not need the features can transfer to.

For example, a household applies for housing and needs the features of an accessible unit. There is an accessible unit that is designated as a 40 percent-designated unit and the household qualifies under the 40 percent limit. However, that unit is currently occupied by another resident who does not need the accessibility features, and has agreed to a unit transfer if a household applies that needs the features of the unit. The only unit available that the nondisabled household can transfer to is a 30 percent-designated unit, but the household does not qualify for that unit. This creates an unnecessary barrier to the transfer and to providing access to accessibility.

The proposed rule will also create significant challenges for properties that are financed with other federal subsidies in addition to Housing Credit equity. Nearly every other major federal housing program has statutory or programmatic rules that require the floating of unit designations to some degree. These notably include Section 8, the HOME Investment Partnerships (HOME) program, the National Housing Trust Fund, Rural Development and tax-exempt bonds. Fixing the AIT designations would not work with these programs and uniquely disqualifies the AIT minimum set-aside from the majority of Housing Credit properties for this reason. In general, it makes the Housing Credit less flexible and effective in serving the needs of communities.

Throughout section 42 and IRS guidance, Congress and the IRS have always made great efforts to allow the combination of other federal programs with the Housing Credit. Examples are many, but include provisions for utility allowances, the 2008 expansion of the 9% credit, and household transfers (as cited above). Creating provisions that would limit the use of these programs based on a minimum set-aside election would be a unique departure in approach for the proposed AIT rule.

Other programs that are often combined with the Housing Credit have income limitations up to 80 percent and often include displacement protections for residents even when their incomes exceed designated levels. Notable examples are public housing, the HOME program and Rural Development. Additionally, programs that target lower income levels, such as the Project Based Section 8 program, may have current residents whose income has increased since initial occupancy, but who still qualify for the program. In all of these cases, the AIT, as described in the statute, would have appeared to be ideally designed to i) meet the funding and preservation needs of the Housing Credit and other programs and help to significantly limit the displacement of households who exceed 60 percent AMI income designations but not the 80 percent when introducing a Housing Credit allocation; and ii) support the preservation of units targeted to those with very low and extremely low incomes. However, the proposed rule completely removes practical access to these benefits for the AIT minimum set-aside.

For example, the Housing Credit is used to preserve a property that receives Project based Section 8 rental assistance to ensure that residents are not rent burdened. A household moves in to one of the units designated for 40% of AMI, but at the next annual recertification, the household's income exceeds 60% of AMI. Under the Project Based Section 8 rules, the tenant cannot be forced to move, but under the AIT rules, the unit would be considered in noncompliance and could jeopardize the Credit for the property as a whole.

The proposed rule's prohibition against changing unit designations would create challenges for assisting households on the waiting list for a property and would prevent an owner from reestablishing compliance should a unit be out of compliance due to a mistake in a tenant's income calculation. For example, a 30 percent-designated unit is leased to a household and the owner certifies that its income is below the 30 percent income limit. During an internal audit or state agency review, a calculation error is discovered. After the correct calculation, the household is determined to be just slightly over the 30 percent income limit but well below the 40 percent income limit. The owner must require the household to vacate the unit and move into a 40 percent designated unit (or higher), assuming a comparable one is available. If the owner has no 40 percent or higher units available in the project (or perhaps the 30 percent designated unit was a 1-BR unit and the only available 40 percent unit is a 2-BR which would be under-utilized or unaffordable to the household) the owner would be faced with non-compliance on the Housing Credit unit or to move the household out of the project altogether, which may be prohibited under other subsidy programs.

COLLABORATE. INNOVATE. ACCELERATE.

<u>Treatment of Existing AIT Properties</u>

The proposed rule for 1.42-19 would apply to Housing Credit properties that chose AIT for taxable years beginning after the date at which the rule is finalized. This means that the proposed rule would apply to existing AIT properties as well as any future AIT properties. Existing properties have been operating and have made agreements between the parties based on perceived risk. The Housing Credit community did not expect IRS to interpret the statute the way it has in this proposed rule. The interpretations in the proposed rule are a significant deviation from and expansion beyond policies state Agencies have developed since the passage of the Consolidated Appropriations Act of 2018 enacting AIT. We understand that 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. Further, some state Agencies include in their policies requirements that owners recertify incomes for households in AIT properties (even if the properties are 100 percent low-income properties) so that units can be redesignated if incomes of the tenants change. The proposed rule introduces significantly greater risk of loss of credits and of conflict with the spirit and compliance requirements of a host of other housing statutes and programs.

<u>Recommendations</u>

We strongly urge the IRS to engage with stakeholders to revise the proposed rule to facilitate implementation of AIT that will allow it to be fully utilized to better serve communities and residents. Key revisions should include the following:

a. The AIT minimum set-aside should be considered met so long as 40 percent of the units in the property have an average of 60 percent or less of AMI. In addition, the property should

750 9TH Street NW Suite 650, Washington, D.C. 20001-4793 ● P (202)737-5970 ● www.sahfnet.com

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 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.

b. The final rule should allow owners to modify unit designations, so long as the state Agency allows for that in its policies 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. This change should allow for both floating units and for modification of individual unit designations.

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 (e.g., the non-eviction rule) 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 at least modify the time period provided for taking mitigating actions. State 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.

Finally, 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 (in an example cited in the proposed rule), 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.

SAHF and NAHT appreciate IRS' attention to these issues and administration of the Housing Credit program. Please feel free to contact Althea Arnold at aarnold@sahfnet.org with any questions about our comments above.

Sincerely,

Althea Arnold
Senior Vice President, Policy
SAHF

Lori Little
President & CEO
NAHT