

Overview

The Consolidated Appropriations Act of 2018, Pub. L. 115-141 (the Act) established a new minimum set-aside election for new Low Income Housing Tax Credit (LIHTC) developments. Under Section 42(g)(1) of the Internal Revenue Code of 1986 as amended by the Act (the Code), a project may qualify as a “qualified low-income housing project”) if 40% or more of the residential units in such project are both rent-restricted and occupied by individuals whose income does not exceed an average imputed income limitation equal to or less than 60% of area median income (AMI), based on designated imputed income limitations. This approach is referred to below as “income averaging” or “AI”.

As owners contemplate whether to seek IA approval, they should be aware of the potential compliance risks that are associated with election of income averaging. **Once the minimum set-aside election is made, it is irrevocable, and failure to satisfy the minimum set-aside test throughout the initial 15-year compliance period will result in recapture of the credit for all units.** It is also important to note that the Federal government has not yet issued regulations implementing this statutory change, and there remain many unanswered questions regarding the legal and practical implications of income averaging. Adherence to many compliance requirements, such as the next available unit (NAU) rule, may be far more challenging than in the typical LIHTC transaction. This is especially true for mixed-income developments that include market rate units. DHCD will require owners who are seeking to utilize income averaging to demonstrate that they have worked with their management agent, investor/syndicator, lender, and LIHTC compliance experts to ensure that electing to utilize income averaging will be a practical approach and will not cause undue LIHTC compliance risk or challenges.

Given the many uncertainties associated with IA, at this time DHCD will only contemplate approval of IA as the basis for threshold eligibility under Section 42(g)(1) of the Code under the circumstances set forth below.

Projects in Which Income Averaging May be Used; Timing

Use of income averaging requires DHCD consent. DHCD currently contemplates limited use of income averaging, primarily in 4% preservation projects, where income averaging may help avoid displacement of residents whose incomes would not otherwise allow them to qualify for LIHTC units. In other contexts, income averaging presents much more complex legal and policy issues, particularly in the absence of implementing Federal regulations. This is particularly true in the context of 9% credits. Accordingly, at this time, DHCD will only contemplate approval of income averaging as the basis under which a project may qualify as a “qualified low-income housing project” under Section 42(g)(1)(C) of the Act in the following circumstances:

- 1) The project has received a commitment of tax-exempt bonds from MassHousing or MassDevelopment and has sought an allocation of federal 4% credit from DHCD under the 2018-19 (or later) Qualified Allocation Plan;
- 2) The project is either:
 - a. A preservation project where income averaging will help avoid displacement of existing tenants while maximizing use of federal LIHTC, or
 - b. A preservation or production project with a workforce housing tier, where there is a material difference between market rents and restricted rents at the 80% AMI level and where the applicant can demonstrate that income averaging is essential to project feasibility;
- 3) The project has not yet received its 42(m) tax credit eligibility determination letter;
- 4) The project has not yet made a minimum set-aside election on Form 8609 as to the threshold eligibility test applicable to the project under Section 42(g)(1) of the Code;

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- 5) The project has not yet been placed in service; and
- 6) The project does not involve a resyndication of a property previously developed or preserved using LIHTC that is subject to an existing extended use agreement (EUA), if the proposed IA would conflict with the existing EUA minimum set-aside requirements. In general, a resyndication application will only qualify if:
 - a. The project has completed its extended use period, or
 - b. Fewer than 100% of the units in the project were LIHTC units and only the non-LIHTC units are proposed to be designated as over-60% AMI units.

DHCD will continue to evaluate the appropriateness of applying IA in other contexts, including projects with 9% credits; however, such projects are not eligible to utilize IA at this time.

Threshold Federal Requirements

- An owner electing income averaging must satisfy the requirements of Section 42(g)(1)(C) and 42(g)(2)(D) of the Code, as amended by the Act. In particular, to meet the minimum set-aside test under income averaging, at least 40% of the units in the property must be affordable to eligible tenants with incomes at or below designated income levels, with rents based on imputed income at those same designated income levels.
- Federal law limits designated income/rent levels to 10% increments beginning at 20% of AMI. (Note that DHCD imposes additional limitations, as described below.)
- “Income averaging” refers to the average designated imputed income/rent levels of the units, not the average income of the tenant households occupying the units.
- The designated limits at different income tiers apply to both income and rent limits. If a unit has a designated limit at 30% AMI, for example, the maximum rent that may be charged to a household in that unit is 30% of 30% AMI.
- Each building within a multiple building project must individually meet IA requirements.
- **The minimum set-aside election is irrevocable once made on Form 8609;** once a development has made its election and has been placed in service, it is not eligible to change that election, either to select income averaging or to change from income averaging to the 40-60 or 20-50 test. **Failure to satisfy the minimum set-aside, once elected, will subject a property to credit recapture.**
- The Act establishes a new, separate “next available unit” (NAU) rule for properties utilizing IA, under which:
 - The NAU rule is triggered if the tenant’s income exceeds:
 - 140% of 60% AMI, if the income target for the over-income unit is 60% AMI or less, or
 - 140% of the designated income target, if the income target for the over-income unit is more than 60% AMI (i.e., an 80% AMI unit); and
 - In general, income and rent restrictions in the “next available” comparable or smaller unit must be based on:
 - The imputed income limit applicable to the unit that is currently occupied by the over-income tenant, if the comparable or smaller unit is a market-rate unit, or
 - The imputed income limit applicable to the “next available” unit itself, if it is already a LIHTC unit.
 - Special rules apply to mixed-income developments with market rate units, and application of the rule will be particularly complex in a property with multiple buildings.

If any comparable unit that is or becomes available is rented to a nonqualified resident, all over-income units for which the available unit was a comparable unit within the same building lose their status as low-income units, resulting in credit recapture.

- The Act modifies Section 42 of the Code, but does not make a similar change to Section 142 of the Code, which covers exempt facility bonds, including multifamily housing bonds. Accordingly, **in addition to satisfying the “income averaging” test for purposes of Section 42, the development must also satisfy one of the minimum set-aside elections applicable to tax-exempt bond financing (20/50 or 40/60 test).** Units with income limits above 60% or 50% of AMI, as applicable, do not count for purposes of the tax-exempt bond minimum set-aside test. All other compliance requirements applicable to tax-exempt bonds will also apply.
- The 30% AMI income and rent level under LIHTC for purposes of IA is not the same as the 30% AMI income and rent thresholds for purposes of the National Housing Trust Fund (HTF). HTF utilizes the U.S. Department of Health and Human Services’ poverty level threshold in calculating eligibility for ELI households; in many counties, this exceeds the 30% AMI thresholds. IA unit designation is based solely on AMI. **An over-income violation will trigger IRS noncompliance.**

DHCD Additional Threshold Requirements Relating to Income Averaging:

- DHCD will allow up to four of the following AMI designations to be selected at a property utilizing IA: 30%, 50%, 60% and 80%.
- Consistent with the QAP, a property must reserve at least ten percent of its total units for persons or families earning no more than 30% of AMI. Accordingly, each property seeking to utilize IA must at least satisfy the QAP requirements for ELI units.
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- Projects with fewer than 60 units will not be approved for IA absent compelling circumstances. While DHCD will examine requests on a case-by-case basis, the following are examples of reasons why DHCD would contemplate IA at a project with fewer than 60 units:
 - A project has several current tenants with incomes between 60% - 80% AMI in a location where there is a substantial disparity between rents at 80% AMI and market rents;
 - A project has an existing, project-based rental assistance contract that will be renewed for an extended period at the time of financial closing, facilitating marketing and rent-up of units notwithstanding the added complexity associated with having multiple income tiers within the affordable units; or
 - A scattered site development includes over-income tenants, and use of IA will enable the project to satisfy IRS audit guide requirements that 100% of units are both income and rent restricted.
- In general, the proposal must create additional LIHTC units AND allow for a reduction in use of scarce State resources (e.g., funding from DHCD or another state or quasi-public agency).
- If the project will receive any deferred-payment loans from either DHCD or MassHousing, the applicant must demonstrate that income averaging will generate additional equity, resulting in a reduction in the aggregate amount of state-funded deferred-payment loans.
 - A portion of any additional equity must be applied to reduce the amount of deferred-payment loans to be provided by state agencies.
 - In addition, DHCD will require mandatory payments from project cash flow, to be applied to reduce the amount of state deferred payment loans.
 - In no event will DHCD approve an increased development fee as a result of income averaging.

DHCD Additional Criteria Governing Consideration of Income Averaging Proposals

- All projects must satisfy all criteria applicable to projects generally under the QAP and Federal law.

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- DHCD will review requests for use of IA on a case-by-case basis, to assess the impact on project feasibility as well as potential benefits to current tenant households with incomes greater than 60% AMI.
- Clear skewing of unit designations is not allowed. Applicants must demonstrate that units at different income tiers will be equitably distributed across the project and among bedroom sizes and unit types.
- When requesting approval for AI, an applicant must submit the following information:
 - An updated market study analyzing project rents at the designated income tiers relative to market rents that shows adequate demand for all possible combinations of unit sizes and percent limits selected, including evidence that proposed tenant-paid rents for each affordable unit type at each income tier will be at least 10% below the weighted average rent for the same unit type in comparable market rate rental properties.
 - An updated One-Stop, with associated exhibits, reflecting all designations/changes. DHCD reserves the right to request additional documentation relating to financial feasibility
 - A matrix showing the AMI percentages for each designated unit type
 - A legal opinion stating that the income averaging set aside will be compatible with the requirements of all other anticipated funding sources
 - A written statement from all construction and permanent lenders, syndicators, and the project equity investor (if known at the time of application), approving the selection of the income averaging set-aside
 - In a preservation transaction, income certification for current tenants, demonstrating the extent to which use of income averaging will increase the number of eligible LIHTC units and decrease potential displacement of households with incomes over 60% AMI.
 - Certification that the project will not require additional commitment of Federal or state rental assistance from DHCD as a result of income averaging
 - Certification that the proposal will continue to maintain the requirements of any state funding award.
 - Evidence that the applicant and the applicant's property management company are in good standing with DHCD and other state housing agencies
 - Disclosure of any noncorrected 8823 findings currently outstanding on properties in the manager's portfolio as well as all open Management and Occupancy reviews with an unsatisfactory or failing compliance score.
 - Documentation regarding the capacity of the applicant's management company to effectively manage properties subject to federal housing compliance requirements in order to handle the additional burdens associated with income averaging, including:
 - Clean track record of timely reporting to DHCD and any other state tax credit allocating agencies funding properties managed by the management company
 - A statement from the management company committing to annual income averaging training for on-site property managers.
 - Evidence that the applicant has retained a compliance expert to provide ongoing advice regarding compliance issues.

DHCD reserves the right to deny implementation of IA at its discretion, solely based upon previous compliance related performance of the property manager.

Other Requirements

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- In addition to other reporting required by the IRS and/or by DHCD under the QAP, an owner electing to satisfy the minimum set-aside test through income averaging must prepare a special annual report on income averaging outcomes, to document:
 - Actual incomes of households in designated income tiers
 - Comparison of actual and projected net income
 - Average time to rent up units in each income tier
- Income averaging must be incorporated into the tenant selection plan and other related management documents.
- Projects utilizing income averaging will be required to pay an increased credit monitoring fee, to cover the anticipated additional costs of monitoring compliance across multiple income tiers. DHCD will publish a separate credit monitoring fee schedule for properties utilizing income averaging. This fee must be incorporated into the project budget.
- DHCD reserves the right to require additional third-party monitoring, at developer expense, for the first 3 years following placement in service.
- Owners of developments with more than one building will indicate on the Forms 8609 to treat all of them as part of a multiple building project (checking “Yes” on line 8b of the current form).
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- Applicants electing IA must provide written acknowledgment to DHCD that subsequent guidance from the IRS may result in changes to IA policies.
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- Owners that elect Income Averaging must have an average income targeting that does not exceed **59% AMI**. The purpose of this provision is to ensure that developments remain in compliance with the federal maximum requirement of 60% AMI under Income Averaging.
 - Any development seeking to implement IA must be able to demonstrate that the proposed rents are achievable based on a DHCD commissioned appraisal and are strongly encouraged to underwrite at rents that are less than the maximum 80% rents.

Additional Guidance

As of the date of this policy, the IRS has issued no regulations or formal guidance on the implementation or administration of the IA minimum set-aside. DHCD strongly encourages applicants considering the use of IA to review all available industry guidance, including materials prepared by recognized industry experts on LIHTC.

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