Costello COMPLIANCE

The Average Income Test Minimum Set-Aside

c Elect minimum set-aside requirement (section 42(g)) (see instructions):
☐ 20-50 ☐ 40-60 ☒ Average income ☐ 25-60 (N.Y.C. only)

FAQs for State Agencies

- ❑ Are Recertifications required at 100% AIT properties?
- ❑ Is Unit Parity required?
- ❑ Do units get redesignated as household income increases?
- ❑ Should the LURA indicate designations?

...and much more!

TABLE OF QUESTIONS

FAQ 1 | Should the AIT be encouraged? 2

FAQ 2 | Does the AIT require income recertification for 100% LIHTC properties? 3

FAQ 3 | Do units need to be redesignated at recertification with income increases or decreases? 3

FAQ 4 | Must a state approve all redesignation of units? 3

FAQ 5 | How tightly should the LURA lock down the designations to be used at a property? 3

FAQ 6 | How can a state track unit designation and redesignation? 4

FAQ 7 | Can an owner redesignate units simply because the project is out of compliance with AIT provisions? 5

FAQ 8 | Are there any specific areas where a state may want to consider explicitly allowing redesignation as a state policy under Treas. Reg. 1.42-19 (d)(1)(ii)? 5

FAQ 9 | Must AIT projects be 100% LIHTC? 6

FAQ 10 | Is unit parity required? 6

Introduction | With the release of the final regulation for the Average Income Test (AIT), state LIHTC agencies are now hard at work on their AIT policies. As owners will need to designate units for the qualified groups to be included in the minimum set aside and the applicable fractions for an AIT project at the end of the year under the new regulation, the industry is eager for the state policies. Here we will ***focus on some of the questions we have received from our state clients*** and other friends in the industry.

Important notes: These answers focus on the underlying federal standards. State policies build on these and may differ. The goal is to provide a factual analysis of the federal rules and not a value judgment of any state policies. Understanding the federal standards and how these may differ from state policies is helpful. Also, in cases where a state adds to the federal regulation, the state will have to develop a regime to monitor compliance with their policy beyond the required AIT minimum. States understanding the issues discussed here will help them evaluate the cost-benefit analysis of specific AIT policies.

FAQ 1 | Should the AIT be encouraged?

Answer | We believe strongly that the AIT should be encouraged. Of course, the minimum set-aside has always been an election that the owner has a right to select among available options. However, there are many benefits to the people that state agencies serve that are very nicely provided by the AIT. It serves a larger range of low-income people, provides more affordable accessible features for more persons with disabilities than they have in conventional housing, and provides greater "soft" quality of life and development opportunities for the apartment communities (see the below real-life case study example). Add this to financial feasibility benefits that may apply to some properties and the AIT is a minimum set-aside that accomplishes a lot for the people that a state HFA serves. With this in mind, it may be worth one or two more monitoring steps for the Agency. That said, it seems that ***state policy choices will be more important to how complex the monitoring process is than the AIT regulations themselves***. The more requirements a state implements, the more work they and the owner/agents will have to do.

Real-life case study | A teacher normally would not have been eligible to live at an LIHTC property if it had been before the AIT. However, she did qualify for a higher 70% income limit at an AIT project. After meeting some of her neighbors and their children in the community, she thought it would be nice to have a tutoring session a couple of days a week in the community room where she could help with homework. The first week she had two students. By the third week, she had 17! This will yield long-term scholastic benefits. The property also had a firefighter who also coached baseball and decided it would be fun to put together a team, inviting children from the community to join. Interviews with management show that residents of this community are spending time with each other, learning from each other, and in the process taking great care of the community in conjunction with the management team in new ways because of the AIT.

Source: Marie Peace | SVP, Chief Compliance Officer | The Franklin Johnson Group

FAQ 2 | Does the AIT require income recertification for 100% LIHTC properties?

Answer | No. Nothing in the AIT requires annual income recertification waived by IRC §42 (g)(8)(B). Congress called any income recertification at 100% projects "irrelevant" in 2008, and the AIT does not change that. As the Available Unit Rule for the AIT at (g)(2)(d)(iii) and (v) establishes that already designated LIHTC units continue to be rented at their assigned designations and do not need to be adjusted, there is no federally mandated benefit to income recertification for these projects.

FAQ 3 | Do units need to be redesignated at recertification with income increases or decreases?

Answer | No. As noted above, an owner will not be aware of changes in household income at 100% LIHTC projects that are exempt from income recertification by law. Even for owner/agents of projects that are aware of changes of income — because the project is less than 100% LIHTC or because state policy requires income recertification — the federal rules do not require redesignation. Following the Available Unit Rule is required (which may require redesignating ***market*** units), but nothing further. Routine redesignation of occupied units to random designations based on household income changes will require considerable effort on the part of the owner/agent, monitoring by the state Agency, and may even risk the minimum set aside. Of course, some states already have policies requiring redesignation relating to their set asides required in QAPs, but not following these policies does not risk the minimum set aside for the properties. Mishandling redesignation for the AIT could. With this in mind, states will evaluate whether existing state policies for their set asides are a good match for their AIT properties.

FAQ 4 | Must a state approve all redesignation of units?

Answer | No. There are several allowances where the regulation permits change to designations at Treas. Reg 1.42-19 (d)(1). These include when the IRS guidance may permit through future guidance, when appropriate to other laws that protect tenants (such as Fair Housing, VAWA, or section 504), for household transfers between units, and to address noncompliance with the AIT. There is one redesignation scenario listed in the regulation where the state must weigh in, and that is when the Agency has issued public written guidance that provides conditions for a permitted change that applies to all AIT projects in the state. This would appear to allow, but not require, that a state approve individual redesignations, but only for matters under their state-specific policies. Of course, the state may also have a blanket policy to allow redesignation under prescribed circumstances and avoid approvals of individual redesignations. They may also simply allow unit designations to "float" at an owner's discretion, as the other federally allowed reasons for AIT redesignation do.

FAQ 5 | How tightly should the LURA lock down the designations to be used at a property?

Answer | Locking in designations too tightly in the regulatory agreement is probably unwise. Considering the flexibility built into the regulation, locking

designations in the regulatory agreement will require considerable extra work for the state Agency. Certainly, indicating the designations by specific units would be a significant challenge in complying with redesignations and transfers allowed in the regulation. However, even the percentage of units and perhaps unit sizes would potentially require LURA amendments when redesignation allowed in the AIT regulation occurs. Because portions of the LURA are enforceable by prospective, present, or former occupants of the building, it has been long a question whether amendments to LURAs that relate to the applicable fraction for a building are legally valid (IRC §42(h)(6)(B)(ii)). The AIT does affect the applicable fraction.

As a practical matter, a plan that involves unit designations must be evaluated in the underwriting process to establish a project's financial feasibility and the need for credits. This will involve assigning designations (and thus rents) to specific unit sizes. Also, the owner must record designations and redesignations in their books and records and communicate these to the state Agency. How these designations are enshrined will be up to the state Agency. However, legally locking them specifically into the LURA without the ability to legally change these easily may create more problems for both the state and owner in the long run than it solves. Other options, or simply the designation method spelled out in the AIT regulation, may suffice. In that case, the LURA may contain basic language from the AIT statute and regulation and allow for the designations to be determined as allowed by the regulation. Alternatively, the LURA could enshrine the initial designations but explicitly allow for changes to designations using a method outside of the LURA.

FAQ 6 | How can a state track unit designation and redesignation?

Answer | Probably using existing mechanisms. The AIT regulation (Treas. Reg. 1.42-19T (c)(ii)) requires that owners designate and redesignate units in their books and records and communicate these to the state Agency. This section of the regulation is designed to be flexible on the state Agency side. For example, the regulation suggests that an Agency *"may allow a taxpayer to describe a current year's information by reporting differences from the previous year's information or by reporting that there are no such differences. Various Agencies may choose to apply this manner of reporting to the identity of a qualified group of units for use in the average income set-aside or applicable fraction determination, or the imputed income limits designated for the various units in a project."* Given this flexibility, current state mechanisms for reporting existing state set-asides probably allow owners to report AIT designations as well, either in online reporting systems throughout the year or with annual reporting. An owner may be viewed as having recorded the designation of a unit in its books and records when it executes a TIC with a household.

Does the average need to be computed at each redesignation? This is more complex for a state than is necessary. The minimum set aside and applicable fractions for a project are both determined on the last day of the taxable year for a project. Analyses of the designation averages would not likely need to be an ongoing process throughout the year. Establishing that the average of designations does not exceed 60% at the close of the year, likely during the review of annual reporting, would seem to be sufficient.

FAQ 7 | Can an owner redesignate units simply because the project is out of compliance with AIT provisions?

Answer | Yes. The new AIT regulation has provisions specifically designed to allow "restoring compliance with average income requirements." During a taxable year, Treas. Reg. 1.42-19 (c)(D)(v) allows for adjustment of designations, where this is possible. This may be with vacant LIHTC or market units, or existing households that qualify for lower designations. Like most other designation changes allowed in the regulation, this does not appear to require state approval. After the taxable year, the regulation further allows corrections to the designation process within 180 days of an owner or state identifying noncompliance (Treas. Reg. 1.42-19T (c)(4)). Unlike corrections during a taxable year, this requires explicit state written approval on a case-by-case basis.

Suggestion | To increase owner and investor confidence in a state's desire to work with owners that run into AIT trouble, ***we strongly suggest that states signal in their policies that they will specifically be willing to allow retroactive redesignation*** as allowed in the 1.42-19T or successor regulation. It may be important to inform owner/agents that, if an issue is not discovered and corrected within the taxable year during which the problem occurs, retroactive correction to designations, if possible, must be made within 180 days of discovery of the issue by the owner or the state Agency. If discovered by the owner, the issue and suggested correction must be promptly communicated to the state to benefit from this correction period.

It is also possible that retroactive redesignations may also be allowed as "Housing credit agency (Agency)-permitted changes" in keeping with Treas. Reg. 1.42-19 (d)(1)(ii).

Without this assurance, owners may avoid the AIT out of fear that a state will not allow the retroactive correction provisions allowed for in the regulation when it is reasonable to do so.

FAQ 8 | Are there any specific areas where a state may want to consider explicitly allowing redesignation as a state policy under Treas. Reg. 1.42-19 (d)(1)(ii)?

Answer | There may be several. We have listed some possibilities below. There may be more.

- ***Many states appear to intend to simply allow the floating of designations among units at a property at an owner's discretion***. As long as an owner records all changes in their books and records and communicates these to the state as required in the AIT rules and state policies, the state may choose not to implement any more restrictive policy that they will then need to track. However, if they do not implement a blanket allowance to float designations, there are situations they may consider building more specific policies around. Such as:
    - ***When noncompliance*** is discovered in a prior year (see FAQ 7 above).
    - ***As required by other housing programs*** also funding an AIT project. Although the AIT regulation allows for redesignation to comply with Fair Housing, VAWA, and owner civil rights legislation and to allow for unit

transfers, it does not explicitly make allowance for redesignation responding to other housing program provisions. These may include HUD, Rural Development, HOME, National HTF, or similar state or local programs. All of these programs may at times require transfers of designation or in-place redesignation of units. Nonsubsidy programs like HOME and NHTF in particular may require redesignation to follow program rules, whether the program units are fixed or floating. This is especially true if nonsubsidized rents need to be changed, such as changing a HOME unit from low- to high-HOME when the new rent moves the unit to another AIT designation.

- ***When a state has existing set-aside programs*** that revolve around changing set asides. After careful consideration, if the state will require that the owner apply existing set-aside rules to AIT projects, they will need to allow for this in writing in their AIT policies.

FAQ 9 | Must AIT projects be 100% LIHTC?

Answer | No. There was uncertainty about the AUR as it applies to the AIT before the publication of the final AIT regulation. This, along with perceived increased ease of monitoring, led many states to originally require that AIT properties be 100% LIHTC. We believe that this may change. Obviously, the Available Unit Rule (AUR) as it applies to 100% projects is simpler for any LIHTC property, but most states have not eliminated the option to have market units at LIHTC properties in general. The AIT does not add considerable complexity to the AUR as compared to non-AIT properties. The rule is followed as it always has been, with the exception that market units are redesignated as LIHTC at specific designations before they are re-occupied (Treas. Reg. 1.42-15 (c)(2)). Since states must have a mechanism to receive information from the owner on other changes to AIT designation for several reasons, and they also have a monitoring mechanism for the AUR for their properties, the monitoring would not appear to be considerably more complex for the AIT. Market units may be helpful or necessary to make some projects feasible. A project may also become less than 100% LIHTC despite efforts to the contrary. States will balance these factors in their decisions going forward on this issue.

FAQ 10 | Is unit parity required?

Answer | No. Unit parity is a term used to describe an owner assigning designations equally among unit sizes. When determining the minimum set-aside, units are included without regard to unit size. An owner should generally attempt parity to a reasonable degree to ensure equal opportunity, avoid disparate impact, and meet general Fair Housing obligations. However, as a matter of state policy, it needs to be recognized that parity is not always possible while following the federal AIT regulation relating to unit redesignations. For example, Fair Housing accommodation or VAWA emergency transfers may result in larger or smaller units being redesignated out of parity. In a worst-case scenario, an owner/agent may deny a needed Fair Housing or VAWA transfer, incorrectly believing that moving out of compliance with the state parity policy represents an unreasonable financial risk to the tax credits for the project. Also, to preserve existing affordable housing, an owner may need to make

designations that do not use parity as a factor. For example, units may need to be initially designated to fit existing households at an acquisition/rehab of a HUD property with AIT. If a state believes that mandating unit parity is important enough to implement a policy, it will need to include some flexibility for several possible scenarios where the unit mix may go out of parity while following the AIT and other regulations.

Conclusion | Much of the success of the LIHTC program over three decades is due to state Agencies coming up with practical and smart policies that comply with federal standards and state-specific needs. We are confident that upcoming state AIT guidance will consider the above issues and best address the specific needs of the low-income people and property owners in each state.