MEMORANDUM

TO: HJN Members
FROM: Kara Brodfuehrer, Staff Attorney, National Housing Law Project
RE: New LIHTC Rule Regarding Income Averaging
DATE:

This memo reviews the new LIHTC income averaging tool, its possible benefits and deficiencies, and what advocates can do to promote better results for meeting tenant and community needs. Income averaging offers the promise of cross-subsidization, so that higher rents from higher-income tenants can be used to offset the lower rental income resulting from designating units for a wider range of very low-income tenants, but pitfalls remain.

The Basics

The enactment of the Consolidated Appropriations Act of 2018[1] (herein "Act"), added income averaging as a third minimum set-aside option for new LIHTC developments. Prior to the addition of income averaging, properties had to choose between two affordability set-asides: 1) 20% or more of the units are rent restricted and occupied by people whose income is 50% or less of the area median income ("AMI") (the "20/50" option), or 2) 40% or more of the units are rent restricted and occupied by people whose income is 60% or less of the AMI (the "40/60" option).[2] Most properties have 100% LIHTC units at one of the designated income levels. The maximum rents are set at 30% of the designated income level. With the addition of income averaging, *new developments* can now elect to rent to people who earn up to 80% of the AMI as long as the average rent and income limit of the "designated[3]" units does not exceed 60% of the AMI.[4]

Income averaging limits the rent/income levels for particular units to 10% increments between 10% and 80% of the AMI. Accordingly, projects can only choose from the following permitted rent/income levels: 20 percent of AMI, 30 percent of AMI, 40 percent of AMI, 50 percent of AMI, 60 percent of AMI, 70 percent of AMI, and 80 percent of AMI.[5] In order to determine the average rent and income limit for a particular building, all of the income/rent levels must be added and divided by the total number of units in the building.[6]

[1] Consol. Appropriations Act of 2018, Pub. L. No.115–141, div. T, §103, 132 Stat. 348, ___ (Mar. 23, 2018).
[2] 26 U.S.C.A. § 42 (g)(1) (West 2018).
[3] The Internal Revenue Code does not include a definition for the term "designated."
[4] 26 U.S.C.A.§ 42 (g)(1)(c) (West 2018); Note: Properties electing income averaging must also ensure that 40% or more "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.
[5] 26 U.S.C.A.§ 42 (g)(1)(c)(ii)(III) (West 2018).
[6] It is unclear whether this calculation would be done on a building by building basis or would include an entire development.

For example:

Ollie Commons is a new 50 unit LIHTC building that elected income averaging as the minimum set-aside option. The building is 100% LIHTC and the units are designated as follows:

10 at 20% of the AMI
30 at 60% of the AMI
10 at 80% of the AMI

[(10 @ 20% AMI) .2 X 10= **(2)**] + [(30 @ 60% AMI) .6 X 30 = **(18)**] + [(10 @ 80% AMI) .8 X 10 = **8**] = 28. 28/50 = .56 so the average AMI for the building is 56%.

Therefore, Ollie Commons complies with the income averaging rule because the average AMI for all of the units in the building is 60% or less (56%). Additionally, it is a 100% LIHTC building so 40% or more of the units are rent restricted and occupied by people whose incomes do not exceed the designated limits for their units.

Most properties will likely structure income averaging to end up at 60% AMI or compliant with whatever additional requirements are established by the state agency or necessary to comply with additional funding sources.

Applicability and Guidance

The IRS has not issued guidance regarding this rule change and may never do so. However, the state housing finance agencies (herein "State Agencies") have the discretion to decide whether they will allow income averaging as part of their particular tax credit program. Many state agencies have already issued guidance on income averaging and many more are expected to do so soon.[7]

The choice to elect income averaging as a set aside is available as of March 23, 2018. Properties cannot make an election[8] for income averaging retroactively so developments already placed in service cannot change their set-aside to income averaging. Additionally, properties that are past the initial 15-year compliance period cannot change the minimum set-aside to income averaging and must abide by the election originally specified in the extended use agreement.[9]

Positive Aspects of the Income Averaging Rule

[7] Novogradac & Company LLP, *State Income Averaging Policies*, https://www.novoco.com/resource-centers/affordable-housing-tax-credits/application-allocation/state-income-averaging-policies.
[8] Properties must make a set-aside election on Federal form 8609. This election is irrevocable and once made, the set-aside cannot be changed to income averaging.
[9] 26 U.S.C.A. §§ 42 (j)(5)(c)(ii) , §42 (g)(1)(B) (West 2018).

LIHTC restricted rents are set at specific AMI levels, and tenants must have incomes at or less than those levels at initial occupancy. Thus, without deep rental assistance subsidies or increases in actual income that exceed the increases in AMI, LIHTC rents are not affordable to the majority of tenants with incomes less than the targeted AMI level. Many affordable housing developers have struggled with offering deeper affordability in LIHTC properties, but the limitations of the 20/50 and 40/60 rules often do not make it financially feasible. With the option to include units and rents at 70% or 80% of the AMI, properties are in a much better position to offset the cost of providing effectively deeper subsidies set at 10% to 40% of the AMI. This means that some projects will be better able to rent some units to a wider range of tenants who are "very low income" (below 50% of AMI)[10] and "extremely low income (below 30% of AMI)."[11]

Income averaging may also facilitate certain preservation transactions and reduce risks to current tenants in those properties. LIHTC serves as a primary financial resource for rehabilitating and preserving properties originally developed under a different federal program, such as public housing or a HUD or RD mortgage or rental assistance program. These properties are commonly occupied by tenants with a wide range of lower incomes, some of whom have incomes (e.g., 75% AMI) exceeding LIHTC-restricted levels (e.g., 60% AMI). Therefore, changing the LIHTC income limitations to allow for some households at up to 80% of the AMI enables the owner to obtain the funding needed to rehabilitate the property to preserve the affordability of units while avoiding any threat of displacing existing tenants when properties are recapitalized.[12] Units converted to project-based rental assistance or Project-Based Vouchers through the Rental Assistance Demonstration (RAD) program, and units with old HUD mortgages or rental assistance contracts may benefit substantially from this authority.

Concerns Regarding the Income Averaging Rule

Vouchers

LIHTC properties provide a significant amount of the housing stock utilized by section 8 tenants, both voucher holders and project-based tenants. Nationally, 40% of all LIHTC units and 70% of units occupied by extremely low-income tenants are using a rental subsidy, including section 8 vouchers.[13]

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[10] 42 U.S.C.A. § 1437a(e)(2)(b) (West 2018).
[11] 42 U.S.C.A. § 1437a(e)(2)(c) (West 2018).
[12] Displacing HUD tenants who do not qualify for LIHTC would not be legal under the HUD lease and agency policy. *See* Memorandum from Benjamin T. Metcalf, HUD Dep. Ass't Sec'y for Multifamily Programs, to All HUD Multifamily Regional Center Directors re Occupancy Protections for HUD-Assisted Households in Properties with Low-Income Housing Tax Credits (Jan. 12, 2015). However, hopefully income averaging removes any incentive for an owner to violate the law in pursuit of the tax credits.
[13] Furman Center for Real Estate & Urban Policy and the Moelis Institute for Affordable Housing Policy, *What Can We Learn about the Low-Income Housing Tax Credit Program by Looking at the Tenants?*, http://furmancenter.org/files/publications/LIHTC_Final_Policy_Brief_v2.pdf.

LIHTC properties cannot discriminate against people utilizing section 8 vouchers.[15] However, this does not directly translate into a duty to accept voucher holders, who may still face rejection on certain non-discriminatory grounds. One such possibility is that the "payment standard,"[16] (the rent maximum the voucher will cover), may not be sufficient to cover the rent for a LIHTC unit. This could potentially cause problems for access by voucher holders-especially for units set at higher AMIs.

Prior to the income averaging rule, it was rare for payment standards to be inadequate to meet the rents in LIHTC properties as they were usually set at 50% or 60% of the AMI. However, with the new rule, some LIHTC units will be set at 70-80% of the AMI -- levels that are much more likely to exceed local payment standards. Accordingly, income averaging may result in a decrease in the number of units available to voucher holders. This is because it is possible to meet the 60% average building AMI mandate while still having a large portion of the building's units set at 70-80% AMI. This could result in voucher holders being ineligible for a significant number of a building's units. Here is an example for a 50 unit building using income averaging:

AMI Percentage	Number of Units
80%	5
70%	15
60%	5
50%	15
40%	10

The average AMI in this building is at 58% but 20 out of 50 of the units are between 70-80% AMI and may be out of reach for voucher holders. For example:

Isabel has section 8 housing choice voucher and is looking for housing in San Francisco. The one bedroom payment standard is set at $1850.

The AMI in San Francisco for one person is $102,000. Isabel applies to live at Oso Landing, a LIHTC building that has elected to use income averaging. Oso Landing has one bedroom units set at both 70% and 80% AMI available. However, due to San Francisco's high AMI, the rent for the 70% AMI unit is $1,925 and the rent for the 80% AMI unit is $2,200. This exceeds the voucher's payment standard of $1,850 and Isabel would not be able to rent a 70% or 80% AMI unit with her voucher.

Thus, it is vital for advocates to ensure that state agencies address voucher usage when awarding tax credits to new developments. Given that state agencies are not bound by the 70-80% requirement allowed by income averaging, they could enact incentives or mandates that the highest LIHTC rents be set at or below the local payment standard.

[15] 26 U.S.C.A. §42(h)(6)(B)(iv) (West 2018).
[16] Payment standards are set by the local housing authority and are based upon (i.e., usually between 90 and 110%) fair market rents published by HUD. *See* 24 CFR 982.503(a)-(b) .

Income averaging may also disqualify applicants with vouchers from LIHTC buildings that require minimum incomes. For example:

Arya Apartments is a LIHTC building utilizing income averaging. They rent one-bedroom units at: $1040 (80% of the AMI) and $780 (60% of the AMI). Arya Apartments requires that all tenants have a minimum income of 3 times the total monthly rent for the unit.

Leo and Juan, a married couple with a section 8 voucher, apply for a one-bedroom unit set at $1040 (80% of the AMI). They have a combined monthly income of $2400 a month. With the voucher, the couple's monthly rent will be $720, which is 30% of their monthly income. Although the couple's monthly rent payment will only be $720, they would not qualify for the unit because they do not earn three times the monthly rent for a unit set at 80% of the AMI which would be $3,120.

However, if the unit's rent was set at 60% of the AMI ($780) the couple would qualify because they earn more than three times this amount ($2340). Thus, although Leo and Juan's rent is the same under both scenarios, they would only be permitted to rent a unit set at 60% of the AMI. Effectively, this will reduce the number of units available to people with vouchers as an income at or above three times the rent in a 70% or 80% AMI unit will likely be out of reach to many voucher holders.

Thus, admissions policies that require minimum incomes may reduce the number of units available to voucher holders-especially in building utilizing income averaging. These policies also have the potential to be used to circumvent the mandate against voucher discrimination. Advocates should engage with state agencies to enact regulation changes to bar or dis-incentivize admissions policies that require minimum rents.

Another problem that may arise as a result of income averaging related to vouchers is that owners may disproportionately rent extremely low-income units to voucher holders. Because housing assistance payments are not included in the calculation of restricted gross rents, some owners can maximize rental income by renting the extremely low-income targeted units created by income averaging to voucher holders. Where voucher payment standards exceed LIHTC-restricted rents, owners can receive more rental income by renting to voucher holders, although the PHA-approved reasonable rents are limited to the payment standard.[17] This amount will likely considerably exceed the 20 or 30% of AMI restricted rent level for the newly authorized extremely low-income units, while the owner is simultaneously using income averaging to recoup higher rents from the units above 60% AMI. State agencies may need to consider additional steps to ensure that extremely low-income units serve their intended purpose without unduly enriching owners. This could include setting limits on the number of vouchers utilized in the low AMI units.

Miscalculation of Rents

[17] 24 C.F.R. §982.507(c) (2018).

For properties not utilizing income averaging, it is relatively simple to determine a unit's rent because it is usually based on 50% or 60% of the AMI. However, some state agencies require or provide incentives for deeper affordability which has resulted in properties having several different income designations (usually 30%-60%) spread throughout the project. With several different designations in a property, it is also more likely that management will make mistakes in calculating a tenant's rent. Given that there are no requirements that a tenant's lease state what income designation is attached to their unit, tenants and advocates have experienced great difficulty in determining whether a tenant is being charged the correct amount of rent. And given that tenants often do not know the number and distribution of units at various income levels, it also becomes difficult for tenants who experience a reduction in income to request a transfer to a lower-income, less expensive unit, although that option has been expanded under income averaging.

These issues are likely to multiply with the use of income averaging as more projects will be utilizing a range in designations. Additionally, for properties that are not 100% LIHTC, these designations may change when the next available unit rule is applied.[18] Advocates should push for more transparency, such as a lease rider or other document that clearly informs a tenant that they are in a LIHTC unit and that informs them of the income designation of their particular unit, and the number of each type of income-designated units at the project.

Increases in Recertification Disputes

In 2008, the Federal Housing Recovery Act was passed. This legislation abolished the requirement for 100% LIHTC properties to recertify annually beyond the certification requirement at move-in.[19] However, with the election of income averaging, 100% LIHTC properties will effectively be required to recertify each year in order to demonstrate compliance with the rule that the average AMI of the building is at or below 60% of the AMI.

Disputes often arise between LIHTC tenants and management when recertifications are processed. This is a result of many factors including: tenants not being given enough notice to obtain documentation, a lack of clarity regarding what documentation is needed, and disagreement as to how income should be calculated. A number of these disputes lead to adverse actions-including terminations of tenancy. Additionally, some properties may use these disputes to sidestep the "good cause[20]" requirement by citing the "failure to recertify" as a basis for evicting "problem" tenants. With the increase in recertification requirements, it is likely

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[18] If a household's income rises above 140% of the income limit associated with the unit, the household will still qualify to remain in the unit at the current rent. However, the property must offer the "next available unit" to an income-qualifying tenant. Therefore, in 100% LIHTC projects, the next available unit will always go to an income qualifying tenant. However, in mixed properties, when a tenant's income exceeds 140% of the AMI for the unit, the next available unit, even if it is set at market rent, must be given to a person with an income at or less than the AMI for the unit where the tenant's income exceeded 140%. This would result in a unit changing in designation from market to 80% of the AMI or less. (26 U.S.C.A. § 42 (g)(2)(D)(i) (West 2018); Guide for Completing Form 8823,Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition, INTERNAL REVENUE SERV. (2011), page 14-1).

[19] Public Law 110-289. 122 Stat. 2654 (2008).

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advocates will also see an increase in the number of tenants evicted due to recertification issues. As a result, advocates should work with state agencies to provide more clarity as to all aspects of the recertification process and to be available for technical assistance in the event there is a dispute.

Other Concerns

The income averaging rule may result in fewer large units for extremely low-income families because it treats all unit sizes the same with regards to calculating a project's average AMI. This means that a building could have most or all of the larger units at the highest AMI and the smallest units set at the lowest AMI and still be in compliance with the averaging rule. As a result, the building would be providing significantly more housing space to higher-income households who can afford to live in higher AMI units. This may also result in a decrease in the number of larger units set at lower AMIs, which many not address a particular area's low-income housing needs. This risk is possibly increased with projects not owned by mission-driven nonprofits as they may have less incentive to keep the property affordable. Accordingly, advocates should work with state agencies to enact policies to ensure that income averaging still addresses the needs of your particular community. This could include requirements or incentives that encourage properties to distribute unit sizes among all AMI categories or allocate them based on demonstrated local needs.

How to Address Income Averaging in your State

There are several opportunities for advocates to get involved in the implementation of income averaging at the state level. While some state agencies have adopted guidance regarding this new rule, many are still in the process of revising guidance or have not addressed income averaging at all. To get started, it is important to determine where your state is in this process[21] and to continue monitoring your state's progress so you will be ready to comment when the opportunity arises.

Another opportunity is the required Qualified Allocation Plan (QAP) process,[22] where each state establishes criteria and priorities for how tax credits will be distributed, as well as restrictions, standards, and other requirements. Most states amend the QAP on an annual basis, creating a process where advocates can weigh in on the different aspects of the state's LIHTC program. Some states will probably wait until the QAP process to propose and adopt guidance regarding income averaging. Advocates can take advantage of this process to provide comments and suggestions regarding how the rule is implemented. Even if a state agency has already issued guidance regarding income averaging, advocates can still submit comments and propose changes pursuant to the next QAP process.

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[21] Novogradac & Company LLP., *State Income Averaging Policies*, https://www.novoco.com/resource-centers/affordable-housing-tax-credits/application-allocation/state-income-averaging-policies.
[22] 26 U.S.C.A. § 42 (m)(1)(b) (West 2018).

For more information contact Kara Brodfuehrer at kbrodfuehrer@nhlp.org.
To view NHLP's recent webinar "What Do Advocates Need to Know About the New Income Averaging Rules for LIHTC Properties?" visit: https://www.nhlp.org/webinars/