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Mr. Michael Novey
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Dear Ms. Cimino and Mr. Novey:

The National Council of State Housing Agencies (NCSHA), on behalf of our state Housing Finance Agency (HFA) and other Low Income Housing Tax Credit (Housing Credit) allocating agency members, looks forward to working with the Department of the Treasury (Treasury) and Internal Revenue Service (IRS) to ensure the successful implementation of the recently enacted new minimum set-aside election for income averaging. Already, many state allocating agencies are working to establish income averaging procedures so that the Housing Credit community will be able to exercise this new option.

State Flexibility to Establish Income Averaging Guidelines

NCSHA expects most allocating agencies will include income averaging as part of their programs; however, we do not believe there is a legal obligation for them to do so. Thus, it is possible that not all states will implement income averaging, and some may choose to postpone implementation until a future date.

As the Internal Revenue Code (IRC) provides significant latitude regarding income averaging implementation, we believe allocating agencies that allow for the new minimum set-aside have considerable flexibility to design income averaging policies and practices to best meet the needs in their state. Specifically, allocating agencies are prepared to proceed with many programmatic decisions and implementation strategies, such as determining whether or how to:

- Restrict income averaging in developments with market-rate units.
- Establish a process for designating units at various income levels and whether or not to allow units to float.

- Institute procedures that would allow owners to change unit designations over time, so long as the 60 percent average is maintained.

- Determine how many income designation levels any individual project may have; for example, a state may want to limit the number of different income designations it allows for any individual project, even though the IRC provides seven different income designation possibilities (20, 30, 40, 50, 60, 70, and 80 percent of area median income (AMI)).

- Require owners of multiple building developments that elect income averaging to do so for all buildings in the development rather than making different elections for different buildings.

- Set the testing period for compliance with income averaging designations. For example, allocating agencies may want to use the end of the year as the end of their testing period and allow for owner certifications of designations.

- Require income recertifications for 100 percent low-income developments if the agency deems it necessary.

- Limit or prohibit income averaging for resyndication deals.

- Require unit parity in regards to bedroom size by income designation to prevent owners from designating larger units at higher income designations and smaller units at lower income designations.

- Adjust compliance monitoring fees to reflect the additional work agencies may need to do to monitor developments that elect income averaging.

NCSHA believes that all of the above articulated policy choices are consistent with income averaging as set forth in the IRC and are within the states' purview to implement as they judge fit.

In addition to considering implementation of income averaging policies for allocation, HFAs are also deciding how they will approach compliance monitoring. To assist them in doing so, NCSHA has provided a hypothetical example below outlining scenarios that would be in compliance and out of compliance with income averaging.

Example: A ten-unit development has four units designated at 20 percent of AMI and six units designated at 80 percent of AMI, for an income average of 56 percent.

<u>In Compliance:</u>

- Owner achieves the 56 percent average by renting four units to income qualified tenants at or below 20 percent of AMI and six units at or below 80 percent of AMI.

- At the end of the first year of the Credit period, the four 20 percent units are rented to income qualified households, but the six 80 percent units have never been rented. The project has met its income averaging minimum set-aside because 40 percent of the units are occupied by qualified households with an average income of 20 percent of AMI.

Out of Compliance:

- Over income at initial occupancy: One of the 20 percent units is rented to a household who, at the time of initial occupancy, has a gross annual household income of 25 percent of AMI. The income averaging of the remaining nine units is 60 percent (three units at 20 percent of AMI and six units at 80 percent of AMI). The project does not fail its income averaging minimum set-aside, but the unit is not in compliance with its designated restriction. This unit is out of compliance on the date of initial occupancy, and the monitoring agency should report it as an over income unit by checking line 11a of Form 8823.

- Ineligible full time student household: One of the 20 percent units is rented to a household who, at the time of initial occupancy, has a gross annual household income below 20 percent of AMI, but all household members are full time students who do not qualify under any of the exemptions to the student rule. The unit cannot be treated as a Housing Credit unit even though the household is income-qualified. The income averaging of the remaining nine units is 60 percent (three units at 20 percent of AMI and six units at 80 percent of AMI). The project does not fail its income averaging set-aside, but the unit is out of compliance on the date of initial occupancy and the monitoring agency should report it as occupied by an illegible full time student household by checking line 11l of Form 8823.

- Failed income averaging minimum set-aside in first year: The owner leases up the six 80 percent units before renting any of the 20 percent units. At the end of the first year of the Credit period, only one of the 20 percent units is rented to a qualified household. The income averaging of the qualifying units is 71 percent (one unit at 20 percent of AMI and six units at 80 percent of AMI). The project fails its income averaging set-aside, thus the owner may not make this year the first year of the Credit period. The owner must address the noncompliance issue for the next year in order for the property to be an qualified Housing Credit development.

- Failed income averaging minimum set-aside after the first year: Two of the 20 percent units are rented to households whose incomes at initial occupancy exceeds 20 percent of AMI. At the end of the taxable year, the income averaging of the remaining units is 65 percent (two units at 20 percent of AMI and six units at 80 percent of AMI). The project

is out of compliance with its income averaging set-aside on the last day of the owner's taxable year. The monitoring agency should file Form 8823, checking both lines 11a to report the over income households and 11f to report the violation of the income averaging minimum set-aside.

- Over rent: All of the 20 percent units are rented to households whose incomes at initial occupancy are at or below 20 percent of AMI. However, the owner is charging rent for one of the units that exceed the 20 percent AMI rent limit. At the end of the taxable year, the income averaging of the remaining units is 60 percent (three units at 20 percent of AMI and six units at 80 percent of AMI). The project is in compliance with the income averaging set-aside; however, the monitoring agency should file Form 8823, checking line 11g to report the applicable unit as out of compliance with the designated rent restriction.

- Failed Uniform Physical Condition Standards (UPCS) inspection: The monitoring agency finds that two of the 20 percent units and one of the 80 percent units are out of compliance for UPCS violations. The income average of the remaining units is 62 percent (two units at 20 percent and five units at 80 percent). At the end of the taxable year the UPCS violations remain uncorrected and the project is out of compliance with the income averaging set-aside. The monitoring agency should file Form 8823, checking line 11c to report the UPCS violations and line 11f to report the violation of the income averaging minimum set-aside.

IRS Action to Facilitate Income Averaging

We believe that the following are areas in which IRS action or guidance would clarify income averaging requirements in practice.

Establish a procedure for HUD to use in calculating area-specific income limits at the various designations allowable under income averaging. IRS Revenue Ruling 89-24 sets the 50 percent of AMI income limit for Housing Credit properties as equal to HUD's "very low-income" limit and provides direction to HUD to calculate the Housing Credit 60 percent of AMI income limit at 120 percent of the HUD very low-income limit. NCSHA urges IRS to issue similar guidance so that HUD may calculate income limits at the 20, 30, 40, 70 and 80 percent of AMI levels.

Until HUD is able to publish Housing Credit income limits that reflect the full range of designations allowed under income averaging, we expect states and other entities, such as owners and managers, will determine income limits using the 50 percent income limit for the applicable area as a base and applying a multiplier to determine the other income limit designations. However, without formal HUD-published income limits, we run the risk of entities making mathematical mistakes when they set income limits, which could have serious repercussions for

owners, investors, and low-income residents alike. Moreover, even absent mathematical errors, entities may apply different rounding rules to determine the different income limit designations.

Update Form 8823. We were pleased to see IRS's swift revision of Form 8609 to reflect income averaging as a new minimum set-aside election. IRS should also revise Form 8823 line 11f, which refers to the 20 at 50 and 40 at 60 minimum set-asides, to also reference income averaging. Until IRS is able to make this revision, allocating agency will continue to use the existing Form 8823 for compliance monitoring.

Establish rules for determining next available unit designation in cases when more than one tenant in units of different designated income levels go over income at the same time. If a state allows income averaging in developments that include market-rate units, the next available unit rule will come into play if the income of a tenant in a low-income unit exceeds the threshold set by the IRC for the tenant's unit (140 percent of the greater of 60 percent of AMI or the designated limit applicable to the unit). Determining the income designation of the next available unit is straightforward as prescribed by the IRC unless the next available unit is a market rate unit and more than one low-income tenant in units at various income designations become "over income" at the same time.

For example, low-income tenant A lives in a unit designated at 30 percent of AMI and low-income tenant B lives in a unit designated at 70 percent of AMI. If both of these tenants become over income at the same time, and the next available unit is a market rate unit, IRS should clarify whether the available unit should be designated at the 30 percent level or at the 70 percent level.

Until such time as IRS provides guidance to the contrary, NCSHA will encourage HFAs to require owners to make a reasonable effort to designate the next available unit (if that unit is a market rate unit) at the lower/lowest income designation of the units with over income tenants. We believe this practice is consistent with the statutory preference for serving the lowest income households. Thus, in the hypothetical case above the available market-rate unit would become a 30 percent unit. If a second market-rate unit also became available, that unit would then become a 70 percent unit.

NCSHA values our longstanding relationship with Treasury and IRS, and we look forward to working with you as you consider further action to help facilitate income averaging. NCSHA would be happy to meet with you to discuss these questions and proposals.

Sincerely,

Stockton Williams
Executive Director