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LAW ALERT

HOLD HARMLESS POLICIES—HELP OR HINDRANCE?

HUD, the IRS and HCD have all adopted (and sometimes abandoned) "hold harmless" policies that are meant to insulate owners and lenders from lowering rents due to HUD’s calculations that median incomes have fallen. This Law Alert provides an overview of these hold harmless policies and how they apply to affordable housing developments.

The Hold Harmless Policy and How it Applies to Your Project

A hold harmless policy, applied to incomes or rents, maintains income or rent limits at the previously published level in cases where the data underlying such limits, such as area median income ("AMI"), would otherwise lead to lower limits. HUD originally adopted a hold harmless policy to ensure the feasibility of existing housing projects, the rents of which were tied to Section 8 income limits. These included projects funded by HUD's HOME Investment Partnerships program ("HOME") and multifamily tax subsidy projects funded by low income housing tax credits ("LIHTCs") or tax-exempt bonds ("MTSPs").[1]

Depending on whether a project is an MTSP or is funded by the HOME program, the hold harmless policy is administered by different regulatory bodies. Thus, in cases where a project receives HOME funds as well as LIHTCs or tax-exempt private activity bonds, both HUD's limits as well as the State of California Tax Credit Allocation Committee's ("TCAC") limits should be monitored. The more restrictive of these limits will apply to units receiving both LIHTC financing and HOME funds.

Hold Harmless as it Applies to Multifamily Tax Subsidy Projects

HERA and HUD's Elimination of its Hold Harmless Policy

In 2008, the Housing and Economic Recovery Act ("HERA") was passed to protect the financial viability of existing MTSPs, the rents of which were tied to Section 8 income limits. HERA did so in the event that HUD decided to discontinue its long-standing hold harmless policy. HUD's policy (which was in fact ended by HUD in 2010) had held Section 8 income limits "harmless" from decreases in household income category levels and AMI.

HERA's hold harmless policy applies on a project-by-project basis and provides that a determination of AMI with respect to a particular MTSP's income limit may not be less than the determination with respect to that project made in the preceding year. Thus, even if AMI in relation to a particular project decreases from one year to the next, the project's income limit is "held harmless" from this decrease. Instead, the project may use the highest income limit obtained during the project's qualifying period.

In a *Federal Register* notice, dated May 17, 2010 (the "2010 Notice"), HUD announced that it was ending its traditional hold harmless provision in response to the passage of HERA. The 2010 Notice explained that HERA had eliminated the "need for HUD to continue its hold-harmless policy for the benefit of MTSPs" and that HUD was therefore going to allow Section 8 income limits to decrease beginning in 2010. To modulate the potential effect of this decision, HUD imposed a cap on annual decreases of no more than 5 percent and on annual increases of 5 percent or twice the change in national median family income, whichever is greater. As discussed further below, HUD also announced that unlike its elimination of the Policy for income limits for the HOME program, it would continue to treat rents used in the HOME program as held harmless.

How HERA Affects MTSPs Leasing Up in 2013

HUD released its 2013 income limits in December of 2012. In a memo put out by TCAC later that month, TCAC explained that all MTSPs placed in service *after* December 4, 2012 would use the following income and rent limits:

- Income limits: MTSP/Section 8 limits as determined by HUD

[1] MTSPs are low income housing developments funded by low-income housing tax credits ("LIHTCs") under Section 42 of the Internal Revenue Code of 1986 ("IRC') or financed with tax-exempt private activity bonds under Section 142 of the IRC.

- Rent limits: the greater of
  a) the current rent limits as published by HUD; *or*
  b) the owner's gross rent floor election.

For MTSPs placed in service *before* December 4, 2012 but after December 1, 2011, the following income and rent limits apply:

- Income limits: The income limit is the greater of the 2012 or 2013 income limits.
- Rent limits: the greater of
  a) either 2012 or 2013 rent limits as published by HUD; or
  b) the owner's gross rent floor election.

The "gross rent floor election" describes the MTSP's selection of the effective date of its project's gross rent floor (the level which the gross rent will never fall below). Generally, the effective date of this level is the date on which a credit agency initially allocated tax credit to a building. However, an owner may elect to have the gross rent floor take effect on the building's placed-in-service date.

Since the gross rent floor depends on AMI, if AMI is higher on an MTSP's placed in service date than it was when the tax credits were initially allocated, the MTSP owner will typically make a gross rent floor election. Such election must be made to TCAC in writing and must be done prior to the MTSP's placed in service date.

<u>Hold Harmless as it applies to HOME-funded Projects</u>

As discussed above, in the 2010 Notice, HUD announced that it was ending its hold harmless policy and would therefore allow Section 8 income limits to fluctuate with the market. At the same time, HUD announced that it would continue to hold <u>rent</u> limits for HOME funded projects harmless. In distinguishing income limits from rent limits, HUD noted that "maintaining the hold-harmless policy for HOME program rents would prevent such rents from falling in areas where incomes may be falling" whereas ending its hold harmless policy "with respect to eligibility requirements would help target HOME funds for use by families with lower incomes and greater need."

<u>How the Hold Harmless Policy Affects HOME-funded Projects Leasing Up in 2013</u>

As discussed above, HUD continues to hold the rent limits for the HOME program harmless. It has not yet released its rent limits for 2013. Because the 2013 rent limits will not be effective until 30 days after they are published, the 2012 rent limits still apply. Because these limits apply on a county-wide basis, operators need only look at their county's published rent limit to determine which limit applies. While income limits may have decreased, rent limits may not have decreased by virtue of HUD's hold harmless policy.

<u>HCD's Adoption of the Hold Harmless Policy for State-Wide Income Levels</u>

When HUD eliminated its hold harmless policy, it noted that states were free to adopt their own policies for income limits in establishing eligibility. In February of 2013, HCD did just that when it adopted a state-wide income limit hold harmless policy. In doing so, HCD restored household income category levels and median income levels at the highest level achieved within each county before any decrease was made by HUD starting in 2010. The state income limits were published on February 25, 2013, and are available on HCD's website. They were based on the deferral income limits published by HUD and adjusted to reflect the hold harmless policy. This policy will impact State and local affordable housing programs required to comply with California Health and Safety Code Sections and federal Section 8 Housing Assistance Program Income Limits annually published by HUD.

<u>When a Project is Financed by both the HOME Program and LIHTC</u>

As discussed above, both the HOME and LIHTC programs have specific income targeting requirements that affect the initial and continued occupancy of the development. Both programs also have rent restrictions to ensure affordability.

At initial occupancy, there may be some combination of units in the property that are either HOME-assisted or LIHTC-assisted or both. If the unit carries the designation of *both* programs, it must meet the more restrictive of the two income limit requirements. For example, if the tax credit income limit for a project requires that tax credit units be occupied by tenants with incomes at or below 60 percent of AMI and the HOME income limit requires the Low HOME Rent units to restrict occupancy to tenants with incomes at or below 50 percent of AMI, the latter income limit should be used.

When establishing rent for a unit subject to both HOME and LITHC rent limits, the unit will be subject to the more restrictive of the two rent limit requirements. Thus, if the 2012 HOME rent limit as published by HUD is less than the 2013 LITHC rent limit as published by TCAC, then the former limit will apply.

Because each project is different, additional questions may arise that this summary does not cover in depth. If you have questions, please feel free to contact Polly Marshall, Isabel Brown, Lynn Hutchins, Dave Kroot or any other attorney at Goldfarb & Lipman LLP for more information.

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