

# First, Do No Harm



## Counting on Section 8 Rent: Why HUD Should Hold Affordable Housing Harmless

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Affordable housing owners may find themselves in financial jeopardy later this month due to suddenly declining rents. Tenants may find themselves ineligible to live in subsidized buildings for which they have been on waiting lists for years. And well-maintained buildings may find themselves unable to continue to finance proper maintenance. All this may be the result of the U.S. Department of Housing and Urban Development (HUD)'s decision to revoke a successful hold harmless policy.

For the past few decades, federally-assisted affordable housing owners have been on autopilot when it comes to calculating rents. Every year, HUD issues its area median income (AMI) limits, which effectively set the rent charged under Section 8 and other federal affordable housing programs. Historically, the allowable rents have increased annually or remained the same. Never have the maximum allowable rents actually decreased.

All that may change soon, however. Many New Yorkers may not know that since 2003, rents for projects in the New York metropolitan area have held steady due to a little-known HUD policy of "holding harmless" incomes that would otherwise have declined due to a decline in the HUD published AMI. The policy froze the official income levels rather than allowing them to decrease. Consequently, affordable housing projects were held harmless and allowed to continue charging the same rents, rather than being forced to decrease rents to correct for errors in HUD's estimation of New York City in-

comes in the late 1990s and early 2000s. This practice enabled projects to rely on a baseline minimum rental income stream for continued operation. For the first time, however, HUD is now likely to eliminate its hold harmless policy, which could result in a devastating decline in rental income for many projects. Citizens Housing & Planning Council firmly believes that the hold harmless policy should be maintained.

### History

First, a little background on AMI and the programs that rely on it. HUD tracks incomes each year to calculate the median income for every metro and rural area across the country, and it uses those median incomes to determine how much should be charged in rent for several federally sponsored or funded affordable housing programs. AMI is used as the basis for determining income limits (and, consequently, rents) for HUD and IRS programs including the HOME Investment Partnership Grant, Low Income Housing Tax Credits (LIHTC), and tax-exempt bond projects. To vastly oversimplify a mad-deningly complex regulatory scheme, the federal government establishes maximum rents for affordable housing programs based on a designated percentage - usually 30% - of a specified income level, often the maximum income allowed for participants in the program.<sup>1</sup> For instance, the maximum allowable income for new tenants in LIHTC units is 60% of the AMI. Consequently, maximum rents for the LIHTC program are set at 30% of 60% of AMI.

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This system of rough justice ensures that rents are within reach for most eligible families even though each resident is actually paying a different percentage of their income for rent, and many are paying well in excess of 30% of their actual income. This approach is fundamentally different than the process in the Section 8 program, where rents are tailored to each household's income and all households pay 30% of their income for rent.

Projects assisted by the HOME Investment Partnership Grant must reserve 20% of their HOME units for very low income renters (families earning less than 50% of AMI). In New York City, a single person is considered very low income if they earn \$26,900 or less a year, while a very low income family of four earns \$38,400 or less.<sup>2</sup> All other units in a HOME project must be leased to families at or below 80% of area median income at set rents. Rents for the units for the very low income households are capped at 30% of 50% of AMI, while rents in the other HOME units are capped at 30% of 65% of AMI. For instance, in New York City HOME rents may range from \$672 a month to \$854 a month for a studio apartment.<sup>3</sup>

Which brings us to the question at hand: if HUD's income estimates are going down, shouldn't the official income levels go down – and consequently, shouldn't HUD lower the maximum rent levels as well? Otherwise, tenants will be paying higher percentages of their income in rent.

Not necessarily. The methodology by which HUD calculated AMI changed in 2007 and 2008, resulting in lower AMI estimates in many areas – though it is not clear that there was an actual decrease in incomes over this period. At the same time, however, the cost of maintaining and operating multi-family affordable housing, which includes mortgage and interest payments, property taxes, insurance, and utilities, has risen sharply over the last ten years. In the six-year period from 1996 to 2004, for example, the cost of insurance rose a staggering 97%.<sup>4</sup> While owners of market rate housing were able to maintain profits by imposing significant increases in rents, affordable housing owners could not raise rents, compounding their financial difficulties.

In February 2003, after 2000 Census data caused income estimates for many metro areas to decline,

HUD was forced to implement its hold harmless policy in order to protect affordable housing owners and managers from decreases in rental income. Under this policy, income limits remained at the previously published level in areas where HUD's estimate of area median income would have lowered income limits. In addition, under the policy, income limits would not rise until the income estimates reached the previously published limit. For instance, assume that income limits were originally at \$30,000 when the hold harmless policy was implemented, and under the policy they remained at \$30,000, though estimates of AMI dropped to \$25,000. Official income limits would not rise from \$30,000, even if estimates rose to \$27,000, \$28,000, and \$29,000, until estimates rose to over \$30,000. Under this policy, buildings suffered the intense pressure of increasing maintenance and operations costs combined with stagnating rents. Financially, however, projects fared far better than if they had been forced to cut rents.



Because HUD implements its hold harmless policy on a discretionary basis rather than by statute, property owners should be concerned about HUD's decision to reverse this policy and the potential impacts on the financial welfare of their projects. The Housing and Economic Recovery Act of 2008 (HERA) contained a provision that effectively mandated the hold harmless procedure for a certain

group of properties. Specifically, the provision revises Section 142(d) of the Internal Revenue Code to hold harmless existing projects that HUD is now referring to as “Multifamily Tax Subsidy Projects”: those funded by LIHTC and tax-exempt housing bonds. However, HOME projects as well as state and locally funded projects that incorporate HUD’s income and rent limits are not included. Nor are future projects.

In response to this statutory change and the new protections afforded to LIHTC projects, HUD has been considering whether to revert its practice of holding incomes and rents harmless, and in all likelihood, will repeal the policy, resulting in lower income limits later this month.

## **Our Position**

CHPC entered the fray of opinion surrounding HUD’s proposed ending of their hold harmless policy in November 2009,<sup>5</sup> submitting written comments recommending that HUD continue the policy. We’ve identified six key reasons that keeping the hold harmless policy is a good idea.

### **1. HOME Developments Must Be Protected**

Thousands of affordable housing developments assisted through HUD’s own HOME program would immediately be placed in financial jeopardy if the policy were discontinued. Like LIHTC properties, HOME owners are contractually bound by long term commitments to maintain rents at levels tied to AMI. As mentioned above, each project must charge rents no higher than the lower of the applicable fair market rent (FMR), or “a rent that does not exceed 30 percent of the adjusted income of a family whose annual income equals 65 percent of the median income for the area, as determined by HUD”. In New York City, the FMR is well above the 30% of 65% level. Consequently, rents for all HOME developments in this area are capped at 30% of 65% AMI. Without the hold harmless provision, these properties would face the prospect of shrinking rental income revenue whenever area median income estimates are reduced.

HUD’s HOME developments need the same protections that Congress is extending to LIHTC developments. HOME project owners, who face ever-increasing operating expenses, cannot be expected to operate these critical developments with reduced rental income. As underwriting specialists know, a reduction in rental income coupled with increases in basic operating costs will lead to operating deficits. Properties operating at a deficit cannot perform routine maintenance or pay debt service, and foreclosure follows. What’s more, elimination of the policy would most likely have a chilling effect on future HOME development, as a developer must be able to rely on a minimum rental income when underwriting a project.

Although HUD notes in its notice that it is separately considering whether to apply the same special protections currently in effect for tax credit projects to HOME projects, it has not committed to do so. Consequently, it is simply not prudent to eliminate the general hold harmless provision until protections for HOME projects are firmly in place.

### **2. Hold Harmless Actually Protects Tenants, Too**

The elimination of the hold harmless policy would also affect tenants and their broader communities. The homes of tenants in affected projects will deteriorate through no fault of their own if the policy is rescinded. Financially strapped households on waiting lists for affordable housing will continue to wait. Tenants and property owners will battle deteriorating neighborhood conditions as nearby properties begin to fail. It would be ironic indeed if HUD’s policy regarding median incomes were to bring about an increased number of defaults in the assisted housing portfolio at the same time HUD is spending billions of dollars through its Neighborhood Stabilization Program efforts to combat the results of the foreclosure crisis.

### **3. Many Programs Use AMI; They All Must Be Protected**

Many state and local governments have incorporated HUD’s AMIs into their own programs. New York City in particular is assisting tens of

thousands of units through programs that utilize AMI to determine rents and/or income eligibility. While rent collection in these developments is not bound by federal law, many owners have nevertheless contracted to limit rents to specified percentages of the established AMI and will continue to be bound by these contracts. New York City and other municipalities designed these programs with the understanding that owners would not suffer with rental income decreases when AMI estimates decreased.

Eliminating the hold harmless policy would also hurt affordable homeownership programs, which incorporate AMI in various ways. For instance, many HOME-assisted homeowner programs restrict resale of property to a purchaser with a specific AMI level. Thus, if AMI decreases, a low or moderate income homeowner might be unable to retire his debt or recoup his investment because his pool of potential buyers would be so restricted.

#### **4. It's Impractical To Protect Projects By Attempting To Exempt Them All**

Some suggest that buildings could be protected by allowing official incomes to decrease but exempting designated projects from the resultant rent decreases (as was done with the LIHTC projects). Such a practice would require HUD to locate and catalog each project with rents tied to AMI in order to explicitly exempt them from any future income decreases. We believe it's more appropriate to simply maintain the existing policy of freezing the income levels in cases where they would otherwise decrease. In fact, even if a perfect exemption system were crafted to protect all projects, the result would be a system where maximum rents could vary significantly depending on when a project was developed. For example, assume that, through the use of an exemption, several existing tax credit projects are able to maintain their existing 2009 rents, despite a drop in AMI. If incomes continue to decline over several years, any new projects would be forced to utilize the lower (actual) AMI and would consequently have lower rents than the older projects. An older project could effectively end up with rents geared to 67% or 70% of the new AMI rather than 60%.

Currently, localities have an established, well-known rent structure that is used by government officials,

advocates, developers, lenders, and potential tenants. For instance, anyone interested in finding out what the maximum rents in a tax credit project in New York City can go to a number of websites or contact city officials and easily find out. Over many years without a hold harmless policy, however, tax credit buildings (as well as HOME or other locally-assisted projects) might end up charging an array of different rents. A variety of rent structures would impede localities' efforts to accurately assess the nature of their assisted stock and whom it was serving, or to describe their efforts to the public. In addition, agencies using single, consolidated waiting lists would struggle to account for properties using different rent levels.



#### **5. ...But Without Hold Harmless, Many Could Be Priced Out Of Some Affordable Projects**

If HUD attempted to craft an exemption program, older developments might price themselves out of the population they're legally required to serve. For instance, assume that the hold harmless policy is eliminated, but a specific project is exempted from declining incomes and rents. In that project, rents originally pegged to 60% of AMI could end up effectively pegged to 75% of the new AMI. In this situation, a family with the maximum allowable income (i.e., a family earning exactly the new 60% of AMI lev-

el) would have to pay 38% of their income in rent, rather than 30% as originally intended. Pricing out tenants would present an intractable problem for these projects. New tenants earning more than the new 60% of AMI figure could not rent in these projects, even though the projects would actually be allowed to charge rents over the 60% of AMI permitted by the IRS.

Depending on the structure and the eligibility rules of the particular program (e.g., tax credit, HOME, local programs, public housing, etc.) some existing tenants at or near the existing income cap for the program could even be forced out of their units. If income limits decrease and a tenant's income (even if stagnant) is judged to exceed the new limit, they may be evicted. It is difficult to assess the size of this problem, but it is a factor that must be considered.

## 6. New York City Will Continue to Help the Neediest Tenants

HUD's notice suggests that eliminating the hold harmless policy might allow for greater income targeting for new projects as incomes are allowed to decrease and new projects would be compelled to serve tenants earning less than the new, lower, income limits. We recognize the importance of targeting scarce resources, but the hold harmless policy is not at odds with our imperative to direct the bulk of federal assistance to the neediest tenants. On the contrary, state and local governments will continue to target their programs to households at levels below the hold harmless maximums allowed under federal law. In fact, New York City has historically directed most of its assisted housing resources to families in need, many of whom earn well under the allowable federal limits. In practice, HPD has used Section 8 vouchers to help the very lowest income families live in federally assisted projects with higher income and rental structures.

HUD's notice also demonstrates that the practice of targeting units to households earning well below the federal maximum income limits (i.e., 50% of AMI or 80% of AMI, depending on the program) is widespread in other parts of the country as well. In fact, fully three quarters of all federally assisted households earn less than 30% of AMI. CHPC is confident that this natural targeting will continue

in areas even as their official income limits are temporarily held harmless. In fact, HUD's annual AMI notices clearly state both the actual income estimate and the hold harmless level, so that localities can adopt either for use in their programs as they see fit.

For all these reasons, and in light of the lack of compelling impetus to change the policy, CHPC advocates maintaining the practice of holding communities with decreasing incomes harmless from the potentially negative consequences. HUD will likely go forward with the change, so all affordable housing owners should be aware of the potential consequences.

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<sup>1</sup>Extremely low income is 30% of AMI, very low income is 50% of AMI, and low income is 80% of AMI.

<sup>2</sup> HUD 2009 HOME Program Adjusted Income Limits, available at <http://www.hud.gov/offices/cpd/affordablehousing/programs/home/limits/income/2009/ny.pdf>

<sup>3</sup> HUD 2009 HOME Program Rent Limits, available at <http://www.hud.gov/utilities/intercept.cfm?offices/cpd/affordablehousing/programs/home/limits/rent/2009/ny.pdf>

<sup>4</sup> Stretched Thin: The Impact of Rising Housing Expenses on America's Owners and Renters, Center for Housing Policy, October 2008.

<sup>5</sup> CHPC's comments may be viewed online at [www.regulations.gov](http://www.regulations.gov) under Docket No. FR-5323-N-02.

*This **Inside Edge**, written by Calvin Parker and Stefanie Marazzi, is based on comments submitted by CHPC in response to HUD's Request for Comments on Ending 'Hold Harmless' Policy in Calculating Income Limits Under Section 3 of the United States Housing Act of 1937 (Docket No. FR-5323-N-02). Please email [smarazzi@chpcny.org](mailto:smarazzi@chpcny.org) or [calvinlparker@rocketmail.com](mailto:calvinlparker@rocketmail.com) with any comments.*