

# Understanding the Section 42/Tax Credit Average Income Test

Presented by:  
Gwen Volk

CPM®, NAHP-e®, RAM®, FHC®, SHCM®, HCCP®  
GWEN VOLK INFOCUS, INC.



## Agenda

INTRODUCTION

---

NEW REGULATIONS:  
UNIT DESIGNATIONS

---

NEW REGULATIONS:  
THE AVAILABLE UNIT RULE

---

NEW REGULATIONS:  
THE APPLICABLE FRACTION

---

RECORD KEEPING

---

Q & A

# Introduction

The minimum set-aside is basic to the tax credit program.

The owner must rent a certain percentage of units in a Project to individuals who qualify at a designated percentage of area median gross income (AMGI) adjusted for family size.

The units must be rent restricted at affordable rents as defined by the IRS

The property must be decent, safe and sanitary

Other restrictions apply:  
 Full-time student household restriction  
 Transient Occupancy restriction  
 Etc.

©2023 GWEN VOLK INFOCUS, INC.

# Introduction – Project Definition

- The Minimum Set-Aside is a Project election with “Project” defined by the Owner on IRS 8609 Form, line 8b

<b>Part II First-Year Certification—Completed by Building Owners with respect to the First Year of the Credit Period</b>	
7 Eligible basis of building (see instructions) . . . . .	7
8a Original qualified basis of the building at close of first year of credit period . . . . .	8a
b Are you treating this building as part of a multiple building project for purposes of section 42 (see instructions)? . . . . .	<input checked="" type="checkbox"/> Yes <input checked="" type="checkbox"/> No
9a If box 6a or box 6d is checked, do you elect to reduce eligible basis under section 42(f)(2)(B)?	<input type="checkbox"/> Yes <input type="checkbox"/> No
b For market-rate units above the average quality standards of low-income units in the building, do you elect to reduce eligible basis by disproportionate costs of non-low-income units under section 42(d)(3)(B)? . . . ▶	<input type="checkbox"/> Yes <input type="checkbox"/> No
10 Check the appropriate box for each election. <b>Caution:</b> Once made, the following elections are irrevocable.	
a Elect to begin credit period the first year after the building is placed in service (section 42(f)(1)) ▶	<input type="checkbox"/> Yes <input type="checkbox"/> No
b Elect <b>not</b> to treat large partnership as taxpayer (section 42(j)(5)) . . . . . ▶	<input type="checkbox"/> Yes
c Elect minimum set-aside requirement (section 42(g)) (see instructions): <input type="checkbox"/> 20-50 <input type="checkbox"/> 40-60 <input type="checkbox"/> Average income <input type="checkbox"/> 25-60 (N.Y.C. only)	
d Elect deep rent skewed project (section 142(d)(4)(B)) (see instructions) . . . . .	<input type="checkbox"/> 15-40

©2023 GWEN VOLK INFOCUS, INC.

# Introduction - Minimum Set-aside Election

- The Minimum Set-Aside for each “Project” in the development is elected by the Owner on IRS 8609 Form, line 10c

<b>Part II First-Year Certification</b> —Completed by Building Owners with respect to the First Year of the Credit Period			
7	Eligible basis of building (see instructions)	7	
8a	Original qualified basis of the building at close of first year of credit period	8a	
b	Are you treating this building as part of a multiple building project for purposes of section 42 (see instructions)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
9a	If box 6a or box 6d is checked, do you elect to reduce eligible basis under section 42(f)(2)(B)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
b	For market-rate units above the average quality standards of low-income units in the building, do you elect to reduce eligible basis by disproportionate costs of non-low-income units under section 42(d)(3)(B)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
10	Check the appropriate box for each election. <b>Caution:</b> Once made, the following elections are irrevocable.		
a	Elect to begin credit period the first year after the building is placed in service (section 42(f)(1))	<input type="checkbox"/> Yes	<input type="checkbox"/> No
b	Elect <b>not</b> to treat large partnership as taxpayer (section 42(j)(5))	<input type="checkbox"/> Yes	
c	Elect minimum set-aside requirement (section 42(g)) (see instructions):		
	<input checked="" type="checkbox"/> 20-50 <input checked="" type="checkbox"/> 40-60 <input checked="" type="checkbox"/> Average Income <input checked="" type="checkbox"/> 25-60 (N.Y.C. only)		
d	Elect deep rent skewed project (section 142(d)(4)(B)) (see instructions)	<input type="checkbox"/> 15-40	

©2023 GWEN VOLK INFOCUS, INC.

# Introduction

## Minimum Set-Aside Choices

- 20% of units must be occupied by individuals at or below 50% AMGI
- Or
- 40% of units must be occupied by individuals at or below 60% AMGI
- Or (NYC only)
- 25% of units must be occupied by individuals at or below 60% AMGI
- Or (The Average Income Set-Aside)
  - Before first occupied, units must be designated “low income” in 10% increments from 20% - 80%, i.e. 20%, 30%, 40%, 50%, 60%, 70%, or 80% of AMGI
  - At least 40% of all units must be “low income” - this is called the “qualified group”
  - The designations of the units in the “qualified group” must average at or below 60% AMGI

©2023 GWEN VOLK INFOCUS, INC.

# New Regulations: Unit Designations

## New Regulations: Unit Designations

Unit designations can be changed in the following cases:

1. When and if the IRS publishes forms or guidance allowing a change
2. If the State Housing Finance Agency rules allow a change that is permitted by the IRS (State can issue more restrictive rules. ☹)
3. To protect the tenant rights required by other laws such as:
  - a. The American with Disabilities Act
  - b. The Fair Housing Act
  - c. The Violence Against Women Act
  - d. Section 504 of the Rehabilitation Act of 1973
  - e. Other laws that are intended to protect tenant rights

©2023 GWEN VOLK INFOCUS, INC.

## New Regulations: Unit Designations

Unit designations can be changed in the following cases (continued):

4. When transferring a household to a new unit, the designated imputed income limit transfers to the new unit. The vacated unit maintains its designated imputed income limit as well.
5. To restore the average of either of these:
  - a. The minimum set-aside
  - b. The applicable fraction

©2023 GWEN VOLK INFOCUS, INC.

## New Regulations: The Available Unit Rule

What triggers the Available Unit Rule on a Project using the Average Income Set-Aside?

1. Households living in units designated as 20% - 30% - 40% - 50% or 60% are considered over-income when their income exceeds 140% of the imputed 60% income limit
2. Households living in units designated as 70% are considered over-income when their income exceeds 140% of the current 70% income limit
3. Households living in units designated as 80% are considered over-income when their income exceeds 140% of the current 80% income limit

©2023 GWEN VOLK INFOCUS, INC.

## New Regulations: The Available Unit Rule

New regulations provide more flexibility in how to restore the set-aside when a qualified household exceeds the designated income limit ceiling

1. The term “Next” Available Unit is not relevant for an Average Income Set-Aside Property
2. For example, if a household needs to transfer to another unit due to a reasonable accommodation for a disability, and the unit they need to transfer to has a lower imputed income limit designation than the unit they are currently residing in, you can move them to the needed unit and swap the designations of the units to restore the set-aside. (Visual example on next slide.)

©2023 GWEN VOLK INFOCUS, INC.

## Example:

### Redesignation due to a Reasonable Accommodation

Unit 9 80%	Unit 7 60%	Unit 5 60%	Unit 3 40% VACANT	Unit 1 60%
Unit 10 80%	Unit 8 70%	Unit 6 40%	Unit 4 40%	Unit 2 70%

Minimum Set-Aside is met (40% at 60% - The Qualified Group). Unit 3 is vacant. Tenant in Unit 10 begins using a wheelchair and requests a Reasonable Accommodation to Unit 3 which is a wheelchair accessible unit. He doesn't qualify for Unit 3 which is designated as 40% and needed to maintain the applicable fraction.

©2023 GWEN VOLK INFOCUS, INC.

# Example:

## Redesignation due to Over-Income Unit, Mixed Income Project

Unit 9 Market Rate	Unit 7 60% Over Income	Unit 5 60%	Unit 3 40%	Unit 1 60%
Unit 10 80%	Unit 8 60%	Unit 6 40%	Unit 4 40%	Unit 2 Market Rate

Minimum Set-Aside is met (70% of the designations are 60% or below –only need 40% of units to average 60% or less). Units 2 and 9 are Market Rate. Tenant in Unit 7 goes Over Income. **Option One:** Make Unit 7 Market Rate. You then have 60% of the designations 60% or below.

©2023 GWEN VOLK INFOCUS, INC.

# Example:

## Redesignation due to Over-Income Unit, Mixed Income Project

Unit 9 Market Rate	Unit 7 60% Over Income	Unit 5 60%	Unit 3 40%	Unit 1 60%
Unit 10 80%	Unit 8 60%	Unit 6 40%	Unit 4 40%	Unit 2 Market Rate Vacant

Minimum Set-Aside is met (70% of the designations are 60% or below –only need 40% to average 60% or less). Units 2 and 9 are Market Rate. Tenant in Unit 7 goes Over Income. **Option Two:** Redesignate Vacant Unit 2 as 60%. You don't need an individual to move in and qualify first (unlike the other set-asides).

©2023 GWEN VOLK INFOCUS, INC.

# New Regulations: The Applicable Fraction

## New Regulations: The Applicable Fraction

The Applicable Fraction is how the Owner determines the dollar value of the property that is “qualified” to take credits

1. It is the lesser of the Unit Fraction (% of qualified units divided by total units) or the Floor Space Fraction (% of square footage of qualified units divided by total square footage of all units)
2. Any “qualified group” can be used to determine the applicable fraction
3. If the owner wants to take maximum credits, they want the average imputed income designation of all the units to be at or below 60% of AMGI. That way they can theoretically achieve an Applicable Fraction of 100%.

©2023 GWEN VOLK INFOCUS, INC.



## New Regulations: The Applicable Fraction

The Applicable Fraction is how the Owner determines the dollar value of the property that is “qualified” to take credits (continued)

- 3. For properties that have Market Rate Units, the Applicable Fraction will never be 100%
- 4. For properties where units that were qualified but fall out of compliance, the owner will simply remove that unit from the “qualified group”.
  - a. This will reduce the applicable fraction
  - b. It will not necessarily change the set-aside which only has to be 40% of the units averaging 60%
  - c. However, removing one unit that was at a lower percentage (30% for example) may require the owner to remove other higher percentage units (70% or 80%) to offset the impact of not including that 30% unit in the average.

©2023 GWEN VOLK INFOCUS, INC.

## Example:

Impact of Removing an Over Income or other wise out of compliance unit numerator of the Applicable Fraction.

Unit 9 40%	Unit 7 40%	Unit 5 80%	Unit 3 80%	Unit 1 80%
Unit 10 40% Over Income	Unit 8 40%	Unit 6 40%	Unit 4 80%	Unit 2 80%

Minimum Set-Aside is met (50% of the designations are 60% or below –only need 40% of units to average 60% or less). The Average of all unit designations = 60% so the Applicable Fraction = 100%. Tenant in Unit 10 goes Over Income. This makes the minimum set-aside average 62%. If you remove Unit 5 also, this makes the average 60%. BUT, it reduces your Applicable Fraction from 100% to 80%.

©2023 GWEN VOLK INFOCUS, INC.

## New Regulations: Record Keeping

### New Regulations: Record Keeping

- The taxpayer must maintain official records in their books of the designations for both the unit designations and the applicable fraction calculations
- Temporary regulations are included in the Final Reg to allow State Agencies to determine the best time and manner for taxpayers to communicate this information
- IRS also emphasizes that state agencies report compliance, they do not impose penalties on the taxpayer. Only the IRS can do that.
- Projects that implemented the Average Income Set-Aside since it was authorized in 2018 and prior to this Final Rule, will be granted some wiggle room between 2018 and the effective date of the Final Rule.

©2023 GWEN VOLK INFOCUS, INC.

## Summary & Q & A

- The Average Income Set-aside is a bit complicated, but thanks to the IRS Final Rule, Owners and Developers now have greater clarity.
- We can expect to see more Owners opt to use the Average Income Set-aside now that the IRS has issued the Rule.

©2023 GWEN VOLK INFOCUS, INC.

thank you!

Gwen Volk

CPM®, NAHP-e®, RAM®, FHC®, SHCM®, HCCP®

[www.gwenvolk.com](http://www.gwenvolk.com)

[gwenvolk@gwenvolk.com](mailto:gwenvolk@gwenvolk.com)