Interpreting the Average Income Test, Part 1

GRACE ROBERTSON AND MARK SHELBURNE

As part of the Consolidated Appropriations Act of 2018, Congress revised Internal Revenue Code (IRC) Section 42 to include a new option for the Minimum Set-Aside (MSA) called the “Average Income Test.” The purpose of this article is to:

- Provide a literal interpretation of the Average Income Test (AIT)
- Discuss how (1) the test affects the definition of a “qualified low-income unit,” (2) the computation of the Applicable Fraction and (3) applying the Next Available Unit Rule

This article will not use the phrase “income averaging” to describe the new MSA option. Not only is the commonly-used shorthand technically inaccurate, it actually refers to an entirely distinct tax concept (applied in a different context). The IRS will always use the title “Average Income Test.”

Minimum Set-Aside (MSA) Election

To qualify as a low-income housing tax credit (LIHTC) project, an owner must provide a minimum number of low-income units. Effectively, the MSA is a threshold test. If the owner fails to provide at least the minimum number of low-income units, the project does not qualify under Section 42 of the IRC.

IRC 42(g)(1) provides three choices:

1. 20-50 Test, where at least 20 percent of the units are rent restricted and occupied by households with income less than 50 percent of area median gross income (AMGI),
2. 40-60 Test, where at least 40 percent of the units are rent restricted and occupied by households with income less that 60 percent of AMGI, or
3. Average Income Test, where at least 40 percent of the units are 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. The designated percentage may be 20, 30, 40, 50, 60, 70, or 80 percent. Further, the average of the designated income limits of the respective units

continued on page 2
cannot be greater than 60 percent, which is called the “Average Test,” and should not be confused with the “Average Income Test.”

Note that while the average income election does not require a distribution of income limits among different size low-income units, most (if not all) allocating agencies have policies mandating a pro-rata distribution.

**Applying the AIT MSA**

How is the AIT MSA applied? An example is helpful.

Suppose the owner of a qualifying 100 percent low-income building with 10 units elects the AIT and designates five units as 50 percent AMGI and five units as 70 percent AMGI.

<table>
<thead>
<tr>
<th>50%</th>
<th>70%</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>70%</td>
</tr>
<tr>
<td>50%</td>
<td>70%</td>
</tr>
<tr>
<td>50%</td>
<td>70%</td>
</tr>
<tr>
<td>50%</td>
<td>70%</td>
</tr>
</tbody>
</table>

To qualify as a low-income unit under Section 42(i)(3), (1) a unit must be occupied by an income-qualified household, (2) the rent must be restricted and (3) the unit must be suitable for occupancy. For the AIT, an owner should use the unit’s designated income limit to determine whether a household is income-qualified and compute the maximum allowable rent. In this example, all 10 units are qualified low-income units.

At least 40 percent of the units are qualified low-income units and the average designated AMGI for all the units is shown as follows.

\[
\frac{50\% + 50\% + 50\% + 50\% + 50\% + 70\% + 70\% + 70\% + 70\% + 70\%}{10} = 60\%
\]

Therefore, the owner has satisfied both requirements under Section 42(g)(1)(C).

**Accounting for Noncompliance**

The challenge is how to account for noncompliant low-income units. What happens if two of the 50 percent units are out of compliance at the end of the taxable year? There are eight qualifying low-income units; i.e., 80 percent. The owner has satisfied the first requirement of the AIT because at least 40 percent of the units are qualified low-income.

However, the average of the qualifying low-income units’ designated income limits is now 63 percent, computed as follows:

\[
\frac{50\% + 50\% + 50\% + 50\% + 50\% + 70\% + 70\% + 70\% + 70\% + 70\%}{8} = 63\%
\]

Has the owner satisfied the Average Test? A literal reading and careful analysis of the IRC is needed to answer this question.

Section 42(g)(1)(C)(ii)(I) requires the taxpayer to “designate the imputed limitation of each unit taken into account.” The following paragraph, Section 42(g)(1)(C)(ii)(II), requires only that “the average of the income limitations designated under (I) shall not exceed 60 percent of area median gross income.” Paragraph II is specific to each unit in paragraph I. Noncompliant low-income units are addressed when determining whether at least 40 percent of the units are qualified low-income.

continued from page 1

continued on page 3
units. There is no requirement to recompute the average income limit to account for noncompliant units a second time when determining whether the Average Test is satisfied. As long as the owner has designated income limits for the units and the average of those designations is 60 percent or less, the Average Test is met.

In this case, the Average Test is computed based on the designation of all 10 units, as

\[
\left( \frac{50\% + 50\% + 50\% + 50\% + 50\% + 70\% + 70\% + 70\% + 70\% + 70\%}{10} \right) = 60\%
\]

Therefore, the owner has satisfied both requirements for the AIT MSA election: at least four of the 10 units are qualified low-income units and the average of the income designations of all the low-income units is 60 percent. The owner, however, would not be entitled to credits for the two noncompliant units.

**Next Available Unit Rule**

Congress also revised the Next Available Unit Rule to account for the AIT. Generally, this rule requires an owner to rent the next available unit (of comparable or smaller size) to an income-qualified household if the income of the occupants of a low-income unit increases above 140 percent of the applicable income limit.

If an owner elects the AIT, the rules are adapted to account for the designated income limits associated with the individual low-income units.

First, a low-income unit will be considered over-income if the household’s income is:

- More than 140 percent of 60 percent AMGI if the unit’s designated income limit is 20, 30, 40, 50 or 60 percent.

Second, an over-income unit ceases to be a qualified low-income unit if any unit in the building of a comparable or smaller unit is occupied by a new household whose income exceeds the designated income limit of that unit (based on the designated income limit prior to becoming vacant). If the unit was not previously occupied by a low-income household (a market-rate unit), then the owner designates the income limit such that the project continues to meet the Average Test.

For example, low-income household A lives in a unit designated at 30 percent of AMGI and low-income household B lives in a unit designated at 70 percent of AMGI. When A’s income exceeds 140 percent of 60 percent AMGI, or when B’s income exceeds 140 percent of 70 percent AMGI, the Next Available Unit Rule is applied. What happens if both households are determined to be over-income at the same time?

<table>
<thead>
<tr>
<th>Market Rate</th>
<th>Market Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over-Income</td>
<td>Over-income</td>
</tr>
<tr>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>30%</td>
<td>70%</td>
</tr>
</tbody>
</table>

Without consideration of unit size for the example, the issue is whether the AIT is satisfied. Before consideration of the over-income units, the Average Test is

\[
\left( \frac{30\% + 30\% + 30\% + 30\% + 30\% + 70\% + 70\% + 70\% + 70\%}{8} \right) = 50\%
\]
continued from page 3

If a market-rate unit is first rented to a household with income less than 30 percent of AMGI, there will be nine units with income designations. The Average Test is

\[
\left( \frac{30\% + 30\% + 30\% + 30\% + 30\%}{70\% + 70\% + 70\% + 70\% + 70\%} \right) \div 9 = 48\%
\]

If a market-rate unit is first rented to a household with income less than 70 percent of AMGI, there will again be nine units with income designations. The Average Test is

\[
\left( \frac{30\% + 30\% + 30\% + 30\%}{70\% + 70\% + 70\% + 70\% + 70\%} \right) \div 9 = 52\%
\]

In both cases, the Average Test is satisfied. The owner can rent either unit first, but must replace both over-income units before renting a market-rate unit. If the Average Test is not satisfied by either option, the owner can select an income limit such that the Average Test is satisfied (see Section 42(g)(2)(v)(II)).

As suggested above, combining the AIT MSA and market-rate units creates additional challenges.

The level of compliance complexity is arguably unprecedented in the LIHTC field. Some agencies have even precluded owners from incorporating both.

Part 2 of this article will appear in the April issue of the Novogradac Journal of Tax Credits and will cover questions about the AIT.

Editorial note: A literal interpretation of the new Average Income Test and its application has been presented in this article. Please consult with your state agency as the housing agencies vary in interpretation of the Average Income Test.

Grace Robertson served as the IRS’ program analyst for the Low-Income Housing Credit Program from 1999 to 2014. She is the primary author of the Guide for Completing Form 8823, IRC Section 42 Audit Technique Guide, and the LIHC newsletters. She earned an accounting degree from the University of Utah (1984) and a postgraduate degree, Organizational Leadership and Innovation, from Marymount University in Virginia.

Mark Shelburne directs the Office of Housing Finance for the Georgia Departments of Community Affairs. Previously, he was a senior manager for Novogradac Consulting, where he contributed to authoring an early draft of the average income test. He served as counsel and policy coordinator for the North Carolina Housing Finance Agency’s rental programs for 13 years. He has degrees in law, planning, and public policy from UNC Chapel Hill.