Identifying and Correcting Noncompliance – Average Income Test

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The affordable housing industry was thrilled to learn about the introduction of the Average Income Test (AIT) as a new minimum set-aside option in 2018. However, our enthusiasm was dampened by the problematic proposed regulation published in 2020. Nevertheless, we were overjoyed when the final regulation was released in 2022, and we celebrated the removal of the nonsensical provisions from the proposed regulation.

One of the most exciting aspects of the final regulation was the allowance for unit designations to change. This provision provides taxpayers with greater flexibility and opportunities to address noncompliance issues. The other change that brought a sigh of relief was that it is no longer mandatory to factor in the imputed income limitation of every low-income unit while assessing compliance with the AIT requirement. Instead, only a "group of qualified units" that accounts for at least 40% of the units in the project must be considered while determining AIT compliance.

This article aims to showcase the various methods available to taxpayers for rectifying noncompliance issues in an AIT project.

AIT Fundamentals

To effectively tackle noncompliance issues in AIT projects, it is imperative to have a basic understanding of the AIT requirements as a whole. Therefore, this article will begin by providing an overview of the Average Income Test requirements.

What is the AIT Set-Aside?

To satisfy the AIT minimum set-aside requirement, a project must have 40% or more units that are designated as LIHTC units and assigned an allowable income limit. The average of the income limits for these units must not exceed 60%. This option permits projects to have higher income limits, provided that the average of the income limits for all low-income units remains 60% or less.

Under the AIT, the allowable income limits are as follows:

- 20%
- 30%
- 40%

- 50%
- 60%
- 70%
- 80%

In order to meet the AIT, a two-part test must be met:

- *Part 1: 40% Test*
  Taxpayers must designate an “AI Unit Group" that comprises at least 40% of the total units in the project. The units within AI Unit Group must be rent-restricted and occupied by households with an annual income that does not exceed the specified income limit.
- *Part 2: 60% Test*
  The designations assigned to the units within the AI Unit Group must average 60% or less.

Applicable Fraction and AIT

Understanding the correlation between a project's minimum set-aside and a building's applicable fraction is a crucial factor in tackling noncompliance for an AIT project.

For an AIT project to qualify as a LIHTC project, the minimum set-aside requirement must be met and consistently maintained throughout the project’s compliance period. The applicable fraction, which indicates the percentage of the building’s space occupied by low-income tenants, is a component in the computation of the taxpayers' annual credit for the building.

As previously discussed, the final regulation states that it is no longer necessary to include all low-income units’ imputed income limitation when determining compliance with the AIT, only a “group of qualified units” representing at least 40% of the units in the project must be used when determining AIT compliance. However, many projects have low-income units that exceed the 40% minimum set-aside requirement, and these excess units are factored in when determining a building’s applicable fraction. However, it is important to note that simply designating all of these excess units as 80% may not necessarily allow a taxpayer to claim credits on them.

In order for taxpayers to claim credits for excess units, it is necessary to carefully evaluate the income limits designated to these units to ensure compliance with the final regulation.

For an AIT project, in order for a unit to be counted as a low-income unit in the building’s applicable fraction, the unit must be included in a taxpayer-identified group of units herein referred to as the applicable fraction group (AFG).

The definition of a “qualified group of units” for the purpose of the AFG is a group of units, for which:

- The rents for the units included in the group are rent-restricted.
- The units included in the group are occupied by qualified households that meet the income limit designated to the unit.
- The average of the income limits designated to the units included in the group average is 60% or less.

Essentially, in order for a unit in a LIHTC project to be defined as low-income for purposes of its building’s applicable fraction the unit must be a part of a group of units within the project, where the income limits designated to the units within the group average 60% or less.

For multiple building projects, as defined by the IRS Form 8609, the units included in the AFG are not limited to one building and can span multiple buildings.

Having covered the essential concepts of the AIT, let's now shift our focus to exploring methods for identifying instances of noncompliance.

Identifying & Correcting Noncompliance

Our primary aims in identifying and addressing federal noncompliance are to reduce or eliminate credit loss resulting from such noncompliance. To achieve this, we strive to accomplish two goals. One, we want to correct all instances of noncompliance prior to receiving notification of an agency audit. Two, we need to ensure that all noncompliance issues are rectified before the last day of the owner's taxable year.

Correcting issues of noncompliance before receiving notification of an agency audit is crucial because any such issues that are identified and resolved by the owner prior to agency notification of an audit will not be reported to the IRS. This is designed to incentivize owners who practice good due diligence and take proactive steps to ensure compliance with LIHTC requirements.

Correcting issues prior to the end of the year is just as critical to avoiding and minimizing credit loss. The number of units that are determined to be low-income units for purposes of determining the applicable fraction is based on the number of units that are in compliance as of the last day of the owner’s tax year.

Example – Correcting Noncompliance Prior to the Last Day of Tax Year

At a LIHTC building, where the owner’s taxable year ends Dec. 31, during the fourth year of the compliance period (2023), management moves in an ineligible household in error. The ineligible

household moved in on May 3, 2023. The issue of noncompliance was discovered on Sept. 12, 2023. Management incentivized the household to move out on Nov. 1, 2023. A new qualified household moved into the unit on Nov. 30, 2023. Since the unit was back in compliance as of the last day of the owner's tax year, there is no decrease in the building's Applicable Fraction or qualified basis and, therefore, no credit loss.

AIT and Correcting Noncompliance

As the Final Regulation now allows for unit designations to change, successfully addressing non-compliance issues is much more achievable.

Unit Designation Changes to Correct Noncompliance

There are several instances where changing a unit's income limit designation can be changed to correct noncompliance and to minimize credit loss.

Timings for Unit Designation Changes

For a vacant unit – The unit's designation must be changed before being occupied.
(Note: When changing the income level designation of a vacant unit in order to address noncompliance, the unit must be occupied by a qualified household by the end of the taxpayer's taxable year.

For an occupied unit – The unit's designation must be changed, prior to the last day of the taxable year.

In some cases, changing a unit's income limit designation can be an effective strategy for remedying noncompliance and minimizing credit loss.

1. A vacant market rate unit can be re-designated as a low-income unit, designated an imputed income limitation, and then rented to a qualified household in order to restore AIT compliance
2. An occupied market rate unit can be re-designated as a low-income unit and designated an imputed income limitation in order to restore AIT compliance, but only if the occupant of said unit meets the designated imputed income limitation.
3. The unit designation on a vacant, previously qualified, low-income unit can be reduced to a lower income limit level and then rented to a qualified household in order to restore AIT compliance
4. The unit designation on an occupied and qualified, low-income unit can be reduced to a lower income limit level in order to restore AIT compliance, but only if the occupant of said unit meets the new, lower designated imputed income limitation.

Examples regarding how to achieve compliance by changing unit designations are provided below.

Bayview Apartments – 10-Unit Building, All units are the same size – New Construction

YEAR ONE

Eligible Basis: $3,000,000 X
Applicable Fraction: 80% =
Qualified Basis: $240,0000

Qualified Basis: $240,0000 X
Credit Percentage 9% =
Annual Credit $216,000

Bay View

YEAR ONE

101 80%	106 40%
102 80%	107 40%
103 80%	108 40%
104 80%	109 40%
105 MKT	110 MKT

AIT Group

Applicable Fraction Group

YEAR TWO:

On December 15 of Year Two, the household in unit 106 was determined to have been income ineligible at the time of initial certification earlier in the year, due to a calculation error made by management.

Management will not be unable to get Unit 106 back into compliance by the last day of the taxable year, therefore, unit 106 must not be included as a low-income unit and must be excluded from the AFG.

The exclusion of Unit 106 results in the average for the AFG to exceed 60%, meaning in order to avoid complete credit loss:

1. An 80% unit must be excluded from the Applicable Fraction Group in order to get the average below 60%, OR
2. Another unit must be designated or redesignated to a lower income level that will reduce the average to 60% or below.

Scenario 1:

In order to reduce the AFG average to 60% or below, management opts to exclude unit 101, an 80% unit, from the applicable fraction and the AFG, reducing the average for the AFG to 51.52%.

While this action does reduce the AFG Average below 60%, it also reduces the applicable fraction for the BIN from 80% to 60%, which reduces the annual credit from $216,000 to $162,000, resulting in a credit loss of $54,000.

Bay View

Scenario 1

101 80% (excluded)	106 (excluded)
102 80%	107 40%
103 80%	108 40%
104 80%	109 40%
105 MKT	110 MKT

AIT Group

Applicable Fraction Group

Scenario 2:

In order to reduce the AFG average to 60% or below, management opts to rent unit 110, a vacant market-rate unit, as a LITHC unit with a designated income level of 40% and occupies the unit with a qualified household prior to the end of the tax year.

Taking this action, completely addressed the noncompliance by reducing the AFG average to 60% or below without reducing the BIN's applicable fraction which avoided credit loss.

Bay View

YEAR TWO

101 80%	106 MKT
102 80%	107 40%
103 80%	108 40%
104 80%	109 40%
105 MKT	110 40%

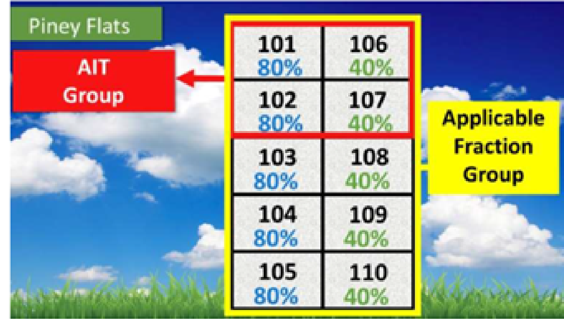
AIT Group

Applicable Fraction Group

Piney Flats Apartments – 10-Unit Building, All units are the same size

YEAR ONE

Eligible Basis:	$3,000,000 X
Applicable Fraction: 100% =	
Qualified Basis:	$300,0000
Qualified Basis:	$300,0000 X
Credit Percentage 9% =	
Annual Credit	$270,000



YEAR TWO:

In Year 2, Unit 106 is destroyed by fire and is not restored to habitable condition by the end of the year. Excluding 106 from the AFG results in an average in excess of 60%.

Group to exceed 60%, meaning in order to avoid complete credit loss and to restore the Minimum Set-Aside:

1. An 80% unit must be excluded from the AFG in order to get the average below 60%, OR
2. A unit must be redesignated to a lower income level that will reduce the AFG average to 60% or below.

Scenario 1:

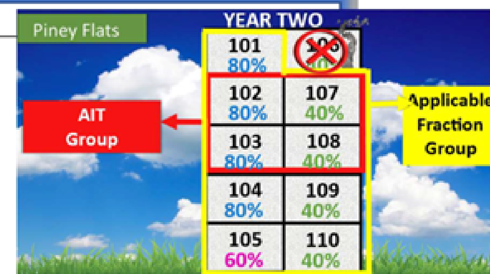
In order to reduce the AFG average to 60% or below, management opts to exclude unit 101, an 80% unit, from the applicable fraction and the AFG, reducing the average for the AFG to 60%. Management also changes the units included in the AIT Group.

While this action does reduce the AFG Average below 60%, it also reduces the applicable fraction for the BIN from 100% to 80%, which reduces the annual credit from $270,000 to $216,000, resulting in a credit loss of $54,000.

Scenario 2:

In order to reduce the AFG average to 60% or below, management determines that the household occupying unit 105, which is designated as an 80% unit, income qualifies at 60%. Management redesignates unit 105 to 60% prior to the end of the taxable year. Management also changes the units included in the AIT Group.

Taking this action addressed the issue of noncompliance by reducing the AFG average to 60% while minimizing the amount of credit loss. This action reduces the applicable from 100% to 90%, which reduces the annual credit from $270,000 to $243,000, resulting in a credit loss of $54,000.



As vice president of training and compliance policy, Amanda Lee Gross brings her vast experience in affordable housing to our training and compliance services. She learned the affordable housing industry from the ground up, starting as a site manager and quickly working her way to a compliance director. Ms. Gross has leveraged that experience and became a nationally recognized expert trainer in Fair Housing, LIHTC, RD, HUD and HOME. She has conducted hundreds of training workshops and seminars throughout the country, helping property management professionals become more effective and better able to protect the assets and reputation of companies. Ms. Gross is a thought leader in the affordable housing industry, speaks at several industry conferences each year and works closely with a number of state agencies.

Gary Kirkman joined US Housing Consultants with more than 17 years working in the affordable housing industry. Gary's experience includes hands-on experience as a regional property manager, an award-winning community manager, a training director for a property management company, and as a trainer covering multiple funding programs. In his years of experience as a trainer, he has developed a style that combines the right amount of entertainment and communication of often deeply complex information. Prior to becoming a compliance trainer, Mr. Kirkman was an award-winning community manager and was awarded Best Overall Compliance in Affordable Housing for the Southeast Region for a property management company portfolio.

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