Back to Basics: LIHTC Minimum Set-Aside

by Scott Michael Dunn, CEO of Costello Compliance

In this series, we cover the basics of tax credit compliance and how to research answers to questions that tax credit professionals have daily. In this Basics article, the focus will be on the important minimum set-aside election made for each tax credit project.

Household income and rent limits for units are two of the fundamental requirements of tax credit compliance, and the minimum set-aside establishes the income and rent limits that are used. Additionally, the point at which a property loses all its tax credits is baked into the minimum set-aside, so this is a crucial topic to understand.

What Does the Minimum Set-aside Do?

The minimum set-aside determines the minimum required threshold number of tax credit units and the income limits applicable to the property. Until 2018, there were three options: 20-50, 25-60 and 40-60.

Starting in 2018, two additional "average test" options were added, for a total of five possible minimum set-asides.

How and When is the Minimum Set-aside Calculated?

The minimum set-aside is calculated based on the number of units, regardless of unit size, and is tested on the last day of each tax year. For instance, if a project needs 40% of its units to meet the minimum set-aside, and has a total of 100 units, 40 units must be maintained as Low-Income Housing Tax Credit (LIHTC). It doesn't matter if the individual units meeting this test are studio apartments or four-bedroom apartments — one unit is one unit when calculating the minimum set-aside.

The minimum set-aside election for a project is made by the owner after the first year of the credit period on IRS Form 8609 line 10(c). The election is irrevocable, so only projects that filed 8609(s) after March 23, 2018, and elect the new Average Income Test minimum set-asides have the newest options.

Is This a Project or Building Rule?

Unlike the applicable fraction, which is calculated for each building, the minimum set-aside is met on a project basis, as defined by the election on IRS Form 8609 8(b). This means that the

multibuilding election will determine if the required percentage of units can be met across one or multiple buildings.

Overview of the Minimum Set-Asides

Minimum Set-Asides (as elected on 8609 line10c) LIHTC

c Elect minimum set-aside requirement (section 42(g)) (see instructions):
☐ 20-50 ☐ 40-60 ☐ Average income ☐ 25-60 (N.Y.C. only)

20% | units at the project must be LIHTC to claim ANY credits

50% | MTSP income limits apply to ALL tax credit units at the project

40% | units at the project must be LIHTC to claim ANY credits

60% | MTSP income limits apply to ALL tax credit units at the project

40% | units at the project must be compliant with their designation

60% | The average of MTSP income limits applied to all units. These designations are from 20% - 80%

20-50 | A minimum of 20% of a project's units must be maintained as tax credit continually. The definition of "low income" at the property is 50% Multifamily Tax Subsidy Projects (MTSP), so all units that will be considered tax credit must be at or below 50%.

40-60 |A minimum of 40% of a project's units must be maintained as tax credit continually. The definition of "low income" at the property is 60% MTSP, so all units that will be considered tax credit must be at or below 60%.

25-60 | This set-aside applies exclusively to New York City. A minimum of 25% of a project's units must be maintained as tax credit continually. The definition of "low income" at the property is 60% MTSP, so all units that will be considered tax credit must be at or below 60%.

The Average Income Tests (Updated based on the 2022 AIT Regulation)

AIT | Effective for minimum set-aside elections after March 23, 2018, the definition of "low income" at the property includes units designated by the owner in 10% increments — 20%, 30%, 40%, 50%, 60%, 70% or 80% MTSP. These designations must average 60% MTSP.

Therefore, units that will be considered tax credit may now include 70% and 80% units at these properties, but enough must be designated below 60% to average 60%. To meet the minimum set-aside, a minimum of 40% of a project's units must meet the designation assigned to the unit, and these must average 60% continually.

2022 Update: Additionally, all units that are used to claim tax credits in the applicable fractions for all buildings throughout the project must have designations that average 60%.

AIT (NYC) | This set-aside applies exclusively to New York City. Effective for MSA elections after March 23, 2018, the definition of "low income" at the property includes units designated by the owner in 10% increments – 20%, 30%, 40%, 50%, 60%, 70% or 80% MTSP. These designations must average 60% MTSP.

Therefore, units that will be considered tax credit may now include 70% and 80% units at these properties, but enough must be designated below 60% to average 60%. To meet the minimum set-aside, a minimum of 25% of a project's units must meet the designation assigned to the unit, and these must average 60%, continually.

2022 Update: Additionally, all units that are used to claim tax credits in the applicable fractions for all buildings throughout the project must have designations that average 60%.

Implications of Noncompliance

In the instructions to IRS Form 8823, the IRS summarizes the consequences of not meeting the minimum set-aside by the end of the first year of the credit period, saying "if the property fails to meet the minimum set-aside by the deadline, no credits can ever be claimed." Clearly, meeting the minimum set-aside during lease-up by the end of the year after placing in service is crucial to a tax credit property's survival. This is the worst possible noncompliance event.

After the initial deadline is met, if the minimum percentage of units at a project are not in compliance at the end of each following year of the compliance period, the IRS continues by stating that "subsequent violations of the set-aside results in recapture of all previously claimed credits and credits cannot be claimed until set-aside is met again." The recapture penalty is generally one-third of all the credits claimed up to the point noncompliance occurred, and all

current credits are disallowed until the problem causing the minimum set-aside violation is resolved.

It is very important to understand that a violation of the minimum set-aside determines if credits can be claimed for a project at all. However, the actual credits claimed by a project that is compliant with its minimum set-aside will be based on the applicable fraction for each building.

2022 Update: For AIT properties, losing a unit to noncompliance may result in the loss of more than one unit when claiming tax credits if the loss of the noncompliant unit raises the average across the project to exceed 60%.

State or Other Set-asides

States or other federal programs funding a project may impose additional set-asides that are more restrictive than the minimum set-aside would require. A 40-60 property has 60% income and rent limits on all tax credit units, based in the federal minimum set-aside. However, it may also have units restricted by state policy to 50% and 40%, for instance. These are generally established during the tax credit application process, as spelled out in the state Qualified Allocation Plan (QAP).

Similarly, units may be restricted to 50% income limits and low HOME rent limits because the property is also HOME funded. Noncompliance with these set-asides will not cause a loss of tax credits, as long as all units are in compliance with the minimum set-aside limits.

When noncompliance occurs, compliance professionals must understand the scope of the problem to develop a recovery plan. Knowing the difference between a violation of federal tax credits and state or other programs is an important part of this assessment.

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