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A Gift from the IRS

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Mistakes Happen

At US Housing Consultants, we provide a training titled "Common Household Eligibility Errors," and the very first thing we teach our attendees is that mistakes happen. We always hear the saying, "No one is perfect." And, yes, that includes all of us.

Although we cannot be perfect, we can still strive to be, and one thing we can do in pursuit of compliance perfection is to diligently work to understand program requirements, and how those requirements affect a project's policies and procedures. By fully understanding the program requirements, we can reduce errors that result in the denial of households that are in fact eligible, as well as eliminate errors that result in the approval of ineligible households.

Additionally, we want to strive to avoid the issuance of the IRS Form 8823 to our projects.

State Housing Finance Agencies (HFAs) are required to report any issue of federal noncompliance they discover or made aware of under the Treasury Regulations §1.42-5(a). HFA's **must** file the 8823 with the IRS, even if the issue of noncompliance is corrected.

"The Gift"

The IRS provides owners with a gift, whether we realize it or not. "A gift," you say? Yes, exactly, a gift. This is surprising to some, as the IRS is known more for taking than for giving.

The 8823 Guide, Chapter 3, page 3-2 states, *"Noncompliance issues identified and corrected by the owner prior to notification of an upcoming compliance review or inspection by the state agency need not be reported, i.e., the owner is in compliance at the time of the state agency's inspection and/or tenant file review."*

There's your gift.

Essentially, this gift means is that if an owner/agent identifies and corrects an issue of noncompliance **PRIOR** to being notified of an agency audit, the HFA should not issue an 8823. However, if an issue of noncompliance is identified and corrected **AFTER** notification of an audit is received, the HFA will issue an 8823 for the issue of noncompliance (if discovered).

By conducting internal audits and physical inspections prior to receiving agency notification of an upcoming inspection, owners/agents are ensuring that they learn of any mistakes before the

Housing Finance Agency discovers the error and reports it as being out of compliance on the IRS Form 8823.

In this article, the following will be discussed:

- Federal vs. State Noncompliance
- Impact of Federal Noncompliance
- Identifying Noncompliance
- Correcting Noncompliance

Federal vs. State Noncompliance

Is it important to understand the difference between federal noncompliance and state noncompliance? Absolutely! HFAs can only issue 8823s for issues of federal noncompliance. This does not mean the owner/agents should disregard state compliance requirements, as there are stiff penalties that can be assessed for state noncompliance. The difference is that state noncompliance will not result in credit loss or credit recapture.

Common state compliance requirements that are confused as federal requirements:

- Full income recertifications for 100% projects
- Prohibiting adding a new member in the first six or 12 months of occupancy
- Overcharging rent for a unit restricted to a state set-aside
- Citizenship requirements/SSN requirements
- Criminal/felony restrictions
- 12-month leases

Example – Springwood Manor

- *Single BIN project*
- *Minimum Set-Aside: 40-60*
- *State Set-Aside: 20% of units restricted to 50%*
- *100% of the units are LIHTC*

Springwood Manor had a LIHTC monitoring review where the following findings were cited:

1. *Unit 102 – 60% - Full income recertification was not completed. (State Noncompliance - No 8823)*
2. *Unit 103 – 50% - Household was charged a gross rent that exceeded the 50% limit. (State Noncompliance - No 8823)*
3. *Unit 203 – 60% - Household was charged a gross rent that exceeded the 60% limit. (Federal Noncompliance - 8823 issued)*
4. *Unit 201 – 50% - A new member was added to the household 10 months after initial occupancy, and the inclusion of this new member's income exceeds the 60% limit. (State Noncompliance - No 8823)*
5. *Unit 403 – 60% - At the time of move-in, the household's income (two-person household) of $48,750 exceeds the 60% income limit for two persons of $47,340. (Federal Noncompliance - 8823 issued)*
6. *Unit 502 -50% - At the time of move-in, the household's income (two-person household) of $46,270 exceeds the 50% income limit for two persons of $45,860. (State Noncompliance - No 8823)*
7. *Unit 602 – 60% - The initial lease for this unit was only six months, instead of 12 months. (State Noncompliance - No 8823)*

Of the above seven findings, only two of the findings are considered issues of federal noncompliance, in which case, the HFA would issue an 8823 (unless the owner/agent is able to demonstrate that units 203 and 403 were always in compliance).

Although the owner/agent must correct the state noncompliance findings and adjust their policies and procedures to ensure that the HFA's requirements are adhered to going forward, 8823s should not be filed for state noncompliances.

Impact of Noncompliance

It is important to understand the impact of federal noncompliance on a project's credits. When a unit is out of compliance as of the last day of the owner's tax year, the unit cannot be included in the numerator when determining the applicable fraction, which will result in a decrease in the qualified basis. In addition, the unit that is out of compliance cannot be counted as a tax credit unit when determining the minimum set-aside.

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Applicable Fraction and Qualified Basis Violations

The Qualified Basis is part of the formula used to determine an owner’s annual credit. The formula is as follows:

> Eligible Basis × Applicable Fraction = Qualified Basis
>
> Qualified Basis × Applicable Credit Percentage = Annual Tax Credit

Applicable Fraction

Simply speaking, the applicable fraction for a building is a representation of the percentage of the building that houses the qualified low-income households.

The applicable fraction is determined by the lesser of the total tax credit units being divided by all residential units (unit fraction) or the total tax credit square feet being divided by all residential square feet (floor space fraction) based on the number of low-income units that are in compliance as of the last day of the owner’s tax year.

Qualified Basis Violations

As the qualified basis is the result of the eligible basis multiplied by the applicable fraction, a decrease in the applicable fraction will decrease the qualified basis, which ultimately decreases the credit allowed and can result in a qualified basis violation.

A qualified basis violation occurs when a building’s qualified basis at the close of any year during the 15-year compliance period has decreased from the preceding year’s qualified basis.

Impact of Noncompliance

Example – Woodsprings Manor:

- *Single BIN project*
- *Minimum Set-Aside: 40-60*
- *100% of the units are LIHTC*
- *10 units, all units are 1,000 square feet*

Year 1:	**Annual Credit: $270,000**
Eligible Basis: $3,000,000	$3,000,000 × 100% = $3,000,000
Applicable Fraction: 100%	$3,000,000 × 9% = $270,000
Qualified Basis: $3,000,000	
Applicable Credit Percentage: 9%	

Year 2:	**Annual Credit: $216,000**
Eligible Basis: $3,000,000	$3,000,000 × 80% = $2,400,000
Applicable Fraction: 80%	$2,400,000 × 9% = $216,000
Qualified Basis: $2,400,000	
Applicable Credit Percentage: 9%	

At the end of the taxable year, 2022, of year two of the compliance period, two units are determined to be out-of-compliance. These units must not be included as low-income units when *determining the applicable fraction. This reduction in the applicable fraction reduces the qualified basis and the owner's annual credit for 2022. The two noncompliant units result in a credit loss of $54,000 and a decrease in qualified basis of $600,000.*

Identifying Noncompliance

Issues of noncompliance are typically identified during file audits conducted by housing finance agencies or investors, or identified during internal audits conducted by the owner/agent.

To reduce the amount of 8823s potentially issued to the project, the goal for the owner/agent is to identify and correct issues of noncompliance before receiving notification of an agency audit.

As previously mentioned, to reward owner/agents for practicing good due diligence, the IRS stipulates that if the owner/agent identifies and corrects an issue of noncompliance prior to being notified of an agency audit, the agency will not issue an 8823 for the corrected noncompliance.

In order to fully take advantage of this "gift," owner/agents need to have policies and procedures in place for conducting internal compliance reviews.

Internal File Reviews

Internal file reviews are generally conducted by a management company's compliance department, regional manager or by a third-party file review service (such as US Housing Consultants). Typically, internal file reviews take two forms: ongoing file reviews and periodic file reviews.

- Ongoing File Reviews

Ongoing file reviews typically occur prior to the execution of the Tenant Income Certification form and lease agreement. The files are usually prepared by the management staff, who then submits the file to the designated reviewer for review and approval. Once the file is reviewed, the reviewer will provide an approval or correction report to the management staff.

- Periodic File Reviews

Periodic file reviews are internal reviews that are conducted on a periodic basis. Some management companies opt to conduct periodic reviews in lieu of having every certification reviewed and approved prior to executing the certifications. Other management companies will use periodic reviews as a supplement to ongoing compliance reviews and to ensure the quality of the ongoing reviews.

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Correcting Noncompliance

Timing for Correction

In order to avoid 8823s, credit loss and credit recapture, it is imperative that all issues of federal noncompliance are corrected prior to being notified of an agency audit and no later than the last day of the taxable year.

In providing our consulting and training services across the United States, we often run across management companies that either do not have an internal audit procedure or they conduct their internal file audits too close to the end of the taxable year, which does not always allow time to correct areas of noncompliance. That is quite scary. Let’s review two examples.

Example – Unable to Correct Noncompliance Prior to Last Day of Tax Year

An owner’s tax year ends on Dec. 31. On Dec. 5, 2022, of the fourth year of the compliance period, the owner/agent conducts an internal file audit and discovers that an over-income household was moved in on July 17, 2022, because of owner/agent error.

In order to correct the noncompliance, the owner/agent must incentivize the over-income household to move out of the unit. Then the owner/agent must reoccupy the unit with a LIHTC qualified household by Dec. 31, 2022. The unit was vacated on Dec. 30, 2022, but the owner/agent was not able to get the unit re-occupied by a qualified household by Dec. 31, 2022.

As the last household to occupy the unit was an over-income household, the unit must not be treated as a low-income unit when determining the applicable fraction and determining whether the minimum set-aside has been met/maintained.

When asked for our opinion, we advise clients to ensure that the timeline used for conducting periodic reviews allows ample time to fully correct any issues of federal noncompliance.

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

An owner’s tax year ends Dec. 31. On Oct. 1 of the fourth year of the compliance period, the owner/agent conducts an internal file audit and discovers that management moved in an ineligible household in error on July 17.

Management incentivized the household to move out of the unit, and the household vacated the unit on Nov. 1. A new qualified household moved into the unit on Nov. 30.

Because the unit was in 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, which means that there is no credit loss for the tax year.

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.