What Every LIHTC Professional Needs to Know About IRS Form 8823

by A.J. Johnson

The IRS Form 8823, titled “Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition,” is utilized by state agencies to report noncompliance with the Low-Income Housing Tax Credit (LIHTC) program or the disposition of buildings within the program. These agencies oversee the LIHTC properties in their jurisdiction and are required to notify the IRS of any compliance issues or when a property is no longer part of the program. The form details the specific nature of the noncompliance or disposition, ensuring the IRS has accurate records for monitoring and administering the tax credits effectively, thereby maintaining the integrity of the LIHTC program.

When is the 8823 Sent to the IRS?

An IRS Form 8823 must be submitted to the IRS by state agencies overseeing LIHTC properties under specific circumstances:

- *Noncompliance with LIHTC Requirements:* If a state agency identifies noncompliance with the provisions of the LIHTC program at any property, it is required to file Form 8823. Noncompliance can include a range of issues, such as failure to meet tenant income and rent requirements, failure to maintain the property, or other violations of the LIHTC program's regulations.
- *Correction of Noncompliance:* If noncompliance is corrected within a certain timeframe, the agency reports the initial noncompliance and the corrective action taken on Form 8823. This helps the IRS track both the issue and the resolution.
- *Building Disposition:* If a building or an interest therein is disposed of (sold or otherwise transferred), the agency must report this on Form 8823. This is crucial because the LIHTC program requires a certain period of compliance, and disposition can affect the continuity of the program’s benefits.
- *Deadline for filing:* The form must be filed within 45 days after the end of the correction period or, if earlier, 45 days after the state agency becomes aware of the noncompliance or building disposition. This timely reporting ensures that the IRS can monitor the integrity of the LIHTC program and take necessary actions if required.

Although the form is used to report the disposition or change in ownership status of a LIHTC building, operators of LIHTC properties are most concerned with issues of noncompliance, and that will be the focus of this article.

Before we begin a discussion of specific types of noncompliance, a review of some of the other information reported on the 8823 will be useful.

- *Line 7:* Line 7 of the form informs the IRS of how many apartment units are in a building, how many are low-income, how many were reviewed and how many have noncompliance. This is important because the IRS can determine whether the building exhibits a "pattern" of noncompliance. For example, if the HFA reviews 10 units in a building and there is noncompliance in one unit, this does not indicate a pattern. But if seven of the 10 units were out of compliance, this is likely to attract additional scrutiny from the IRS.
- *Line 8: Date of Noncompliance:* This line is used to indicate the specific date when the noncompliance was identified. Accurately reporting the date is crucial as it helps determine the beginning of the correction period and ensures timely action in addressing the issue.
- *Line 9: Date Noncompliance was Corrected:* If the noncompliance issue has been resolved, this line is used to report the date on which the correction was completed. This line is essential for documenting that the issue has been addressed and for determining the timeliness of the corrective action. If the noncompliance has not been corrected by the time of reporting, this line will be left blank.
- *Line 10: Correction of Previously Reported Noncompliance:* This is one of the most important elements of the form. Although the HFA may only allow 90 days for correction of noncompliance (with a possible extension of up to six months), owners actually have three years to correct noncompliance from the date of the original correction deadline. If the noncompliance is corrected within this three-year timeframe, the HFA will report it to the IRS by checking Line 10 and placing a correction date on Line 9. This will put the building back into compliance and possibly reduce the amount of credit loss to the building.

Critical Areas of Noncompliance

Not all noncompliance is created equal. Some areas of noncompliance place a building's credits at risk, while others are simply an indicator that a program requirement has not been met. In many cases, failure to follow the rules of the LIHTC program will not result in a loss or recapture

of credits. The form contains 17 possible failures of compliance. The remainder of this article will focus on the eight that have the greatest potential for resulting in credit loss or recapture.

- *Line 11a – Household income above the income limit upon initial occupancy:* If the HFA determines that a household had income in excess of the qualifying income limit at move-in, it is reported on this line. This is also the case if the documentation in the file is inadequate to demonstrate eligibility at move-in.

  At a minimum, the following documentation is required for move-in files: (1) application or Income and Asset Questionnaire; (2) verification of income and assets [except when the HFA will accept self-certifications of assets of $50,000 or less]; (3) student status; and (4) a Tenant Income Certification (TIC) signed by all family members age 18 or older. HFAs will consider a unit to be out of compliance if (1) the resident is clearly ineligible; (2) the initial TIC is inaccurate; (3) documentation of initial eligibility is insufficient; (4) no initial TIC was completed for a household member that moved in after the initial household members; or (5) there is no record of the household.
    - *Correction of Line 11a:* Units are in compliance with it is determined that an income qualified household occupies the unit. This is one of the cases where retroactive certifications are recommended. If management can obtain documentation showing that the household clearly qualified at move-in, and the HFA accepts such documentation, no 8823 will be issued. *This is the best possible outcome.* However, if such documentation is not possible, but the household qualifies based on current circumstances — or a new qualified household occupies the unit — the correction date is the date on which the unit is occupied by a qualified household.
    - *End of Year Issue:* If a unit is occupied by an ineligible household at the end of the property's tax year, the unit is not entitled to any LIHTC for that year — regardless of when the household moved in. On the other hand, even if an ineligible household occupies a unit for 11 months of a year, if the unit is occupied by a qualified household on the last day of the year, a full year of credits may be claimed for the unit.
- *Line 11c – Violation of Physical Inspection Standards (including casualty losses):* HFAs may choose between two standards when conducting physical property inspections. They may use either the HUD NSPIRE standard (which has replaced UPCS), or they may use state or local codes. Virtually all states use the HUD standard. When conducting property reviews, HFA staff will inspect units, the interior of buildings and all elements outside the buildings.

Habitability violations are the most common violation, with 1,750% more violations reported than any other category. However, unless the violation is so serious that it actually makes a unit or a building non-habitable, violations reported in this category do not generally result in a credit reduction. There may also be credit risk due to casualty loss or vacant units that are not suitable for occupancy.

- *Casualty Loss:* This is damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected or unusual.
  - If damage occurs during normal use, the owner willfully caused the damage or was willfully negligent, or through progressive deterioration (such as termites), it is not a casualty loss.
  - Unless the casualty loss is on a project located in a federal disaster area, casualty loss that exists at the end of a tax year may result in a loss of credits for that year. Because these losses are not the fault of the owner, they are usually unavoidable. When they do occur, restoration prior to the end of the year will prevent any loss of credits.
- *Vacant Units:* Vacant units not suitable for immediate occupancy are out of compliance, but reasonable turnover time should be considered. This is why it is so important to turn vacant units as soon as possible after they become vacant. Managers should keep in mind that HFAs are required to inspect vacant units, so all should be in a suitable condition at the time of the inspection.

There is no self-correction of physical violations; repairs must be made.

A LIHTC unit, building and/or entire project is out of compliance if:

1. The owner discloses violations of local standards, or incorrectly certifies that the buildings and units in a LIHTC project were suitable for occupancy, taking into account local standards (or other habitability standards).
2. During a physical inspection by the state agency, the property had elements that failed to meet the requirements.
3. The property otherwise fails to comply with the requirements of the UPCS or local codes at any time.

Correction of Physical Violations

A property is back in compliance when noted violations are corrected.

- The correction date is the date of the repair, the date of the inspection at which the repair was observed, or the date of the certification that the repair had occurred, whichever evidenced the correction to the agency's satisfaction.
- Acceptable evidence of the corrected violations includes items such as a certification from an appropriate licensed professional that the item now complies with the inspection standard or other documentation demonstrating that the violation has been corrected. Alternatively, the state agency may determine that the owner is back in compliance by visual inspection.

Line 11e - Changes in Eligible Basis:

Eligible basis is essentially the cost of a project's improvements (with some exceptions). This figure is established at the end of the first year credits are claimed for a building, and although eligible basis may not increase, it can decrease.

Since the amount of credit claimed on a building is contingent on the amount of eligible basis (more basis equals more credits), management should ensure that no errors are made that can result in a reduction in eligible basis. Two of the most common mistakes are (1) the charging of fees for the use of common area, and (2) making common area unavailable to all residents on a comparable basis.

<u>Common Area Fees</u>

IRS Regulation 1.42-5(b)(ix) states that owners of tax credit properties must maintain records that show for each year in the compliance period "the character and use of the nonresidential portion of the building included in the building's eligible basis under Section 42 (d) (e.g., tenant facilities that are available on a comparable basis to all tenants and <u>for which no separate fee is charged</u> for use of the facilities, or facilities reasonably required by the project)."

The *Eligible Basis* discussion of the <u>General Explanation Report on the LIHTC</u> states that "the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas may be included (*in basis*) provided there is no separate fee for the use of these facilities, and they are made available on a comparable basis to all tenants in the project."

This requirement is also outlined in Treasury Regulation 1.103-8 (b)(4)(iii).

Note: 2019 guidance from the IRS indicates that a violation of common area rules will result in all the affected common area being removed from eligible basis – not just the affected square footage or components. (e.g., renting 200 square feet of a 3,000 square foot community room to a beauty salon operator will result in the entire community room being removed from eligible basis).

In Compliance

The Eligible Basis of a building is determined at the end of the first year of the credit period. As long as there is no reduction in the Eligible Basis amount upon which the credit is based, the property is in compliance.

Out of Compliance

- The Eligible Basis of a property is reduced when space that originally qualified as residential rental property changes character or space that was originally designated for use by qualified tenants is no longer available to them.
- Typical noncompliance may involve converting common areas to commercial property or charging fees for facilities (such as a swimming pool), the cost of which were included in the Eligible Basis.

The date of noncompliance is the specific date the residential space is converted to commercial space or when a fee is charged.

Back in Compliance – Commercial Space

- Common areas and tax credit rental units may be converted to commercial space.
- Whether the cost of these converted spaces can be restored to Eligible Basis by changing the properties back into common areas or tax credit rental units has not been determined.
- In these instances, the state agency should not report the building back in compliance. Instead, the state agency should contact the IRS National Office LIHC Program Analyst for instructions. This makes common area mistakes particularly serious and may increase the risk of an IRS audit. To avoid this problem, owners and management should (1) ensure that all common areas are available to all residents on a comparable basis; (2) make sure no fee is charged to anyone for the use of common area; and (3) do not convert any common area into a commercial use.

Line 11f – Project Failed to Meet the Minimum Set-Aside Requirement

Each building is considered a separate project unless line 8b, Form 8609 is marked "yes" and the required attachment accompanies each form. The minimum set-aside elected on line 10c of the 8609 must be the same for all buildings in a project. There are three possible set-asides: (1) 20/50; (2) 40/60; and (3) Average Income. Once elected, the minimum set-aside election is irrevocable and can only be changed with a Private Letter Ruling from the IRS.

Vacant units count toward the minimum set-aside as long as the last household was eligible, the unit is suitable for immediate occupancy and reasonable attempts are being made to rent the unit.

A property is not below the minimum set-aside based on a sampling of files. The owner must be given opportunity to prove the minimum set-aside was met, but the burden is on the owner.

If the minimum set-aside is not met for the initial year of credit period, all credit is lost.

If the minimum set-aside is not met for any year after the initial year (as of the close of the year), all credit is lost for the year and the project is subject to recapture, but correction is possible.

In Compliance

A property is in compliance if the elected minimum set aside requirement (20/50, 40/60 or Average Income) is met by the end of the first year of the owner's credit (and compliance) period and continues to be met each year throughout the compliance period. The LIHTC residential units must also be rent restricted.

Out of Compliance

The initial analysis of compliance with the minimum set-aside requirement is generally based on a sample of tenant files. In the event that the sample does not meet the minimum set-aside, the owner must be given the opportunity to demonstrate that the minimum set-aside is met in the project. Noncompliance should be reported by the HFA only if the owner cannot demonstrate compliance for the minimum number of units. The burden is on the owner to show that the minimum set-aside was met.

Noncompliance with the minimum set-aside will also be reported if systemic errors affecting all the LIHTC units are identified (e.g., using incorrect income or rent limits for all the units). Excess rent or inappropriate fees pose the greatest

risk to the minimum set-aside, since these findings have the potential to impact large numbers of units. For this reason, great attention must be paid to ensuring that property rents are properly determined, and no fees are charged to residents that do not meet both IRS and HFA approval.

Line 11g – Gross rents exceed limits

The noncompliance that is most likely to result in significant loss of credits is the charging of excess rent. This is simply because it can impact so many units.

For example, assume a 100-unit property with 80 two-bedroom units. If an HFA discovers that too much rent is being charged for a two-bedroom unit at the property, unless the owner can prove that the excess rent was only being charged for the one unit, all 80 units could be lost from the applicable fraction, leaving only 20% of the units as low-income. To compound this, if the property operates under the 40/60 minimum set-aside, at least 40 units have to be low-income. Because of the rent violation, the property has fallen below the minimum set-aside, resulting in an applicable fraction of zero, and the loss of all credits with the potential for catastrophic recapture.

Another major problem with this finding is that, per IRS guidance, excess rent discovered by the HFA cannot be corrected until the following year. So, even if excess rent is not being charged at the end of the year, a credit loss will result. If the rent being charged is within permitted limits at the beginning of the year after the noncompliance finding, credits may be resumed.

With the possible exception of a building that is condemned (which is extremely rare), there simply is no noncompliance as serious as excess rent. Even if the overcharge occurred in only one month of the year, if discovered by the HFA, all affected units are out of compliance until the following year.

This is a finding that you do not want to have to correct. It is imperative that correct rents be charged at all times. This also means that any fees charged to residents must either be clearly optional or included in the gross rent.

One of the most common reasons for excess rent is a mistake regarding the determination of utility allowances, which we will cover shortly.

Line 11i – Violation of the Available Unit Rule

The Available Unit Rule (AUR) — also known as the “140% Rule” — allows families who qualified under the LIHTC income limits at move-in to remain in a tax credit property as long

as they want to — regardless of their income in years after move-in. If fact, unless an existing LIHTC household becomes a non-qualifying student household, they never have to leave a property because of a LIHTC eligibility issue.

This rule is a “building” rule — not a “project” rule. This means that if a household in a building recertifies with income above 140% of the current income limit for the family size, only the next available unit in that building must be of concern. The rule itself is fairly straightforward. Basically, if any low-income household recertifies with income above 140% of the current income limit, the next comparable or smaller available unit in that building must be rented to a qualified low-income resident.

This rule does not generally present problems for 100% low-income buildings since every available unit will be rented to a low-income resident. It is in the mixed-income (i.e., low-income and market units) buildings where the AUR is an issue. In these buildings, if the next available unit is rented to a non-qualified household, all over-income units in the building that are comparable or larger than the market unit that was incorrectly rented are lost as low-income units. In other words, they are considered market units. In essence, multiple units can be lost from the building’s applicable fraction simply by renting one vacant market unit incorrectly.

Correction of the AUR Violation

Once the Available Unit Rule has been triggered, the noncompliance can be corrected by renting any combination of market rate units, over-income units, and out of compliance low-income units as rent restricted units to income-qualified households until the applicable fraction upon which the credit amount is based is restored. The applicable fraction can also be restored through “self-correction” if:

1. The tenant’s income decreases to an amount below 140% of the income limit in place, or
2. The area median gross income (AMGI) increases to an amount, such that 140% of the income limit is more than the tenant’s income.

The date of correction is the date the last household, which restores the applicable fraction, moves into the building or the income of an existing household falls below the current income limit.

Line 11m – Utility allowance (UA) errors

The IRS utility allowance requirements are outlined in Regulation 1.42-10. A utility allowance is only required for a LIHTC property when the tenants are required to pay one or more utilities.

Utility allowance errors are one of the easiest types of noncompliance to avoid. Just remember the seven acceptable methods for establishing the allowance: Rural Development, HUD, local PHA, local utility company, HFA estimate, HUD model allowance, or estimate by a professional engineer. Be sure to review — and if necessary, update — the allowance at least once each calendar year, and put any new allowance into effect 90 days after the date of the update.

Owners will be in violation of the utility allowance requirements when:

a. The appropriate allowance is not used;
b. The allowance is not properly calculated;
c. Rents are not reduced for a utility allowance when utilities are paid directly by the tenant to the utility provider;
d. The owner did not review the basis on which the utility allowance is established at least once during the calendar year;
e. The owner failed to update rents for a revised allowance after the 90-day period; or
f. The owner failed to maintain adequate documentation regarding the computation of the allowances (without proof of the amount of the allowance, and how it was derived, there is no way to correctly compute rent.)

Correction of UA Error

A unit is considered back in compliance when the rent charged is reduced and correctly reflects the utility allowance. The date of correction is date that the rents correctly reflect the utility allowance.

*When an owner does not apply a utility allowance to reduce rent and account for utility costs paid directly by the tenant, the noncompliance can only be corrected by performing an annual review to determine a utility allowance using current information.

- If the rent paid plus the new utility allowance does not exceed the current maximum gross rent, then the owner is in compliance with the utility allowance requirements and no further action is required.
- If the rent paid plus the new utility allowance exceeds the current maximum gross rent, the back in compliance date is the date the rents are reduced to reflect the new utility allowances. However, keep in mind that excess rent may not be corrected until the following year.

Correction When There is No Annual Review

If the owner has applied a utility allowance, but failed to conduct an annual review, then the noncompliance can be corrected in one of three ways:

1. A retroactive annual review can be performed using information applicable to the last date the annual review should have been performed. Assuming the owner can document compliance with the utility allowance that would have been in place and that the rents were restricted, no further action is required. The owner has clarified the noncompliance and, therefore, Form 8823 should not be filed.
2. A new annual review can be performed using current information. Assuming the owner is in compliance with the new utility allowance requirement and the rents are restricted, the owner is currently in compliance. No further action is required. The owner has clarified the noncompliance and, therefore, Form 8823 should not be filed.
3. In the event that either the retroactive annual review under (1) above or the new annual review under (2) above indicates that the utility allowance needs to be increased, the back in compliance date is the date the rents are reduced to reflect the new utility allowances.

Line 11p – Building is out of the program

This is the "death penalty" for LIHTC projects and is a recapture event. The most common event that precipitates a Line 11p finding is failure to either complete the project within the required timeframe or failure to meet the project's minimum set-aside by the end of the first year of the credit period. When a project fails to meet the minimum set-aside, it is almost always a result of excess rent.

Properties may also be removed from the program by the HFA for egregious noncompliance. Examples include conspicuous, flagrant and systemic problems that the owner does not make reasonable attempts to correct.

It is important to remember that even if the property is removed from the LIHTC program, the Extended Use Agreement remains in place and may be enforced by the HFA or any other interested party.

There is no correction for a Line 11p finding.

Bottom Line

Understanding the Form 8823 is crucial for LIHTC owners and managers because it directly relates to maintaining the tax credit's compliance. This form, issued by the HFA, reports non-

compliance and other issues to the IRS. Recognizing and addressing the infractions listed can prevent the recapture of credits, ensuring the financial viability of the housing project. Knowledgeable management of Form 8823 helps in preserving the project's eligibility for the LIHTC program, maintaining investor confidence, and ensuring the continuous provision of affordable housing, all of which are vital for the long-term success and sustainability of LIHTC projects.

Prior to becoming a private developer in August 1983, A.J. was with K-Mart Corporation, Portsmouth Redevelopment & Housing Authority, and Suffolk Redevelopment & Housing Authority. While with the public housing agencies, A.J. was responsible for the implementation of a variety of federally funded programs, including public housing, Section 8 housing, housing rehabilitation (single family and multi-family), Community Development Block Grant (CDBG), Urban Development Action Grants (UDAG), Urban Homesteading, and was a Section 202 Housing Consultant. As a private developer, A.J. coordinated the development of over 70 multifamily housing complexes utilizing federal, state and conventional financing, of which more than 40 used the federal low-income housing tax credit. Currently, A.J. is a training advisor to the Housing Credit Certification Board of the National Association of Home Builders, which is responsible for implementing the requirements of a national certification examination for tax credit management personnel and carries the designation of Housing Credit Certified Professional (HCCP). A.J. is a nationally known trainer in affordable housing issues and served as a technical advisor to Congressional staff during the drafting of both the Low-Income Housing Tax Credit Program and the Fair Housing Amendments Act of 1988 and is a certified Fair Housing Specialist through the National Center for Housing Management.

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