

# Chapter 1

## Introduction

### Background

#### State Agency Responsibilities

State and local housing credit agencies (herein referred to as “state agencies”) are responsible for monitoring low-income housing credit (LIHC) properties for compliance with the requirements of Internal Revenue Code (IRC) §42; for example, health and safety standards, rent ceilings and income limits, and tenant qualifications. State agencies perform desk audits, inspect housing, and review tenant files.<sup>1</sup> When noncompliance is identified or the state agency becomes aware of a disposition of a building, the state agencies are required to notify the Internal Revenue Service using Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition.

Briefly, a state agency performs a desk audit, conducts a site visit, or reviews the owner’s tenant files and provides the owner with a summary report of its findings. If the report indicates noncompliance, the owner is expected to respond to the state agency within a maximum of 90 days to provide clarification or document that issues of noncompliance have been addressed. Then, the state agency determines whether the owner was always in compliance, has corrected the noncompliance, or remains out of compliance. The time to correct the noncompliance may be extended up to a total of 6 months with state agency approval. Regardless of whether the owner remedied the noncompliance or remains out of compliance, a Form 8823 must be filed with the IRS.

If the state agency reports that the owner is out of compliance, the IRS sends a notification letter to the owner identifying the type of noncompliance reported on Form 8823. The notification letter also states that the owner should not include any nonqualified low-income housing units when computing the tax credit under IRC §42 and that the noncompliance may result in the recapture of previously claimed credits. The notification letter also instructs the owner to contact the state agency to resolve the issue.

Once the noncompliance is resolved, the state agency should file a “back in compliance” Form 8823. If the noncompliance is corrected within three years after the end of the correction period, the state agency must file a Form 8823.<sup>2</sup> See Exhibit 1 at the end of this chapter for a complete description of the process.

#### IRS Analysis of Forms 8823 Submitted by State Agencies

Forms 8823 are routinely analyzed by the IRS. Based on categories of noncompliance, and without regard to subsequent “back in compliance” Forms 8823, taxpayers are evaluated to determine whether an audit of the owner’s tax return is needed.<sup>3</sup> The taxpayer’s tax returns and all Forms 8823 filed for the property are evaluated. If it is determined that an audit is warranted, the complete file is sent to the appropriate IRS field office. The taxpayer is then notified that an audit has been scheduled. It should be noted that this is not the only

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<sup>1</sup> State agencies perform “desk audits” of information submitted to their office rather than inspecting the documents at the property site; e.g., annual reports required under Treas. Reg. §1.42-5(c).

<sup>2</sup> Treas. Reg. §1.42-5(e)(3).

<sup>3</sup> Forms 8823 are immediately analyzed for audit potential when received from the state agencies. Subsequent receipt of Forms 8823 noting correction of previously reported noncompliance do not impact the original evaluation. Under Treas. Reg. §1.42-5(e)(3), if the noncompliance is corrected within three years, the state agency is required to file another Form 8823 reporting the corrected noncompliance and documenting the date the taxpayer was back in compliance. From the owner’s perspective, the best strategy is to address noncompliance identified by the state agency quickly so that the initial Form 8823 will indicate that the noncompliance was

method for selecting for audit tax returns on which the low-income housing credit has been claimed and, at the examiner's discretion, the audit may be expanded to include additional issues or tax returns.

## Authority of Guide

The guide is not a legal authority. The guide provides state agencies with a single accumulative reference of current legal authorities needed for determining whether a state agency must file Form(s) 8823 with the IRS under Treas. Reg. §1.42-5(e)(3), along with guidelines and examples of the law's application to specific fact patterns.

1. The scope of the guide is limited and does not address the tax consequences of noncompliance. Taxpayers are responsible for evaluating the tax consequences of noncompliance with IRC §42.
2. The guide should not be used or cited by taxpayers as authority for setting or sustaining a technical position when filing tax return for any tax period for which the taxpayer is subject to IRC §42 requirements.<sup>4</sup> Taxpayers can rely upon and cite the Internal Revenue Code and formal IRS guidance<sup>5</sup> as referenced extensively in the text and footnotes.
3. The guide, or chapters of the guide, may become obsolete if the underlying authority is revised subsequent to the Guide's revision date. Examples include: (1) IRC §42 is revised by Congress, (2) the IRS provides formal guidance, or (3) HUD revises the definition or treatment of income as explained in HUD Handbook 4350.3, Chapter 5.

The guide (or chapter) is obsolete as of the effective date of the revised legal authority. State agencies and owners should disregard affected text and legal references.

The Guide's revision date is identified on the cover, in the index, and at the bottom of every chapter page.

## Purpose of Guide

The fundamental purpose of this guide is to provide standardized operational definitions for the noncompliance categories listed on Form 8823. It is important that noncompliance is consistently identified and categorized. Resulting benefits include:

1. Consistent interpretation and application of IRC §42 requirements among states;
2. Consistent reporting of noncompliance to the IRS; and

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corrected. From the IRS' point of view, the owner's responsiveness is indicative of due diligence, but does not preclude initiating an audit.

<sup>4</sup> In limited circumstances, pending the release of formal IRS guidance, the guide may specifically state that guidelines presented in the guide will be used by the IRS to evaluate a taxpayer's compliance. See Chapter 14 for an example.

<sup>5</sup> For example, Treasury regulations, revenue procedures, revenue rulings, and notices can be relied upon as formal IRS guidance. Although often providing insight into IRS interpretation, private letter rulings are binding only for the taxpayer who requested the ruling and should not be cited as authority.

3. Enhanced program administration by the IRS; i.e., timely processing of the forms and identification of appropriate follow-up actions by the IRS.

## Content of Guide

The guide includes instructions for completing Form 8823, and guidelines for determining noncompliance and reporting property dispositions. The guide reflects current rules under IRC §42, Treasury regulations under IRC §42, other guidance published by the Department of Treasury and the IRS, and IRS administrative procedures for the LIHC program.

Generally, the noncompliance categories listed on Form 8823 are addressed in separate chapters. There are three categories of noncompliance for which there are two chapters because multiple issues are reported under the same category. They are:

1. Category 11e, Changes in Eligible Basis or the Applicable Percentage
2. Category 11h, Project not available to the general public
3. Category 11q, Other

For convenience, the term “owner” in the singular is used, although low-income housing properties often have more than one owner and state agencies must identify each owner in a schedule attached to the Form 8823 when filing the form.

Depending on the problem, noncompliance may extend to one or more housing units within an LIHC building, may apply to the whole building, or may encompass the entire project. Units, buildings, or projects that are out of compliance with the requirements of IRC §42 are referred to as “nonqualified” units, buildings, or projects.

## Organization of Chapters

Generally (as applicable) each chapter includes the following sections.

*Definitions* - Brief descriptions are provided to explain the basic compliance issue being addressed. The intent is to sufficiently define the category of noncompliance so that state agencies will uniformly select the same category for the same issues.

*In Compliance* - Descriptions and examples are used to illustrate fundamental compliance with IRC §42 and its regulations.

*Out of Compliance* - Descriptions and examples are used to illustrate common noncompliance issues.

*Back in Compliance* - This section includes explanations and examples illustrating how noncompliance can be corrected. Treas. Reg. §1.42-5(e)(4) allows a corrective action period, not to exceed 90 days, for the owner to remedy the noncompliance. The state agency can extend this period for up to a total of 6 months if there is good cause. Suggested correction periods are noted in the discussions.

*References* - A list of references is included at the end of each chapter. Specific references or explanations of relevant rules under IRC §42, the Treasury regulations under IRC §42, or other published guidance, may be included in the text or identified in footnotes.

## Reference

Treas. Reg. §1.42-5