Chapter 6
Nonprofit Set-Aside

Introduction
Congress, aware of the important role played by nonprofit organizations in the development of affordable housing, provided additional tax incentives for these entities to be involved in the development and management of IRC §42 projects.

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Law
IRC §42(h)(5) provides that a portion of each state’s annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations. Specifically, IRC §42(h)(5) provides:

Nonprofit Set-Aside
(A) In general. Not more than 90% of the State housing credit ceiling for any State for any calendar year shall be allocated to projects other than qualified low-income housing projects described in subparagraph (B).

Qualified Low-Income Housing Projects
(B) Projects involving qualified nonprofit organizations. For purposes of subparagraph (A), a qualified low-income housing project is described in this subparagraph if a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.

Qualified Nonprofit Organizations
(C) Qualified nonprofit organization. For purposes of IRC §42(h)(5), the term “qualified nonprofit organization” means any organization if—
(i) such organization is described in paragraph (3) or (4) of IRC §501(c) and is exempt from tax under IRC §501(a),
(ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and
(iii) one of the exempt purposes of such organization includes the fostering of low-income housing.

(D) Treatment of certain subsidiaries.
(i) In general. For purposes of IRC §42(h)(5), a qualified nonprofit organization shall be treated as satisfying the ownership and material participation test of subparagraph (B) if any qualified corporation in which such organization holds stock satisfies such test.
(ii) Qualified corporation. For purposes of clause (i), the term "qualified corporation" means any corporation if 100% of the stock of such corporation is held by one or more qualified nonprofit organizations at all times during the period such corporation is in existence.
Additional Discussion

Refer to Chapter 22 of the Guide for Completing Form 8823 for additional discussion.

Audit Issues

1. Whether the taxpayer received an allocation from the nonprofit set-aside.

2. Whether the nonprofit is a qualifying nonprofit organization and satisfies the requirements for its tax exempt purpose.

3. Whether the nonprofit has maintained an ownership interest in the project.

4. Whether the nonprofit materially participated (within the meaning of IRC §469(h)) in both the project development and operation of the project throughout the building’s 15-year compliance period.

Audit Techniques

Step 1: Identify Credit Allocations from Nonprofit Se-Aside

Allocations from the nonprofit set-aside are identified on Line 6g of Form 8609, Low-Income Housing Credit Allocation and Certification, starting with the November 2003 revision of the form. If an earlier revision was used, then contact the state agency that made the allocation. Confirmation from the state agency is needed because:

1. Even though a nonprofit may be a partner in the partnership under audit, the taxpayer is not subject to the IRC §42(h)(5) requirements unless the taxpayer received the credit allocation from the nonprofit set-aside.

2. Although a nonprofit is not currently a partner in the partnership under audit, the taxpayer may have originally included a qualifying tax-exempt entity and received a credit allocation from the nonprofit set-aside.

If a determination is made that the taxpayer did not receive its credit allocation from the nonprofit set-aside, no further action is required.

Step 2: Confirm Nonprofit’s Status as a Qualified Tax-Exempt Organization

IRC §42(h)(5)(C) defines a qualified nonprofit organization as any organization meeting the tax-exempt requirements of IRC §§ 501(c)(3) or 501(c)(4), and for which one of the exempt purposes includes the fostering of low-income housing. As low-income housing projects are typically owned by partnerships, allocations under the nonprofit set-aside are frequently made to partnerships for which the general partner is a qualifying nonprofit organization.

First, determine whether the nonprofit is a tax exempt entity in good standing by using the IRS website (www.irs.gov). Enter “78” into the “Search IRS site for” feature; the response will be “Most likely you are looking for “Publication 78, Search for Exempt Organizations.” Clicking on the underline portion will provide an alphabetical listing of exempt organizations.

Second, determine whether one of the nonprofit’s exempt purposes includes the fostering low-income housing. IRC §501(c)(3) provides, in part, that an organization may be considered exempt if it is organized and operated exclusively for one or more
of the following purposes; religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals. Nonprofits participating in the IRC §42 program are usually designated as “charitable.”

Treas. Reg. §1.501(c)(3)-1(d)(2) defines the term “charitable,” as it relates to an organization's exempt purpose and provides that the term should be construed liberally. Notwithstanding, IRC §42(h)(C)(iii) requires that one of the exempt purposes of the organization must include the fostering of low-income housing. IRC §42(h)(5)(C)(i) also referencing IRC §501(c)(4), which relates to nonprofit civic leagues or organizations operated exclusively to promote social welfare, or local associations of employees, the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes. As is the case with an organization described in IRC §501(c)(3), one of the exempt purposes of such a league, organization, or association must include the fostering of low-income housing.

Rev. Proc. 96-32 provides guidance for determining whether a qualified nonprofit organization involved in low-income housing is pursuing a charitable purpose by fostering low-income housing. The determination is based on the percentage of low-income units provided and the income level of the tenants. These guidelines are applicable continuously throughout the 15-year compliance period. Under the revenue procedure, a qualified nonprofit organization must establish (for each project) that at least 75% of the units are occupied by residents whose incomes are 80% or less of the area's median income, and either:

1. 40% of the units are occupied by residents whose incomes are 60% or less of the area median income, or
2. 20% of the units are occupied by residents whose incomes are 50% or less of the area median income.

To coincide with IRC §42 requirements, this determination can be made based on the residents’ income at the time the household moves into the low-income unit.

Rev. Proc. 96-32 also provides safe harbor guidelines. If the taxpayer does not satisfy these requirements, the assistance of an Exempt Organization specialist should be requested for further development of this issue. See IRM 4.10.2.6.5 for instructions.

See also Step 5 and Related Issues (below) for additional considerations impacting the exempt status of the nonprofit.

**Step 3:** Ownership Test

The nonprofit must have an ownership interest in the low-income housing project throughout the 15-year compliance period. A qualified nonprofit organization can own an interest directly, or indirectly through a partnership, or own stock in a qualified corporation that owns a low-income housing project. A qualified corporation must be a corporation that is 100% owned at all times during its existence by one or more qualified nonprofit organizations.
Step 4: Material Participation

A qualified nonprofit organization must materially participate (within the meaning of IRC §469(h)) in both the development and operation of the project throughout the 15-year compliance period. IRC §469(h) defines material participation as activity that is regular, continuous, and substantial. The legislative history suggests the following guidelines in defining material participation in a business activity:

1. Material participation is most likely to be established in an activity that constitutes the principal business/activity of the taxpayer.

2. Involvement in the actual operations of the activity should occur. That is, the services provided must be integral to the operations of the activity. Simply consenting to someone else’s decisions or periodic consultation with respect to general management decisions is not sufficient.

3. Participation must be maintained throughout the year. Periodic consultation is not sufficient.

4. Regular on-site presence at operations is indicative of material participation.

5. Providing services as an independent contractor is not sufficient.

Accordingly, a nonprofit entity will be considered to materially participate where it is regularly, continuously, and substantially involved in providing services integral to the development and operations of a project.

Nonprofits play an important role in the IRC §42 program. With their expertise, nonprofits can focus on the on-going performance of the housing project and the provision of services. For-profit entities may also have an interest in promoting low-income housing, but are also interested in the financial aspects of a project and have the funds to make capital contributions to the project. The motivation of both, enhanced by the ability of the nonprofit entity to access the nonprofit set-aside credit, often results in the creation of a partnership that includes both a nonprofit entity and a for-profit entity.

The partnership is often structured so that the nonprofit is a general partner with a 1% or less interest in the partnership and the for-profit investor(s) are limited partners with a combined ownership interest of 99% or more. This structure allows the nonprofit to participate in the project to achieve its special housing objectives of the credit, while providing the financial benefit of the credit to the for-profit investor partners.

If the partnership has one or more for-profit general partners, the nonprofit partner may have less participation in the partnership, which raises the issue of whether the nonprofit’s participation in the project is substantial (and thus material).

Step 5: Exempt Status and Private Inurement

The nonprofit and for-profit general partner should not be related parties; i.e., share officers or board of directors. Such relationships may indicate that the primary purpose of the nonprofit organization is to access credit from the nonprofit set-aside. More importantly, such associations may call into question the exempt status of the nonprofit entity. The issue being whether the nonprofit entity acts exclusively in
furtherance of a charitable purpose or to further the interests of private investors. Although there is no all-inclusive list, some indicators that the nonprofit entity is not acting exclusively to further the charitable purpose are identified here.

1. The nonprofit is not the only general partner,

2. The nonprofit’s minority partnership interest provides for minimal participation in the IRC §42 project’s operation,

3. The nonprofit makes guarantees to the limited partners against loss of low-income housing credits, and

4. Excessive private benefits result from real property sales, development fees, or management contracts.

If there are indicators that the nonprofit entity is being unduly influenced by a for-profit entity, then assistance of an Exempt Organization specialist should be requested for further development of this issue. See IRM 4.10.2.6.5 for instructions.

Audit Adjustments

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h)(5)(B) requirements. Failure to comply with IRC §42(h)(5)(B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c)(1). Therefore, the IRC §42(j) credit recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA dated September 16, 2013.

Step 1: Determination “as of the Close of the Taxable Year”

Determine whether the noncompliance was corrected before the close of the taxable year in which the noncompliance originally occurred. As explained by Chief Counsel in their September 16, 2013, advisory, and consistent with IRC §42(c)(1)(A), compliance should be determined “as of the close of the taxable year.” If a taxpayer is found to be compliant “as of the close of the taxable year” in which the noncompliance first occurred, then no disallowance of credit is required.

Step 2: Noncompliance Corrected within a Reasonable Period

If the noncompliance is not corrected “as of the end of the taxable year in which the noncompliance occurred,” then determine whether responsibility for the noncompliance rests solely with the qualified nonprofit organization.

- If responsibility does not rest solely with the qualified nonprofit organization, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).

- If responsibility rests solely with the qualified nonprofit organization, then the agent should determine whether the noncompliance was corrected within a “reasonable period.”

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“Reasonable Period” Quantified

Under IRC §42(j)(4)(E), taxpayers are provided relief from the credit recapture provisions in the event of a casualty loss if the loss is restored within “a reasonable period established by the Secretary.” In CCA 200124006, Chief Counsel concurred that a reasonable period of up to 2 years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties under IRC §165.

Therefore, to ensure fair and equitable treatment of taxpayers in comparable situations, the “reasonable period” provided in IRC §42(j)(4)(E) to restore a casualty loss should be used to determine whether a taxpayer corrected the IRC §42(h)(5)(B) noncompliance within a reasonable period of time when the cause of the noncompliance rests solely with the qualified nonprofit organization. That is, the reasonable period of time for correcting noncompliance with IRC §42(h)(5)(B) is no longer than 2 years following the end of the tax year in which the noncompliance first occurred.

- If the noncompliance was corrected within a reasonable period, then no disallowance of credit is required.
- If the noncompliance was not corrected within a reasonable period, then no credit is allowable for the taxable year the noncompliance occurred or any subsequent taxable year until the noncompliance is corrected (if the taxpayer is otherwise compliant and eligible to claim the credit).

Related Issues

Federal Financing

Nonprofit organizations usually have access to federal funding sources, including federal grants and below-market rate loans. Typically, nonprofit organizations will secure the federal financing and then loan the proceeds to the taxpayer. Depending on the facts and repayment terms, the loans may not be bona fide debt or will be subject to limitations. See Chapter 10 for additional discussion.

Developer Fee

In addition to sponsoring the development of the low-income housing, a nonprofit entity may act as the project’s developer and earn a developer’s fee. The issue is whether the nonprofit entity had the expertise needed to develop an IRC §42 project and, in fact, did develop the project. See Chapter 8 for additional discussion.

Tax-Exempt Status (Private Inurement & Taxable Income)

If the nonprofit entity is earning a development fee, there are two issues that may affect the tax-exempt status of the entity.

1. Private Inurement. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) provides that an exempt entity must be organized and operated exclusively for an exempt purpose specified in IRC §501(c)(3). Because these purposes serve public rather than private interests, an exempt entity must establish that it is not organized for the benefit of private interests. A developer fee paid to a nonprofit entity that may be ascribed, in whole or in part, to the benefit of private persons may call into question whether the entity is being operated “exclusively” for an exempt purpose, which in turn, may jeopardize the tax-exempt status of the entity.

2. Unrelated Business Taxable Income. Nonprofit entities may generate income through activities not directly related to their tax-exempt purposes. The developer fee may be subject to taxation under IRC §512 and if the nonprofit entity has an excess of taxable income, the entities tax-exempt status could be jeopardized.
In *Housing Pioneers, Inc. v. Commissioner*, the Tax Court determined that private inurement existed where the founders of the nonprofit organization operated it to privately benefit an existing housing partnership. See Appendix J.

The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.

**Summary**

1. IRC §42(h)(5) provides that a portion of each state’s annual credit ceiling be set aside for allocation to projects involving qualified nonprofit organizations.

2. The qualified nonprofit organization must own an interest in the project and materially participate (within the meaning of IRC §469(h)) in the development and operation of the project throughout the compliance period.

3. Once it has been determined that a taxpayer received a credit allocation from the nonprofit set-aside, audit issues include determining whether the nonprofit is a qualifying nonprofit entity and satisfies the requirements for its tax exempt purpose, whether the nonprofit has maintain an ownership interest, whether the nonprofit materially participated in the project development and is participating in the on-going operation of the project.

4. The assistance of an Exempt Organization specialist may be needed. See IRM 4.10.2.6.5 for instructions.

5. The taxpayer may be subject to disallowance of the entire annual credit if noncompliance with the IRC §42(h)(5)(B) occurs. However, the IRC §42(j) credit recapture provisions are not applicable.