

Chapter 22
Category 11q
Other Noncompliance
Qualified Nonprofit Organization Failed to Materially Participate

Definition

IRC §42(h)(5) requires that each state set aside at least 10% of its state housing credit ceiling for allocations to projects in which qualified nonprofit organizations own an interest, and materially participate in the development and operation of the projects. “Qualified nonprofit organization” is defined as an IRC §501(c)(3) or 501(c)(4) organization exempt from tax under IRC §501(a) that is determined by the state agency as not being affiliated with or controlled by a for-profit organization, and one of the exempt purposes of the organization includes the fostering of low-income housing.

For purposes of this allocation, a nonprofit organization must have an ownership interest in the low-income housing project throughout the 15-year compliance period and materially participate in the *development* and *operation* of the project. Whether a nonprofit sponsor materially participates will depend on the application of IRC §469(h) to the facts and circumstances of a given project.

Under IRC §469(h)(1), the nonprofit must participate on a *regular, continuous, and substantial* basis in the development and operation of the project.¹ Although this standard is vague, 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

¹ Treas. Reg. §1.469-5T provides rules for determining the material participation for individuals. IRC §469(h)(4) and Treas. Reg. §1.469-5T(g)(3) provide rules for determining the material participation of certain corporations. Because neither of these provisions applies to nonprofit organizations, they should be reviewed for illustrative purposes only. The general facts and circumstances test of IRC §469(h)(1) is the test applicable to nonprofit organizations.

the development and operations of a project.

Pursuant to IRC §42(h)(5)(D), the ownership and material participation test can be met by the organization if it owns stock in a qualified corporation that satisfies the ownership and material participation test. A qualified corporation must be a corporation that is 100 percent owned at all times during its existence by one or more qualified nonprofit organizations.

In Compliance

For purposes of reviewing properties for compliance with the requirements of IRC §42(h)(5) during the 15-year compliance period, the state agencies' responsibility is limited to consideration of whether the qualified nonprofit entity is *materially participating* in the *operation* of the project; i.e., both management decision making and the day-to-day operations. In order to materially participate, the qualified nonprofit must be engaged in the activities on a basis that is regular, continuous, and substantial.

Example 1: Qualified Nonprofit Organization Materially Participates

A for-profit organization and a qualified nonprofit organization are general partners for an LIHC project. The state agency sent the review notification letter to the nonprofit and the nonprofit's executive director was on site at the time of the review to answer questions and participate in the physical inspection. The nonprofit received the compliance report, corrected a noncompliance issue and report back to the state agency.

The owner has demonstrated management involvement.

Example 2: Property Managed by Nonprofit Representatives

A qualified nonprofit organization owns an LIHC project. Not having the expertise to operate an LIHC property on a day-to-day basis, the nonprofit hires an affordable housing management company. The management company reports to, and is paid by, the qualified nonprofit organization.

The application of the material participation rules under IRC § 469 should be flexible. In this case, the owner has demonstrated both management decision making and control of the day-to-day operations through their oversight of the management company.

Out of Compliance

A taxpayer is out of compliance if:

1. The qualified nonprofit organization does not materially participate (as determined under IRC §469(h)(1)), or

2. The qualified nonprofit organization does not materially participate in both the *development and operation* of the project; i.e., both management decisions and day-to-day activities.

A property is out of compliance for any taxable year where the entity does not participate on a basis that is regular, continuous and substantial within the meaning of IRC §469(h)(1) for that year. Noncompliance can be identified by interviewing the qualified nonprofit organization's management representatives and observation while at the property site.

Example 1: Qualified Nonprofit Does Not Participate in Management Decisions

A for-profit organization and qualified nonprofit organization are general partners for an LIHC project. The nonprofit organization fully participated in the development of the project, but has not participated in (directly or through a representative) any monthly management meetings in year 3 of the compliance period and does not otherwise participate on a regular, continuous, or substantial basis.

The property is out of compliance for year 3 of the compliance period.

Example 2: Management Company Employee Provides Volunteer Services

A for-profit organization and qualified nonprofit organization are general partners for an LIHC project. The third party management company operating the property reports to the for-profit general partner. The management company employs a property manager who signed an agreement to be a "volunteer" for the non-profit and provide services for the nonprofit organization.

The property is not in compliance because the property manager's agreement to be a volunteer is part of its employment responsibilities to the for-profit organization.

Should a state agency become aware of noncompliance with other requirements imposed under IRC §42(h)(5), Form 8823 should be filed noting the issue. Areas of noncompliance may include:

1. The qualified nonprofit organization loses its exempt status. As part of the preparation for a review of an LIHC property owned by a qualified nonprofit organization under IRC §42(h)(5), state agencies may confirm that the nonprofit is a qualified tax-exempt organization by using the IRS website (www.irs.gov). Enter "78" into the "Search IRS site for" feature; the response will be "Chances are you are looking for Publication 78, Search for Exempt Organizations"; clicking on the underline portion will provide an alphabetical listing of exempt organizations. The state agency should request documentation of tax-exempt status if the organization is not included on the list.
2. The qualified nonprofit organization does not have an ownership interest in the low-income housing project.

Back in Compliance

LIHC projects are considered back in compliance in a taxable year when a qualified nonprofit organization owns an interest in the project and satisfies the material participation test set forth in IRC §469(h)(1) for that taxable year.

Example 1: Qualifying Nonprofit Organization Begins Attending Management Meetings

A for-profit organization and a qualified nonprofit organization are general partners for an LIHC project. The nonprofit organization materially participated in the on-going operation of the project in years 2, 3, and 4. They did not materially participate in year 5. It was determined that in year 7 of the compliance period, the nonprofit organization materially participated.

The property is out of compliance as of December 31st of year 5 and back in compliance as of December 31st of year 7.

Reference

1. IRC §42(h)(5)
2. Senate Report. 99-313, 99th Cong. 2nd Session, 1986-3 C.B. (Vol. 3) 732