Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Glenn Deloriea
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(Small Business/Self-Employed)

from: Christopher J. Wilson
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subject: Noncompliance under § 42(h)(5)(B) of the Internal Revenue Code

This Chief Counsel Advice responds to your request regarding the tax consequence(s) of a failure to comply with the requirement of § 42(h)(5)(B) to maintain the involvement of a qualified nonprofit organization in the development and operation of the project throughout the compliance period. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Date 2 =

Date 3 =

FACTS

Taxpayer, a limited partnership, owns a multi-building low-income housing project. Initially, Taxpayer consisted of: (1) a nonprofit corporation general partner ("nonprofit GP"), a qualified nonprofit organization under § 42(h)(5)(C), (2) an investment limited partner ("LP"), and (3) a special limited partner ("special LP").

On Date 1, the project received from the applicable state housing credit agency an allocation of low-income housing credits derived from the state ceiling set-aside for projects involving qualified nonprofit organizations under § 42(h)(5). All of the project buildings were placed in service in Year 1. The credit period for all the project buildings also began in Year 1.

In Year 2, Taxpayer gave the nonprofit GP notice of removal from the partnership for breach of the partnership agreement and failure to perform the duties of the general partner under the agreement. The notice also informed the nonprofit GP that removal constitutes an "event of withdrawal" from the partnership and a relinquishment of the nonprofit GP's entire partnership interest in the partnership. Under the partnership agreement, the special LP, which is not a qualified nonprofit organization described under § 42(h)(5)(C), became the general partner of Taxpayer.

The LP consulted with the state housing credit agency prior to removing the nonprofit GP. The state housing credit agency allowed Taxpayer a specified period of time to replace the nonprofit GP with another qualified nonprofit organization described under § 42(h)(5)(C). Taxpayer promptly started to search for another qualified nonprofit organization as a replacement, without success. In Year 3, after the specified period of time allowed by the state housing credit agency had expired, the agency reported the noncompliance to the Service and provided that the project ceased to be in compliance with § 42 as of Date 2.

On Date 3, Taxpayer found a qualified nonprofit organization replacement that is described § 42(h)(5)(C). The state housing credit agency reported to the Service that Taxpayer had corrected the noncompliance and was again in compliance.

The nonprofit GP is contesting removal from the partnership in state court.

LAW AND ANALYSIS

Section 42(h)(5) provides that each state must set aside at least 10% of its annual state housing credit ceiling for allocations to projects involving a qualified nonprofit organization. Under § 42(h)(5)(B), a qualified nonprofit organization is involved in the project if it owns an interest in the project (directly or through a partnership), and

materially participates (within the meaning of § 469(h)) in the development and operation of the project throughout the compliance period. Under § 42(h)(5)(C), a "qualified nonprofit organization" is any organization described in § 501(c)(3) or (4) and is exempt from tax under § 501(a), determined by the state housing credit agency as not to be affiliated with or controlled by a for-profit organization, and has as one of its exempt purposes the fostering of low-income housing.

Under § 42(i)(1), the compliance period for any building is the period of 15 taxable years beginning with the 1st taxable year of the building's credit period. Under § 42(f)(1), the building's credit period begins the year the building is placed in service, or, at the election of the taxpayer, the succeeding taxable year.

Under § 42(j), if at the close of any taxable year in the compliance period the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, the taxpayer's tax for the taxable year will be increased by the credit recapture amount as determined under §§ 42(j)(2) and (3).

The legislative history to § 42 provides generally that any change in ownership of a low-income building during the compliance period is a recapture event and that all dispositions of ownership interests in buildings are treated as transfers for purposes of recapture. H.R. Conf. Rep. No.841, 99th Cong., 2d Sess., II-96 and II-102 (1986), 1986-3 (Vol.4) C.B. 1, 96, 102.

Section 42(j)(6)(A) provides, however, that the increase in tax under § 42(j) shall not apply solely by reason of the disposition of a building (or interest therein) if it is reasonably expected that such building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period.

Neither the statute, regulations, nor legislative history to § 42 provide the tax treatment for a failure to maintain the involvement of a qualified nonprofit organization in a project throughout the compliance period under § 42(h)(5)(B). Failure to maintain the involvement of a qualified nonprofit organization in a project under § 42(h)(5)(B) occurs when the qualified nonprofit organization does not own an interest in the project (directly or through a partnership) or fails to materially participate (within the meaning of § 469(h)) in the development and operation of the project throughout the compliance period.

Although the statute and legislative history are silent regarding the tax consequences resulting from noncompliance with the requirements of § 42(h)(5)(B), it is reasonable to infer that negative tax consequences can result from a violation of these requirements.

Under § 42(j)(1), recapture of credit results when the amount of qualified basis of any building with respect to the taxpayer is less than the qualified basis as of the close of the preceding taxable year. Failure to maintain the involvement of a qualified nonprofit organization in a project under § 42(h)(5)(B) does not, in and of itself, result in an actual (or an imputed) decrease in the qualified basis of a building that results in recapture under § 42(j)(1). This is distinguishable from the disposition of a building (or an ownership interest therein) where the statute and legislative history to § 42(j) specifically provide that recapture can occur, and if so, a decrease of qualified basis must necessarily be imputed because there is no actual decrease in the qualified basis of the building. There is no evidence of Congressional intent to extend the tax consequences for a disposition of a building (or ownership interest therein) to a violation of § 42(h)(5)(B), and we do not infer such an intent.

Section 42(h)(5)(B) provides that a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participate in the development and operation of the project ***throughout the compliance period.*** (emphasis added) This language infers that failure to meet the ownership or material participation requirements of this section during the compliance period results in a negative tax consequence. In this instance, we believe the proper tax consequence is loss of credit for any taxable year where the violation remains uncorrected as of the close of the taxable year. We recognize that this tax consequence may be viewed as inadequate for a violation of § 42(h)(5)(B) occurring after the 10-year credit period for projects where there remains no allowable credit and therefore, no credit to disallow. However, alternative approaches may be available in state court. For example, as is the case here, a qualified nonprofit may bring suit in state court if it believes that it has been improperly removed. Similarly, it may be possible for a state allocating agency to enforce the terms of the allocation in state court, or, if impracticable, to seek some other form of remedial relief (e.g., damages) for a breach of the terms of the contractual arrangement represented by the allocating document.

In summary, if the Service finds that the facts and circumstances support a finding that Taxpayer failed to maintain the involvement of a qualified nonprofit organization in the project under § 42(h)(5)(B) as of the close of a taxable year, the Service may disallow credit for the taxable year. Taxpayer may claim credit for the taxable year that the violation is corrected (assuming Taxpayer is otherwise eligible to claim credit for that taxable year).

Finally, we point out that the cause of most § 42 violations are usually under the control of the taxpayer (i.e., ownership entity). However, a violation of § 42(h)(5)(B) can occur solely by the actions of the qualified nonprofit organization (e.g., loss of § 501(c)(3) or (4) status, a decision by the nonprofit to terminate the organization or withdraw from the partnership, etc.) and thus, outside the taxpayer's control.

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In accordance with § 6110(k)(3), this document may not be used or cited as precedent. Please call me or Jian H. Grant at (202) 622-3040 if you have any further questions about this matter.