Housing Authorities: Do You Know Your Nonprofit’s Type?

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There are many legitimate reasons for a public housing authority ("Authority") to form a separate nonprofit corporation ("Nonprofit"). One of the most significant reasons is to help shield the Authority's assets from potential liability when the Authority engages in a special project. For example, an Authority developing a new low income housing project may form a Nonprofit to provide an additional layer of protection for the Authority's assets in case the new project fails or triggers substantial liabilities.

An Authority that forms a Nonprofit must carefully comply with the applicable tax rules. The Authority should organize its Nonprofit as a Nonprofit entity under North Carolina state law, but this will not automatically exempt the Nonprofit from federal or state income taxation. The Nonprofit must also apply to the Internal Revenue Service ("IRS") to request a determination that it is exempt from federal income taxes. Additionally, the Nonprofit must also apply to the North Carolina Department of Revenue ("NCDOR") for exemption from state income taxes, but the NCDOR will "piggyback" off the IRS determination.

The most common tax-exempt entity is a Section 501(c)(3) organization. There are, however, various types of Section 501(c)(3) organizations, with each having numerous and separate requirements and restrictions. One type of Section 501(c)(3) organization is an independent public charity which generally obtains its tax-exempt status based on its charitable activities and broad source of funding. Another type of Section 501(c)(3) organization is the supporting organization ("SO") which generally obtains its tax-exempt status based on its relationship with the tax-exempt organization it supports. An SO is further classified as a Type I, Type II, or Type III supporting organization.

The tax rules governing the organizational and operational requirements of each type of Section 501(c)(3) organization can be complex and an inadvertent violation of a rule may affect the entity's tax-exempt status. For example, generally, a Type I SO must be controlled by the organization it supports (i.e., the Authority). The requisite level of control may be established by including certain language in the Type I SO's organizing documents, such as the articles of incorporation. If those organizing documents are subsequently amended to remove or modify the qualifying language, however, the amendment could sever the connection that serves as the basis for the Type I SO's tax-exempt status thereby jeopardizing the tax-exempt status.

To preserve a Nonprofit's tax exemption, the Authority or the Nonprofit should be aware of the Nonprofit's tax classification and comply with the rules governing such classification. Additionally, if a Nonprofit's organizational structure or activities change after it receives tax-exempt status as a certain type of Section 501(c)(3) organization, it may need to request a reclassification from the IRS to another type of Section 501(c)(3) organization in order to maintain its tax-exempt status.

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