DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: AUG - 1 2001

Contact Person:
[redacted]
Identification Number:
[redacted]
Telephone Number:
[redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Sir or Madam:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS:

You were incorporated on [redacted] under the nonprofit laws of the State of [redacted]. The Articles of Incorporation state that you are formed exclusively for charitable, scientific, or educational purposes within the meaning of section 501(c)(3) of the Code.

You were formed to participate as a member of [redacted], a [redacted] limited liability company [redacted]. [redacted] is a partnership for federal income tax purposes. [redacted] plans to acquire and rehabilitate a [redacted]-unit apartment building ([redacted]) for rental exclusively to very low-income elderly and disabled individuals. You represented that the substantial rehabilitation of [redacted] qualifies for low income housing tax credits under section 42 of the Code.

You serve as a co-managing member along with [redacted], a nonprofit section 501(c)(3) organization. The co-managing members ("managing member") own a 0.01 percent membership interest. To utilize the tax credits you have entered into [redacted] with an investor set up to invest in low-income housing projects acquiring tax credits for its investors. The investor is [redacted] ("related member"), and its affiliate, Related

[redacted]

[redacted] ("special member"). Related member owns a 99.98 percent interest. [redacted] ("special member") owns a 0.01 percent interest. Together, related member and special member are known as the investor member.

[redacted] has signed a development agreement with a developer to rehabilitate the property. [redacted] will finance the rehabilitation with funds it obtains from investor member and from lenders. Once [redacted] is ready for occupancy by low-income elderly and disabled individuals, a management agent will manage the day-to-day operations of [redacted] pursuant to a management agreement.

The maximum rental rates are set by the low income housing tax credit program ("tax credit program"). At least 20 percent of the rental units in the apartment building will be rent restricted and individuals whose incomes are 50 percent or less of the area median gross income will occupy the rental units. [redacted] has elected to set its maximum rent at 84 percent or less of the applicable rent limit established under the Tax Credit Program.

Once [redacted] is rehabilitated and occupied, you will be primarily involved with managing the affairs of [redacted] as managing member and supervising the management agent's management of [redacted]

The respective rights and duties of the members are set forth in a series of agreements including, without limitation, a contribution agreement, an operating agreement, a development deficit guaranty agreement, an operating deficit guaranty agreement, a replacement reserve guaranty agreement and a recapture guaranty agreement.

The operating agreement provides that [redacted] may withdraw as co-managing member once you receive section 501(c)(3) exemption status under the Code. The operating agreement gives the investor member various controls over the operation of [redacted] or control over the managing member to ensure the protection of the investor partner.

Many provisions specify rights that may be exercised by the investor member. Section 5.2.C provides that the budget prepared by the managing member shall not be adopted without the consent of the special member. Section 5.3.D provides that if it is determined that the managing member cannot serve as the tax matters member, the special member may designate itself as the tax matter member. As tax matters member, managing member must obtain the consent of the special member in connection with material decisions and determinations made with respect to income tax matters. Section 5.4. A provides that the consent of the special member must be

[redacted]

obtained with respect to any lease, conveyance or refinancing of the assets of the [redacted]. Section 5.4.B provides that at the end of the Compliance Period under section 42 of the Code, the special member has the right to require that the managing member use its best efforts to obtain a buyer for the apartment complex. Section 5.5.B provides that the consent of the special member must be obtained regarding the services of the accountants, architects, and the choice of or termination of management agent. The section also lists other restrictions on the authority of the managing member, including avoidance of any action causing recapture of credits previously recognized or a reduction or disallowance of credits anticipated. For its services in monitoring the actions of the managing member, the special member will be paid an annual administrative fee pursuant to Section 6.3. Section 9.2.D provides that the investor members may receive a return amount in the event that the amount of credits finally allowed and allocated to the investor member is less than the credit amount adjusted. There shall also be distributed to the investor member amounts that would otherwise have been distributed to the managing member out of the cash flow or sale or refinancing transaction proceeds. Section 11.1 provides that the managing member may not withdraw from [redacted] or assign its interest without the consent of the special member. Section 11.4 provides that the special member may remove the managing member if the managing member materially violates its fiduciary responsibility or is in material breach of any of the agreements, including the guaranty agreements, or if the [redacted] is in material breach of any project document.

The contribution agreement and operating agreement provide that capital contributions by the investor member are made in installments that become due only after various contingencies have been satisfied. Failure of any conditions could preclude payment of further installments. The contribution also provides that you represent to the best of your knowledge that the property does not contain hazardous materials except in compliance with applicable law and that the property is not in violation of any environmental laws. You agree to indemnify the related member and investor member from any liability.

The development deficit guaranty agreement provides that you guarantee to pay any development deficit, to purchase the interests of the related member and investor member in the event that construction of the apartment complex is not timely completed; and to pay all expenses of operating and maintaining the apartment complex in excess of gross collections to the extent necessary to maintain break even operations until the break even date. The operating deficit guaranty agreement provides that you guarantee to loan to the LLC any funds required to fund operating deficits. The replacement reserve guaranty agreement provides that you guarantee to fund the required reserves for repairs and replacements. The recapture guaranty agreement provides that if any credit is recaptured, you guarantee the amount of the credit, plus interest and penalties.

[redacted]

APPLICABLE LAW:

Section 501(c)(3) of the Code exempts from federal income tax, as provided in section 501(a), organizations organized and operated exclusively for exempt purposes no part of the net income of which inures to the benefit of any private individual or shareholder.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term "charitable" in its generally accepted legal sense and it is not limited by the separate enumeration of exempt purposes in section 501(c)(3) of the Code. The term includes, inter alia, relief of the poor and distressed, or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration.

Rev. Proc. 96-32, 1996-1 C.B. 717, provides a safe harbor test that an organization providing housing will be considered to relieve the poor and distressed if it establishes that 75 percent of the units are occupied by residents that qualify as low income and that either (a) 20 percent of the units are occupied by very low income residents or (b) 40 percent of the units are occupied by residents that do not exceed 120 percent of the area's very low income limit. In addition, the units must be affordable to the residents. In the case of home ownership programs, this requirement will be satisfied by the adoption of a policy that makes the initial and continuing costs of purchasing a home affordable to low and very low income residents. If this safe harbor is not satisfied, an organization may demonstrate that it relieves the poor and distressed by reference to all the surrounding facts and circumstances.

[redacted]

In the case of Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "...the presence of a single...[non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of ... [exempt] purposes."

Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), held that an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it satisfies the requirements of the particular exemption statute. Whether an organization has satisfied the operational test is a question of fact.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court concluded that an organization that trained campaign workers for the benefit of the Republican Party was not exempt under section 501(c)(3) of the Code due to the greater than incidental private benefit to the Party and to Republican Party candidates. The court noted that section 501(c)(3) organizations may benefit private interests only incidentally. Conferring more than incidental benefit on private interests is a nonexempt purpose.

In Plumstead Theatre Society, Inc. v. Commissioner ("Plumstead") 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982), the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of the costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as a general partner and two individuals and a for-profit corporation were the limited partners. Significant factors in the Tax Court's finding included that the limited partners played a passive role as investors only, that the organization remained in control of all aspects of the play, that none of the limited partners were directors or officers of the organization, and that the investors' interests in the particular play were not intrusive or indicative of serving private interests.

In Housing Pioneers v. Commissioner ("Housing Pioneers"), 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), amended 58 F.3d 401 (9th Cir. 1995), the Tax Court concluded that the organization did not qualify as an organization described in section 501(c)(3) of the Code because its activities performed as co-general partner in limited partnerships substantially furthered nonexempt purposes, and private interests were served by its activities. The organization entered into partnerships as a one percent co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for-profit partners. Under the management agreement, the organization's authority as co-general partner was narrowly circumscribed. It had no management responsibilities and could describe only a vague

[redacted]

charitable function of surveying tenant needs.

ISCUSSION

Based upon the above statement of facts and applicable law, we conclude you are not described in section 501(c)(3) of the Code. We reach our conclusions based on the analysis below.

Because the owner of the low-income housing project, [redacted], satisfies the residency requirements and the rent restrictions imposed pursuant to an allocation of low-income housing tax credits, you, as co-managing member, may claim that you satisfy section 3 of Rev. Proc. 96-32 provided that you can demonstrate that as managing member you cause [redacted] to satisfy the safe harbor. Because there is nothing in the agreements that would enable the for-profit members to prevent you from carrying out the occupancy and rental restriction requirements, we conclude that you satisfy the safe harbor. However, whether you qualify for exemption depends on whether you also do not provide a private benefit for the investor members.

The conduct of activities for purposes described in section 501(c)(3) of the Code must be the exclusive purpose of an organization before it can be recognized as exempt from tax under section 501(a) of the Code. An organization is not operated exclusively for charitable purposes if the benefits to private individuals are more than an incidental consequence of its operations. Section 1.501(c)(3)-1(d)(1) of the regulations. Whether an organization has satisfied the operational test is a question of fact. Harding Hospital, Inc. United States, supra.

As demonstrated in Better Business Bureau of Washington, D.C., Inc. v. United States, supra, a single function may actually achieve more than one purpose. If one purpose is nonexempt and substantial in nature, it destroys the exemption regardless of the number or importance of the exempt purposes. Thus, regardless of the fact that you may cause the partnership to provide housing to persons regarded as poor and distressed, you will not qualify for exemption if you have a substantial purpose to benefit the investor members.

In your case, you have but a single function, which is to manage a limited liability company treated as a partnership for federal income tax purposes that will rehabilitate and operate a low-income housing project. Thus, controls that the investor members have over the creation or operation of the joint venture will necessarily detract from your exempt operations. Certain controls that the investor members have under the agreements, in regard to penalty and guaranty provisions, are intrusive.

[redacted]

Your obligation to acquire the interest of the related member and investor member is an obligation to return capital to the investor from your own funds which is directly contrary to the holding in Plumstead supra. The holding in Plumstead understands that transactions can fail, which is the time a return of the capital would be important to the related member and investor member. Nonetheless, the court did not suggest that in some circumstances it may be alright for a tax-exempt general partner to return capital to the limited partner out of its own pocket.

You have also agreed to make up any difference between the anticipated benefits outlined in the original financial projections and the benefits actually received by the investor member and related member. Under the terms of the agreements, you are indemnifying the related member and investor member's speculation that its investment will pay off as projected. This constitutes a substantial nonexempt purpose, in that it has a substantial purpose to benefit the related member and investor member. Conferring more than incidental benefits to private interests is a nonexempt purpose. American Campaign Academy v. Commissioner, supra.

Also, you have agreed to insure the related member and investor member from all losses from the presence of hazardous materials at any time on or around the property whether or not in your control. This is not merely a warranty as to the condition of the property upon admission of the related member and investor member. In that case, you would be liable for misrepresentation or negligent investigation, breaching a fiduciary duty. However, when you insure against any losses resulting from any introduction of hazardous materials, you are insuring the related member and investor member's investment.

In addition, if the investor member regards you to be in material violation of any of the agreements, the special member may become the managing member. Since a material violation would include a failure to make the out-of-pocket payments enforced by the guarantee agreements and indemnification provisions, the investor member controls the joint venture in a manner that intrudes on your exempt function. Under this agreement, you are not able to operate exclusively for charitable purposes, since you must also operate for the limited partner's private benefit.

Further, your only operation is the management of the joint venture. This does not, in itself, constitute a charitable purpose. Your exemption is dependent on whether you control the joint venture in order to carry out your charitable purpose of aiding the poor and distressed or the underprivileged by providing low-income housing. Your failure to maintain control adversely impacts on your ability to ensure that charitable purposes are furthered by your participation in the joint venture. See Rev. Rul. 98-15, 1998-1 C.B. 718, which provides that a section 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income

[redacted]

tax purposes, and meet the operational test if participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

The intrusive power afforded to the special member under the provisions of the agreements over your ability to manage [redacted] and the project demonstrates a nonexempt purpose. If the investor member does intrude into your exempt operation, under the operating agreement you are prevented from leaving [redacted] without the consent of the special member. If you do leave without the special member's approval, you forfeit your right to any distributions or amounts due you from [redacted] whether or not the investor member has suffered any damages.

Although Plumstead demonstrates that a charitable organization's operation as a managing member in a joint venture is acceptable when specified conditions exist, Housing Pioneers, supra, makes it clear that when an organization fails the conditions of Plumstead, that organization cannot rely on Plumstead to establish its qualification for exemption. Your situation is by its very nature more intrusive than the facts described in the Plumstead case. The intrusions cause you to fail section 7 of Rev. Proc. 96-32 and precludes your qualification for recognition of exemption, notwithstanding your satisfaction of the safe harbor in section 3 of Rev. Proc. 96-32. When you operate to insure the investment of the for-profit members, you are not operating exclusively for charitable purposes as required in section 1.501(c)(3)-1(d)(1) of the regulations.

CONCLUSION:

Because your activities confer impermissible private benefits to the limited partners, you have not demonstrated that you will be operated exclusively for exempt purposes. Therefore, we conclude that you are not described in section 501(c)(3) of the Code and are not exempt under section 501(a).

Accordingly, contributions to you are not deductible under section 170 of the Code. You must file federal income tax returns on Form 1120.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

[redacted]

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
T:EO:RA:T:1
Attn: [redacted]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

To help further expedite our handling of this matter, you may fax your response at the following telephone number: [redacted] Please also mail the original of your response to the address listed.

[redacted]

[redacted]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

We have sent a copy of this letter to your authorized representative as indicated in your power of attorney.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1

bcc: State officials, [redacted]

bcc: [redacted]

bcc: [redacted]

bcc: [redacted]

[redacted]