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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: OCT 17 2003

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

[redacted]

Employer Identification Number: [redacted]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code (the "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 this section. The basis for our conclusion is set forth below.

You were organized on March 12, 2002 as a [redacted] nonprofit corporation. You plan to provide housing to low and moderate income persons, through wholly-owned nonprofit corporations of which you will be the sole member. You also may conduct other projects, including housing rehabilitation or construction of community centers, in or outside the State.

The first project will be construction and operation of a rental housing project for persons age 55 and over. You represent that the project will meet the low-income housing requirements of Rev. Proc. 96-32 and section 42 of the Internal Revenue Code. You will have no direct involvement in the project except through the corporate subsidiary, which will be solely responsible for the obligations of the general partner of the project. If the proposed revenue procedure introduced to the IRS that would extend the safe harbor provisions of Rev. Proc. 96-32 is adopted as presented in the near future, you would not form a corporate subsidiary but conduct the activities directly.

According to a March 21, 2002 letter agreement between you and [redacted] Ltd ([redacted]), an agreement that you describe as quickly becoming moot given its time frames, the subsidiary will be the [redacted]% general partner in a tax credit partnership, [redacted]. [redacted] will be the [redacted]% investor partner. The partnership will develop and operate the property. The subsidiary will guarantee: completion; operating deficits up to $[redacted] for up to five years; full refund to the limited partner upon occurrence of non-completion by 3/31/04, loan foreclosure, or failure to receive tax credits; the $[redacted] annual fee of the asset manager (related to limited partner); and recapture or reduction of tax credits, with interest. The guarantees will be limited by unspecified caps. Limited partner controls over the

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nprofit general partner will be limited in unspecified ways. The subsidiary will receive management fees of up to $[redacted] annually, depending on cash flow. The developer (not you or the subsidiary) will receive a development fee. The limited partner may approve the management. According to the Tax Credit application, [redacted] is co-developer, [redacted] the development consultant, [redacted] the Project Director, [redacted] is the contractor, [redacted] the architect, [redacted] the managing agent/asset manager. It is intended that the management company not be affiliated with you or any limited partner. You do not plan to contract with any entities in which your directors or officers (or their close family members) have a financial interest.

You are awaiting recognition of exemption before forming a corporate subsidiary or making the partnership agreement or any contracts in relation to the [redacted] project.

Section 501(c)(3) of the Code exempts from federal income tax organizations that are organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(b)(2) of the Income Tax Regulations provides that the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a), and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

Section 1.501(c)(3)-1(c)(1) of the 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). 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, to meet the requirements of this subdivision, 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.

Rev. Proc. 90-27, 1990-1 C.B. 514, Section 5.02 provides that exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere restatement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures or other means adopted or planned for carrying out the activities, the anticipated

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sources of receipts, and the nature of contemplated expenditures. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or determination letter will be issued. In those cases where an organization is unable to describe fully its purposes and activities, a refusal to issue a ruling or determination letter will be considered an initial adverse determination from which administrative appeal or protest rights will be afforded.

Rev. Proc. 96-32, 1996-1 C.B. 717, sets forth procedures for determining whether an organization that provides low-income housing will be considered charitable as described in section 501(c)(3) of the Code because it relieves the poor and distressed. Section 7 provides that if an organization furthers a charitable purpose such as relieving the poor and distressed, it nevertheless may fail to qualify for exemption because private interests of individuals with a financial stake in the project are furthered.

In Rev. Rul. 98-15, 1998-1 C.B. 718, the Service surveyed the judicial authorities pertaining to a section 501(c)(3) organization in a partnership with for-profit organizations. The ruling reasoned that the activities of a partnership (including an LLC treated as a partnership for federal tax purposes) are considered to be the activities of a nonprofit partner when evaluating whether the nonprofit organization is operated exclusively for exempt purposes under section 501(c)(3) of the Code. A section 501(c)(3) organization may form and participate in a partnership 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. Similarly, a section 501(c)(3) organization may enter into a management contract with a private party, giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets, provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. However, if a private party is allowed to control or use the non-profit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes. The nonprofit in Situation 1 continued to be operated exclusively for charitable purposes where the partnership's governing documents gave priority to charitable purposes over maximizing profits for the owners, the partnership's board structure gave the nonprofit's appointees voting control, and the nonprofit appointed community members familiar with the hospital to the partnership board. The nonprofit in Situation 2 was held not to be operated exclusively for exempt purposes where there was no binding obligation in the partnership's governing documents to serve charitable purposes, the nonprofit shared control of the partnership with its for-profit partner and thus could not necessarily give priority to charitable concerns over profits, the primary source of information for the nonprofit's board members was the chief executives (who had a prior relationship with the for-profit partner), and the management company was a subsidiary of the for-profit with broad discretion over the partnership's activities and assets.

Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943) held that, for income tax purposes, a taxpayer cannot ignore the form of the corporation that he creates for a valid

business purpose or that subsequently carries on business, unless the corporation is a sham or acts as a mere agent.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the court held that an organization was not organized and operated exclusively for charitable purposes. The court reasoned 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.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

In Plumstead Theatre Society, Inc. v. Commissioner, 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 costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations or over the management of the partnership. Another significant factor was that the organization was not obligated for the return of any capital contribution made by the limited partners from its own funds.

In Housing Pioneers, Inc. v. Commissioner, T.C.M. 1993-120, aff'd, 49 F.3d 1395 (9th Cir. 1995), amended, 58 F.3d 401 (9th Cir. 1995), a substantial nonexempt purpose was found where a nonprofit organization entered into limited partnerships with for-profit entities to operate low-income housing projects. While the nonprofit served as a co-general partner, its actual authority was narrowly circumscribed. The organization had no on-site management authority, no authority to screen or select tenants, and could describe only a vague charitable function of surveying tenant needs and ensuring that requirements for federal tax credits under sections 38 and 42 of the Code were met. The organization had been formed to promote low-income housing, but the court found that the "keystone" of its plan was "achieving the objective of property tax reduction," and that it "has made no attempt to adopt any actual plan by which [it] expects to use its hoped-for share of property tax reductions to implement its stated objectives." The Tax Court concluded that the organization did not qualify under section 501(c)(3) because it had a substantial non-exempt purpose and served private interests, and therefore did not reach the Service's inurement argument based on the indirect participation by insiders in the partnerships. On appeal, the Ninth Circuit did not reach the inurement argument either, but held that the organization had a substantial non-exempt purpose because it failed to "'materially

participate' . . . in the development and operation of the project . . . . It has shown no regular, no continuous, no substantial activity in developing or operating the projects", and instead allowed the for-profit partners to control the activities. The court distinguished Plumstead as not involving a situation where the partners included insiders of the nonprofit organization.

Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff'd, 243 F.3d 904 (9th Cir. 2001), held a nonprofit organization was not operated exclusively for exempt purposes under section 501(c)(3) of the Code where its sole activity was participating as co-general partner with a for-profit corporation in a partnership that was general partner of an operating partnership that owned and operated an ambulatory surgery center. The court reasoned that an organization's purposes may be inferred from its operations, and that to the extent it cedes control over its sole activity to for-profit parties having an independent economic interest in the sole activity and having no obligation to put charitable purposes ahead of profit-making objectives, the organization cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. The court determined from the facts involved that the nonprofit organization had ceded effective control over the operations of the partnerships and the surgery center to the for-profit partners and management company, impermissibly benefiting private interests. Nothing in the partnership agreement or any binding commitments relating to the operation of the surgery center established any obligation that charitable purposes be put ahead of economic objectives in the center's operations. The nonprofit lacked formal control over the partnerships in several significant respects. For example, the management contract between the operating partnership and management company (an affiliate of the for-profit partner) gave the latter broad power to make contracts, negotiate with third-party payors, and set patient charges. The contract provided for fees of 6 percent of gross revenues, providing an incentive to maximize profits. The term of the contract ran for at least 15 years, terminable for cause only by majority vote of the managing directors. Also, nothing in the record indicated that the nonprofit exercised informal control over the surgery center.

You claim exemption under section 501(c)(3) of the Code based on the activities of a proposed partnership that would own and operate an elderly low-income housing project. You would not be a partner in the partnership, but instead your corporate subsidiary would be. A central question is whether the activities of the subsidiary can be considered your activities for purposes of determining your qualification for exemption under section 501(c)(3) of the Code.

For federal income tax purposes, a corporation and its sole shareholder are separate taxable persons so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities (including tax-exempt functions) or the subsidiary subsequently carries on business activities. Moline Properties. An exception applies where the corporation is a sham, or acts solely as the agent of its owner. You have not established that the subsidiary would be a sham, or that it would act solely as your agent. If it were a sham or your agent, that would defeat the apparent reason for its creation in the first place, which is to limit your potential liability arising from the partnership; creditors could pierce the subsidiary's corporate veil in such case.

Thus, we must focus initially on your own activities, not those of your subsidiary, in

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determining your qualification for exemption. It appears that your activities will consist of providing support and guidance to your corporate subsidiary. However, the corporate subsidiary does not qualify for exemption under section 501(c)(3) of the Code. Moreover, you have failed to establish that providing services to a for-profit subsidiary constitutes a charitable purpose. Your application also suggests that you might undertake some other projects directly, but these are far too vague and hypothetical to establish 501(c)(3) exemption.

Even if the for-profit subsidiary's activities could be considered as your activities, you have failed to establish that such activities will qualify as exclusively charitable under section 501(c)(3) of the Code. We have asked you for partnership agreements, contracts, and other details and have not received them. Without such documents, we cannot determine that the partnership activities will not result in substantial private benefit to the for-profit partners or contractors for such projects. The rulings and cases discussed above indicate that private benefit problems may arise from unreasonable terms in partnership agreements or contracts with for-profit interests. Unreasonable terms may include guarantees and for-profit control over the venture. Under Rev. Proc. 90-27, an organization must establish to the satisfaction of the Service that its proposed activities will be exempt in order to obtain recognition of exemption.

Moreover, to the extent that the activities are to be construed as providing relief to the elderly, you have failed to establish that the minimum age of 55 for residents is considered elderly.

Accordingly, you have failed to establish that you qualify for exemption as an organization described in section 501(c)(3) of the Code, and thus you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

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.

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.

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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
[redacted]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

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

Sincerely,

[redacted]
Manager, Exempt Organizations
[redacted]