

LIHTC MONTHLY REPORT

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IRS Releases Criteria for Tax-Exempt Status for Not-for-Profit General Partners of LIHTC Partnerships

By Ruth Sparrow, Esquire, Future Unlimited Law PC

The process for obtaining federal income tax-exempt status for general partners of low-income housing tax credit (LIHTC) partnerships had become arduous, in particular since the Internal Revenue Service's Exempt Organizations Division issued the 2003 article, "Housing Partnership Agreements." The article, written by Mary Jo Salins and Robert Fontenrose was one of several published in October 2002 as the part of the IRS's Tax Exempt Bonds Continuing Professional Education (CPE) Technical Instruction Program for Fiscal Year 2003.

In the article, the authors concluded that certain standard provisions of LIHTC partnership agreements would preclude exemption under Sections 501(c)(3) or (c)(4) of the Internal Revenue Code (IRC). (For a more detailed discussion of the article, please see the December 2002 issue of the *LIHTC Monthly Report*.) For example, the article provided that (i) a limited partner's right to remove the general partner, (ii) obligations of the general partner to repurchase the limited partner's interest in the partnership in the event of certain defaults, and (iii) the limited partner's ability to hire or fire management agents or accountants without general partner consent were not acceptable. In addition, guarantees, return of capital and indemnification obligations of the not-for-profit general partner were considered suspect. In practice, these provisions have been allowed by the IRS with significant restrictions. The lack of specific guidelines, however, has made the process difficult and unpredictable for investors and developers. The IRS has also required the submission of final agreements, or near-final agreements with representations that the final version would not significantly deviate from the approved draft. Consequently, IRS approval of the general partner's tax-exempt status generally would not be available until the equity investment was ready to close and could delay closing. (In mixed-

finance Section 202 transactions, HUD will not close without the issuance of the IRS determination letter.)

In response to practitioner and industry efforts, on April 25, 2006, Joseph Urban, IRS acting director for Exempt Organizations Rulings and Agreements, issued a memorandum for exempt organization determinations that provides criteria for processing requests for tax-exempt status under IRC Sections 501(c)(3) or 501(c)(4) for general partners of LIHTC partnerships. By providing specific and generally reasonable guidelines, the memorandum should facilitate the approval process. The memorandum provides that a failure to satisfy any of the specific criteria may be overcome if an applicant addresses the issue in another manner satisfactory to the IRS.

Briefly, the criteria are as follows:

- ♦ **Description of the Project:** The application must include a description of the proposed activities, including the specific project to be operated by the partnership and how the project will further the organization's charitable purposes consistent with Revenue Procedure 96-32, 1996-1 CB 717. Rev. Proc. 96-32 provides a safe harbor for low-income housing organizations to meet the charitable requirement of relieving the poor and distressed.
- ♦ **Documentation Required:** A final partnership or LLC agreement is not required to obtain approval but should be submitted to the IRS upon execution. In the absence of a final agreement, the applicant is required to represent that the agreement will provide: (i) for the operation of housing in a manner that furthers the organization's charitable purposes; and (ii) that in the event of a conflict, the obligation of the not-for-profit to operate the partnership consistent

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with its charitable purposes must prevail over any obligation of the not-for-profit to maximize profits for its partners.

- ♦ **Conflict of Interest Policy:** The not-for-profit is required to adopt a conflict of interest policy to protect the not-for-profit in connection with any transaction that may result in a private benefit to its officers, directors, trustees or partners.
- ♦ **Guarantees and Indemnifications:** The not-for-profit is required to provide representations that the organization's financial exposure will be limited as follows:

(i) **Environmental Indemnities:** The not-for-profit must review an independent Phase I environmental report and minimize its risks before providing environmental indemnities.

(ii) **Fixed-Price Construction Contract:** The partnership must enter into a fixed price construction contract with a contractor that is bonded or that provides a performance letter of credit or personal guarantee.

(iii) **Operating Deficit Guarantees:** A not-for-profit's guarantee must be limited to no more than five years from the date the project first achieves break-even operations (defined as the date upon which the project achieves 95 percent occupancy and operating revenues equal operating expenses for three consecutive months after completion); and/or to six months of operating expenses including debt service. The not-for-profit must conduct due diligence to determine that break-even operations is expected within a reasonable period after completion.

(iv) **Tax Credit Adjusters:** The not-for-profit general partner's obligation to make tax credit adjuster payments must be limited with respect to each separate adjuster to the aggregate amount of developer and other fees that the not-for-profit or any affiliate is entitled to receive in connection with the project; and/or by providing that payments by the not-for-profit will be treated as a capital contribution or as a loan which have priority over any other distribution to partners upon a sale or refinancing of the property.

(v) **Right of First Refusal:** The not-for-profit must have a right of first refusal to acquire the project at the end of the compliance period. The price must be reasonable as determined by the not-for-profit's board of directors.

(vi) **Repurchase Obligations:** The obligation of the not-for-profit to repurchase the investor's interest in the event of a failure of

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the project to meet certain significant benchmarks, such as a failure to qualify for a significant portion of the LIHTC, can not exceed the amount of the investor's capital contributions.

(vii) Investor Consents: The investor's consent to partnership decisions that do not involve day-to-day operations can not be withheld unreasonably. Consent may be withheld if necessary to preserve the housing as a low-income housing project. The memorandum includes a list of certain standard investor consent rights and implies that an investor should not have day-to-day management control.

(viii) Removal rights. The not-for-profit general partner may be removed as general partner by the investor only for cause and after written notice and a reasonable cure period have been provided.

The foregoing criteria should facilitate and expedite the approval process. In addition, investors and not-for-profits will not have to negotiate (or re-negotiate) these provisions. These criteria should also be included in future partnership agreements with respect to existing exempt organizations in order to assure maintenance of tax-exempt status. ♦

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