

LIHTC MONTHLY REPORT

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Practical Implementation of IRS Directive: A Safe Harbor for New LIHTC Not-for-Profits and IRC §4965

By Michael I. Sanders, Esq. and Jerome A. Breed, Esq., Powell Goldstein LLP

On April 25, 2006, the Internal Revenue Service (IRS) released guidance for its agents who process applications for federal income tax exemption for organizations that will participate in low-income housing tax credit (LIHTC) limited partnerships or limited liability companies (LLCs) as general partner or managing member. The guidance sets forth a safe harbor for new not-for-profits participating in such LIHTC transactions; if the criteria are met, the exemption should be forthcoming. Section 4965 of the Internal Revenue Code (IRC), which was enacted on May 17, 2006, provides for excise taxes applicable to tax-exempt organizations and their managers for participation in certain LIHTC transactions. On July 11, 2006, the IRS issued Notice 2006-65, which describes the provisions of IRC §4965 and the application thereof. Since that time, both the IRS and tax practitioners have attempted to structure transactions in such a way as to stay within the guidelines set forth for LIHTC projects under the guidance without being subject to the newly imposed excise taxes under IRC §4965.

The provisions contained in the guidance are frequently incorporated by not-for-profits that serve as general partners in LIHTC transactions to ensure that their participation will not jeopardize their tax-exempt status. Syndicators generally have been receptive to inclusion of the guidance standards in LIHTC transaction documents. This article will reference tax-exempt general partners, but the guidance is equally applicable to non-profits that serve as the managing members of LLCs. In addition to the right of first refusal and guarantee restrictions described below, the guidance requires the parties to include in the partnership agreement a statement that the partnership will be operated in accordance with the charitable purpose of the tax-exemption, and provisions restricting the removal rights and consent rights of the investor. The principles contained in the guidance are equally applicable to historic rehabilitation and new markets tax credit (NMTC) transactions.

Right of First Refusal

Tax-exempt general partners must secure a right of first refusal to acquire the project at the end of the LIHTC compliance period for an amount equal to the lesser of fair market value or the formula price under IRC §42(i)(7). While the requirement provides that the right of first refusal price may be less than the minimum right of first refusal purchase price under IRC §42(i)(7), under general tax principles, the owner of property may grant a right to another party to purchase the property for fair market value without jeopardizing ownership of the property. Accordingly, the guidance approach does not jeopardize the availability of LIHTC to the investor.

Completion and Operating Deficit Guarantee

Before providing an unlimited construction completion guarantee, LIHTC limited partnerships must enter into a fixed-price construction contract with a bonded contractor or a contractor that provides a performance letter of credit or adequate personal guarantee. If an operating deficit guarantee is required of the applicant organization, its liability either must be limited to a period of not more than five years from the date the project achieves break-even operations or limited to an amount equal to no more than six months of operating expenses.

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Tax Credit Adjusters

Tax-exempt general partners may provide tax credit guarantees to investors subject to certain limitations. The limitations may be adopted through *either* of two approaches. First, if the governing document of the limited partnership or LLC includes separate tax credit adjuster provisions, the guarantee would be limited under each separate adjustable provision to an amount that does not exceed the aggregate amount of developer and other fees (both payable and deferred) that the applicant organization, or any affiliate, is entitled to receive in connection with the project. Second, any payments by the applicant would be treated as capital contributions or loans to the limited partnership or LLC, and their repayment must take priority over any other distribution of residual assets to partners upon sale or refinancing of the property. To the extent that a right of first refusal is included, the capital account alternative is likely not to produce any economic effect because the purchase price for the investor's interest is not calculated by reference to capital account balances.

Repurchase Obligations

If the tax-exempt general partner guarantees the repurchase of the investors' interest in the limited partnership in case of a failure to meet certain fundamental requirements relating to the viability of the project, the repurchase price may not exceed the amount of capital contributions. Under this representation, "mark up" of the repurchase amount to cover syndication costs would not be permitted, regardless of whether the syndicator is a for-profit or a tax-exempt entity.

Emerging Issues for the IRS and Tax Practitioners

Failure to Satisfy All Criteria in Safe Harbor

Some tax practitioners have expressed concern that new nonprofits participating in LIHTC transactions may be unable to satisfy all the criteria set forth in the guidance. The guidance is only a safe harbor and transactions that fall outside the safe harbor may not jeopardize the tax-exempt status of the general partner provided that there are alternative provisions in the documents that provide equivalent protection for the not-for-profit.

Use of a For-Profit Subsidiary

Lois Lerner, director of the Exempt Organizations branch of the IRS, has confirmed that a wholly-owned for-profit subsidiary of an exempt organization does not have to comply with the provisions of the safe harbor, provided that the parent exempt organization is not required to make the guarantees described above. However, if a disregarded LLC is used in the LIHTC transaction and the LLC must make such guarantees, the representations required by the safe harbor must be provided.

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LIHTC INFORMATION

Novogradac & Company LLP

246 First Street, 5th Floor

San Francisco, CA 94105

E-mail: cpas@novoco.com

Address all correspondence and

editorial submissions to:

Jane Bowar Zastrow

Telephone: 415.356.8034

Address inquiries regarding

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Amendment of Existing Documents

It is not recommended that not-for-profits attempt to retroactively apply the safe harbor guidelines to previously executed documents, although documents entered into after the issuance of the guidance should comply with the requirements of the safe harbor.

Application of Safe Harbor Guidelines on Audit

Taxpayers should anticipate that the IRS will apply the safe harbor criteria when auditing exempt organizations participating in LIHTC transactions. With respect to transactions that were closed prior to the issuance of the guidelines, however, it seems logical that revenue agents would resolve any noncompliance through the addition of provisions included in the guidance to the documents utilized in the prior transactions.

Tax Credit Adjustor Guarantees

The safe harbor provision regarding tax credit adjuster guarantees, described above, has received a large amount of attention. It should be noted that either of the two approaches described above, or a combination thereof, would satisfy this provision.

IRC § 4965 and LIHTC Transactions

IRC §4965 imposes excise taxes on exempt organizations and organization managers that enter into transactions in which a taxpayer "has the right to a full or partial refund of fees...if all or part of the intended tax consequences from the transaction are not sustained" or a transaction for which "fees are contingent on the taxpayer's realization of tax benefits from the transaction." In LIHTC transactions that are not part of a guaranteed fund, the syndicator is not required to return its fees in the event of an LIHTC recapture. While general partner affiliates receive developer, property management and other fees, the amount of such fees are not reduced by any tax credit adjuster obligations. Accordingly, taxpayers may take the position that the fees are not "refunded" or conditioned on the availability of LIHTC to the investor.

Because of some uncertainty in the application of the tax shelter registration rules, some investors have made "protective filings" in an effort to insure against the possible assertion of tax shelter registration penalties, but the practice of making protective elections would expose exempt organizations participating in such projects and their organization managers to severe penalties. Practitioners have requested that the IRS exempt such transactions from the definition of "reportable transactions," or issue guidance that such transactions will not violate IRC §4965 if they comply with the safe harbor criteria set forth in the guidance. While Treasury appears sympathetic to these issues, no relief has been provided to date for LIHTC or other credit transactions.

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Given the proliferation of new guidance concerning exempt organizations participating in LIHTC transactions, it is clear that issues will continue to arise regarding the implementation of such guidance. Practitioners are hopeful that the IRS will continue to be responsive to their concerns. ❖

Michael Sanders is the head of Powell Goldstein's tax department and focuses his practice in the area of taxation, offering particular expertise in matters affecting partnerships, limited liability companies, S-corporations, real estate and tax controversy. He also has a large practice in the area of exempt organizations involving health care and low-income housing, associations and joint ventures between for-profits and non-profits. Jerome A. Breed is a partner in the Washington, D.C. office of Powell Goldstein LLP. Mr. Breed focuses his practice on tax planning and the structuring of low-income housing tax credit, historic rehabilitation tax credit, new market tax credit and community development transactions.

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