

Housing Partnership Agreements

By Mary Jo Salins and Robert Fontenrose

Housing Partnership Agreements

By Mary Jo Salins and Robert Fontenrose

Overview

Purpose This article updates the discussion on housing partnerships that appeared in the 1996 CPE Text, Topic B. It will review the historical framework for the Service position on exempt organization participation in partnerships with for-profit entities. This article will also consider the general terms of a partnership agreement, and highlight areas of concern for exemption.

Introduction The use of joint ventures is a popular financing tool for low-income housing projects. Tax credits under IRC 42 attract private investors to invest in low-income housing partnerships with tax-exempt organizations. Private investors provide a ready source of funding for low-income housing projects. The investors who provide the money are often in a position to dictate the terms of the agreements. Interests of the investors are often at odds with the interests of exempt organizations. Partnership agreements attempt to satisfy both interests.

In this article This article contains the following topics:

Topic	See Page
Overview	1
Historical Synopsis	2
Low-Income Housing Tax Credit Requirements	7
Limited Partnership Structure	9
Limited Liability Company Structure	11
Exemption Analysis	13
Specific Problem Provisions in the Agreement	15
Conclusion	21

Historical Synopsis

Original IRS Position

Before 1980, the Service considered that an exempt organization's participation as a general partner in a limited partnership with for-profit limited partners was not consistent with an organization's exempt status under IRC 501(c)(3). The Service asserted that the fiduciary obligations as a general partner conflicted with the organization's requirement to act exclusively in furtherance of exempt purposes. The Service modified its position in response to the following case.

Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982)

This case involved a nonprofit theatre group. To help fund one of its plays, it became a general partner in a limited partnership with for-profit investors. The Service denied exemption based on its activities as a general partner in a limited partnership with for-profit investors.

- The Tax Court held that this activity did not disqualify Plumstead as an IRC 501(c)(3) organization.
 - The court concluded that Plumstead's partnership obligations did not conflict with its tax-exempt status because:
 - Plumstead did not have an obligation to return the limited partner's capital contributions from its own funds,
 - the limited partners did not have control over the partnership's activities, and
 - none of the limited partners had any involvement in Plumstead.
 - The Circuit Court agreed.
-

Adoption of the Two-Prong Standard

In response to the Plumstead decision, the Service acknowledged that a partnership arrangement could be structured so as to preclude a conflict between an exempt organization's exempt purpose and the fiduciary obligations of a general partner to its limited or co-general partners.

- The Service adopted a two-part analysis to determine whether participation by an exempt organization as a general partner in a partnership with for-profit investors adversely affects exemption. GCM 39005 (June 28, 1983).

Charitable Purpose Test; Private Benefit Test

- The first inquiry is whether the organization's participation in the partnership serves its exempt purposes.
 - The second inquiry is whether the partnership arrangement permits the organization to act exclusively in furtherance of exempt purposes rather than for the benefit of for-profit partners.
-

Continued on next page

Historical Synopsis, Continued

**Housing
Pioneers, Inc. v.
Commissioner,**
65 T.C.M. 2191
(1993), **aff'd,** 49
F.3d 1395 (9th
Cir. 1995),
amended, 58
F.3d 401 (9th
Cir. 1995).

This case involved a nonprofit organization that became a 1- percent co-general partner in existing limited partnerships for the purpose of splitting the anticipated state property tax benefits.

- Applying the two-part standard, the Service determined that Housing Pioneers' participation in the partnerships furthered a substantial non-exempt purpose and resulted in impermissible private benefit to the for-profit partners. The Service concluded that Housing Pioneers did not qualify for exemption as an organization described in IRC 501(c)(3).
 - Housing Pioneers could articulate no clear charitable purpose beyond qualifying for state tax benefits and ensuring that federal housing tax credit requirements were met. It had no on-site management authority and no authority to screen or select tenants.
 - One of the first housing projects that acquired tax benefits from the organization's participation as a general partner was owned by its own founders and managers, thereby benefiting insiders.
- The Service's position was that acquisition of tax credits by the for-profit partners is not itself impermissible.
 - An incidental benefit to for-profit investors, such as the receipt of tax credits, is permissible as long as the organization, through the partnership, furthers exempt purposes.
 - However, Housing Pioneers' participation in the partnerships furthered a substantial nonexempt purpose by assisting the for-profit partners to receive state property tax exemption and benefiting insiders..
- The Tax Court held that the organization in Housing Pioneers did not qualify for exemption because:
 1. it had a nonexempt purpose that was "substantial in nature"
and
 2. private investors benefited more than incidentally from the partnership.
- The Circuit Court affirmed the Tax Court's decision.

Continued on next page

Historical Synopsis, Continued

Rev. Proc. 96-32, 1996-1 C.B. 717 – Safe Harbor

In Rev. Proc. 96-32, the Service established a safe harbor for low-income housing organizations to determine whether they meet the charitable requirement of relieving the poor and distressed.

- For housing partnerships, Rev. Proc. 96-32 is instrumental for determining whether an organization satisfies the first prong of the two-step analysis.
- The safe harbor is met if:
 1. At least 75 percent of the units are occupied by families that qualify as low-income, and either at least 20 percent of the units are occupied by residents that are very low-income or at least 40 percent of the units are occupied by residents whose incomes do not exceed 120 percent of the area's very low-income limit.
 - The term "low-income" is defined under the Department of Housing and Urban Development ("HUD") guidelines as family income of no more than 80 percent of the median family gross income of the area, adjusted for family size.
 - The term "very low-income" is defined under HUD guidelines as family income of no more than 50 percent of the median family gross income of the area, adjusted for family size.
 - 120 percent of the area's very low-income limit equals 60 percent of the median family gross income of the area, adjusted for family size.
 2. The project is actually occupied by poor and distressed residents.
 3. The housing is affordable to the charitable beneficiaries (for example, under government-imposed rent restrictions).
 4. If there are multiple buildings, the buildings must share the same grounds if they do not separately meet the 3 requirements listed above.
- If the safe harbor is met, the first prong of the two-step analysis is satisfied (the Charitable Purpose Test).
- If the safe harbor is not met, Rev. Proc. 96-32 lists facts and circumstances whereby an organization may nevertheless demonstrate that it relieves the poor and distressed.
- Rev. Proc. 96-32 makes it clear, however, that even if the safe harbor is satisfied, a housing organization may fail to qualify for exemption because private interests are furthered more than incidentally. In other words, the second prong of the two-part standard must still be met.

Continued on next page

Historical Synopsis, Continued

**Rev. Rul. 98-15,
1998-1 C.B. 718**

Rev. Rul. 98-15 provided the first IRS guidance on partnerships between exempt organizations and for-profit entities.

- Although Rev. Rul. 98-15 focused on a hospital joint venture, the analysis applies to other types of joint ventures, including low-income housing partnerships.
 - Rev. Rul. 98-15 reasoned that the activities of a partnership, including an LLC treated as a partnership for federal income tax purposes, are considered the activities of the exempt partner when evaluating whether the organization operates exclusively for IRC 501(c)(3) purposes.
 - Rev. Rul. 98-15 recognizes the application of the two-part standard in evaluating an organization that seeks to qualify as exempt on the basis of participation in a partnership, citing Plumstead Theatre Society and Housing Pioneers.
-

**Redlands
Surgical
Services v.
Commissioner,
113 T.C. 47
(1999), aff'd,
243 F.3d 904
(9th Cir. 2001)**

This case involved a nonprofit hospital subsidiary whose sole activity was participating as co-general partner with a for-profit corporation in a partnership that was itself a general partner of a limited partnership with physicians. The limited partnership owned and operated an ambulatory surgery center.

- The Tax Court held that the organization was not operated exclusively for IRC 501(c)(3) purposes.

**Ceded
Effective
Control**

- The court found that the nonprofit organization had ceded effective control over the operations of the partnerships and surgery center to the for-profit partners and management company.
 - It had no more than equal representation on the governing board that made all policies and decisions.
 - There was no obligation under the partnership agreements to put charitable purposes ahead of profit-making motives.
 - The management company was an affiliate of the for-profit partner, and the management contract was for a 15-year term, renewable at the will of the management company, terminable only for cause, and provided for fees based on a percentage of gross revenues.
-

Continued on next page

Historical Synopsis, Continued

**St. David's
Health System
v. United
States, No. A-
01-CA-046 JN
(W.D. Texas
June 7, 2002)**

The United States District Court for the Western District of Texas ("District Court") issued an order on June 7, 2002, granting summary judgment to St. David's Health Care System ("St. David's") with respect to St. David's qualification for exemption as an organization described in IRC 501(c)(3). As of the date this article was submitted for publication, the Government had made no decision as to whether it will appeal the District Court decision.

**Summary of
Historical
Perspective**

It is clear that satisfaction of the two-part test is crucial for any housing organization seeking tax exemption that is involved in a partnership with private investors. An exempt housing organization must ensure that charitable purposes will prevail over for-profit motives.

Low-Income Housing Tax Credit Requirements

IRC 42 requirements

IRC 42 allows for low-income housing credits. The federal government allocates low-income housing tax credits ("LIHTC") to designated state agencies to award to low-income housing projects. The project must comply with certain requirements to receive and maintain the credits.

- The project must restrict unit rental to households with below-average incomes. It must satisfy either the 20-50 test or the 40-60 test. IRC 42(g).
 - 20-50 test: At least 20 percent of the residential units in the project must be occupied by individuals whose income is 50 percent or less of area median gross income.
 - 40-60 test: At least 40 percent of the residential units in the project must be occupied by individuals whose income is 60 percent or less of area median gross income.
- The units must be rent-restricted.
 - A unit is rent-restricted if the gross rent of the unit does not exceed 30 percent of the household's monthly income.
 - Gross rent does not include any federally subsidized housing assistance.
- The project must maintain the rent restrictions for a minimum compliance period of 15 years.

Why a partnership structure?

IRC 42(h)(5) provides for states to allocate low-income housing tax credits to projects involving exempt organizations, which generally cannot use tax credits. The credits are an incentive to private investors to provide a source of funding for the projects. Hence, both exempt organizations and private investors benefit from these partnerships.

- The resulting transaction has generally been structured as a limited partnership between the exempt organization and the for-profit investors.
 - The exempt organization serves as general partner and retains a nominal percentage interest, while the investors serve as limited partners, obtaining the majority financial interest, including profits, losses, deductions, and credits.
 - As the general partner, the exempt organization assumes the partnership liabilities.

Continued on next page

Low-Income Housing Tax Credit Requirements, Continued

Why a partnership structure?, continued

- The limited liability company ("LLC") structure has become increasingly popular. The LLC is treated as a partnership for federal income tax purposes (unless it elects to be treated as a corporation). An LLC is often preferable to an actual partnership because all members enjoy limited liability protection in accordance with state law.

Qualified nonprofit organization IRC 42(h)(5)

LIHTC qualification criteria are the same for both for-profit and nonprofit housing entities. However, IRC 42 states a preference for allocating credits to exempt organizations.

- IRC 42(h) requires that states agencies award at least 10 percent of the total credits to projects where a "qualified nonprofit organization"
 - Owns an interest (either directly or through a partnership) **and**
 - Materially participates in the development and operation of the project through the 15-year compliance period.
- To be a "qualified nonprofit organization", the organization:
 - Must have IRC 501(c)(3) or IRC 501(c)(4) exemption;
 - May not be affiliated with or controlled by a for-profit organization; **and**
 - Must have an exempt purpose to foster low-income housing.
- An exempt organization will generally satisfy the "material participation" requirement if it serves as the general partner of the partnership or the managing member of the LLC owning the project.

Limited Partnership Structure

What is a "Limited Partnership"?

A limited partnership is a business organization formed by two or more persons under the limited partnership laws of a state.

Requirements – Revised Uniform Limited Partnership Act

The Revised Uniform Limited Partnership Act ("RULPA") is a model act. Each state has its own statutory requirements that should be consulted.

- A limited partnership must have one or more general partners and one or more limited partners.
 - It must be formed for business purposes.
 - General partners manage the limited partnership and may incur unlimited personal liability for the partnership's debts.
 - Limited partners do not incur personal liability beyond the amount of their partnership contributions.
 - Limited partners are prohibited from taking an active role in the management of the partnership.
 - However, RULPA does allow specific activities in which limited partners may engage without risking the imposition of personal liability. These include, among others, the removal of general partners and derivative suits by limited partners.
 - The partnership must comply with applicable statutory requirements to avoid unlimited personal liability.
 - In order to form a limited partnership, a certificate of limited partnership must be executed and filed with the applicable state agency.
 - The certificate must contain specific information, including:
 - name of the limited partnership
 - address
 - date upon which the partnership is to dissolve
 - name and address of each general partner
 - The certificate may also contain the basic information regarding partnership formation, thus making a separate partnership agreement superfluous.
 - In common practice, however, the certificate includes only the minimum statutory requirements and the parties draft a separate partnership agreement.
-

Continued on next page

Limited Partnership Structure, Continued

The Partnership Agreement

The partnership agreement is a contractual document that sets forth the rights, responsibilities, and obligations of the partners, both general and limited.

- Unlike the certificate, the partnership agreement does not have a filing requirement.
 - In addition to provisions required by state law, the agreement can include any other provision reflecting concerns of the partners and specifying the relationship and duties.
 - Some important provisions include:
 - Purpose of the business
 - Contribution amounts
 - Allocation of profits, losses and tax credits
 - Distributions
 - Powers, rights and duties of the general partner
 - Powers, rights and duties of the limited partners
 - Transfer rights and obligations
 - Dissolution
 - In LIHTC partnerships, the limited partnership investors contribute the money, and thus they, or the syndicator, generally can dictate the terms of the agreement.
-

Limited Liability Company Structure

What is a Limited Liability Company?

A limited liability company ("LLC") is a business organization formed and operated under state law. All fifty states and the District of Columbia have adopted LLC statutes.

- In most states, an LLC can be formed for any lawful purpose, except banking and insurance.
- An LLC is a hybrid entity that provides insulation from liability to the same extent as a corporation, but is taxed as a partnership unless it elects to be taxed as a corporation.
- The persons that own equity in an LLC are called members. They are analogous to shareholders in a corporation or partners in a partnership.
- Members are not personally liable for the debts and obligations of the company. However, members are permitted to participate in the management and control of the business.
 - In other words, the LLC structure allows members to participate directly in the management of the business without jeopardizing their limited liability.
- Unlike a limited partnership, where the general partner manages the affairs and the limited partners must not be involved in management, the LLC allows flexibility.
 - All members may manage the company.
 - Members may appoint a governing board to manage the company.
 - Members may delegate the day-to-day decisions to one or a few of the members, as managing members.
 - Members may appoint officers to run the day-to-day operations, while retaining the final voting power for certain major decisions.

Continued on next page

Limited Liability Company Structure, Continued

Organizing Documents

State law generally requires an LLC to execute articles of organization, a contribution agreement, and an operating agreement.

- States require the filing of the articles of organization with the proper state agency.
 - Generally, information similar to that required in the certificate of partnership must be included. The main reason for requiring articles of organization is to list the members and acknowledge the existence of the company.
 - If no limitations or restrictions are contained in the articles of organization, an LLC may possess and exercise all powers that are necessary or convenient to carry out the purposes of the LLC.
 - The contribution agreement specifies the members' contribution amounts and expectations regarding the operations of the company.
 - An operating agreement sets forth the day-to-day operating powers. It specifies how the LLC will operate and how it will be dissolved. It stipulates the terms and conditions of the company and defines the powers, responsibilities, and obligations of the members.
 - For analyzing an LLC, the operating agreement is the critical document. It will generally contain provisions similar to those listed for the partnership agreement.
 - Often, the operating agreement will reference outside agreements regarding specific duties. Each of these documents is important. Some of these include the following:
 - Management agreement
 - Construction agreement
 - Development contract
 - Loan agreements
 - Security agreements
 - Indemnity agreements
-

Exemption Analysis

**Analysis Same
for limited
partnerships
and for LLCs**

The analysis is the same whether the low-income housing partnership is a limited partnership or an LLC treated as a partnership for federal income tax purposes. It is the two-part analysis discussed in the historical synopsis.

- First, determine whether the participation by the exempt organization in the partnership serves its exempt purposes.
 - Answer the question: Would the activity of the partnership be a permissible activity if conducted directly by the exempt organization?
- Second, analyze whether the partnership arrangement permits the exempt partner to act exclusively in furtherance of its charitable purposes rather than for the benefit of the for-profit partners.
 - Examine the partnership agreement or operating agreement to determine whether the exempt organization faces potential conflicts between furthering its charitable purpose and furthering the interests of the limited partners or members of the LLC, or exposes the exempt organization's charitable assets to possible risk.

**Charitable
Purpose Test**

The activities of the partnership must further the exempt partner's charitable purpose. This is because the activities of a partnership are considered to be the activities of the partners. See Rev. Rul. 98-15.

- For low-income housing organizations, the purpose is usually to relieve the poor and distressed or the underprivileged.
- This prong of the two-part standard will be satisfied if the housing project meets the safe harbor provisions of Rev. Proc. 96-32.
 - If the safe harbor is not met, Rev. Proc. 96-32 lists other facts and circumstances that show that the housing project operates for the charitable purpose of aiding the poor and distressed.

Continued on next page

Exemption Analysis, Continued

Charitable Purpose Test, continued

- The housing project must satisfy either the safe harbor test or the facts and circumstances test of Rev. Proc. 96-32 to comply with the charitable purpose test.
- If it does not, the housing organization will not qualify for exemption unless it demonstrates that it independently qualifies on some alternative basis.
- It is not enough for a housing project to meet the IRC 42 tax credit requirements or the IRC 142 housing set-aside requirements (either the 20-50 test or the 40-60 test).
 - Under Rev. Proc. 96-32, the housing project must also show that at least 75 percent of the units are occupied by families that qualify as low-income (80 percent of the area's median income).

Private Benefit Test

Most housing projects have no trouble meeting the safe harbor test of Rev. Proc. 96-32 because the 20-50 percent or the 40-60 percent test must be satisfied for them to qualify for the credit. Furthermore, the amount of the credit depends upon the basis in the low-income units in the project. Thus, it is the second part of the analysis that requires greater attention.

- The partnership structure and documents should be carefully perused to ensure that conflict between charitable goals and private interests does not result in impermissible benefit to private investors.
 - Often low-income housing projects have rent restrictions. Therefore, while rental income is always a consideration, housing partnerships may have little income to distribute to partners.
 - Of greater interest to investors in an LIHTC partnership is the receipt of tax credits allowed under IRC 42, which is often the principal inducement for their investment.
 - Investors want to ensure that they will receive the tax credits and that they do not lose their invested capital. This results in a tension between charitable purposes and investor protection.
-

Specific Problem Provisions in the Agreement

**Provisions
Necessary due
to State Law**

As discussed previously, in partnerships where the exempt organization is a general partner, the Service is concerned with the conflict between charitable goals and private interests because the general partner has fiduciary obligations to the limited partner.

- The Service analyzes this conflict using the two-step analysis.
- A general partner has a fiduciary responsibility to the limited partners regarding their investment and the operation of the business. However, the exempt general partner must ensure that the partnership does not sacrifice its charitable mission for the private benefit of the for-profit limited partners.
 - Provisions similar to these are essential:
 - No disproportionate allocation of profits or losses
 - No commercially unreasonable loans required from the exempt partner
 - No provision allowing insufficient or abnormally low capital contributions by the limited partners, **and**
 - No special distributions to the limited partners.

**Management
Control
Permissible
under State
Law**

By law, limited partnership agreements must restrict day-to-day management control by the limited partners to maintain their limited liability status.

- This restriction refers more to the operation of the partnership's daily business rather than the ability to exercise structural changes.
- Agreements may contain certain rights for the limited partner to protect their investment. For instance:
 - The agreement will typically contain a provision for the limited partners to have a right to approve amendments to the partnership agreement or to approve the dissolution of the partnership.
 - The agreement will often give the limited partners the right to approve a change in the general partner.

Continued on next page

Specific Problem Provisions in the Agreement, Continued

Management Control Permissible under State Law, continued

- Such provisions protect the limited partner's investment by restricting the right of the general partner to change the structure of the partnership after the investment is made.
- The partnership agreement may allow for some circumscribed supervision by the limited partner to guard against mismanagement or negligent acts by the general partner in order to protect their investment.

Federal Tax Law Restrictions for Exempt Organizations

The following provisions indicate excessive private benefit and are not permitted: any provision that dilutes the effective control by the exempt general partner or exempt managing member over the activities of the partnership or LLC. Some examples:

- Authority by limited partners to amend the partnership agreement or to dissolve and terminate the partnership without general partner concurrence
- Authority by limited partners to remove the general partner
- Obligation of the general partner to purchase the partnership interest of the limited partner under certain circumstances (including, for example, if the partnership is in default of any financing obligation, any loan commitment is terminated, foreclosure proceedings have commenced, or the project becomes ineligible for a certain percentage of the tax credits anticipated.)
- Authority to choose the builder or architect, or to hire or fire the management agents, attorneys, or accountants, without the concurrence of the general partner.

Provisions such as those listed would subject the agreement to change solely on the needs of the investor partner without considering the effect on the exempt charitable assets.

Continued on next page

Specific Problem Provisions in the Agreement, Continued

Power of Attorney Rights to the Limited Partner

Be wary of provisions granting a power of attorney to the limited partner to carry out certain partnership business.

- Such a provision does not allow the exempt general partner to ensure that its charitable assets will be used exclusively for exempt purposes.
 - Unless the provision is written in very restrictive terms and only for very particular transactions, it permits the limited partner to initiate actions that may be contrary to furthering charitable purposes.
-

Rights and Duties Outlined in Series of Agreements

The partnership agreement or operating agreement should be carefully scrutinized. As stated previously, each of these documents stipulates the structure of the relationship and how the partnership or LLC will be operated.

- It is common for the partnership or operating agreement to reference and incorporate other agreements as well.
 - If that is the case, each agreement so referenced must be reviewed.
 - Most commonly incorporated are:
 - Outside guarantee agreements
 - Development agreements
 - Management contracts
 - Security agreements
 - Indemnification agreements.
-

Guarantees, Return of Capital, Indemnification

Housing projects generally have a low asset value, because rents are restricted, and rental properties are generally valued on the basis of the income they generate.

- To ensure sufficient security for their investment, investors may require guarantees and indemnifications.
 - Partnership agreements sometimes contain a capital call provision drafted in favor of the private investors or require a return of capital.
-

Continued on next page

Specific Problem Provisions in the Agreement, Continued

**Guarantees,
Return of
Capital,
Indemnifi-
cation,
continued**

- Such obligations imposed on the general partner are suspect, and must be closely scrutinized.
- Any investment poses some risk. If all risk of the investment lies with the general partner and very little with the limited partners, the benefit to the limited partner is more than incidental.

**Environmental
indemnification**

Environmental indemnifications are standard in the housing industry.

Under certain circumstances the Service has approved environmental indemnifications, such as when a Phase I environmental survey was completed and the indemnification covered only hazards due to the negligence of the general partner. These provisions must be evaluated on a case-by-case basis.

Loss Reserves

Loss reserves are common provisions in housing partnership agreements.

- A provision where the exempt partner guarantees the anticipated tax credits from its own assets is not permissible.
- Loss reserves may be allowable where the reserve account is maintained out of partnership earnings.

**Completion
Guarantees or
Guarantees of
Performance
Levels**

Any provision that guarantees a return of capital to the investor partner if stages of the project are not completed at certain time periods, or certain goals are not met, is unreasonable and should be removed.

A different result may be possible if the lack of completion is due to the negligence of the general partner,

Continued on next page

Specific Problem Provisions in the Agreement, Continued

Minimum Investment Return

Investments carry with them a degree of risk. A provision that requires the general partner to guarantee the tax credits due to the investor partners is beyond the fiduciary duty of the general partner and would be impermissible private benefit to investors.

- Compare this provision, however, with a provision that only obligates the general partner to make all reasonable efforts to ensure that the partnership operates in a manner to qualify for tax credits.
 - This second provision does not guarantee a return, only that the general partner will satisfy its fiduciary responsibility.
-

Covering Tax Liabilities

Any provision where the exempt general partner agrees to cover partnership tax liabilities of the investor partners is not permissible. Covering tax liabilities is beyond the fiduciary obligations of the general partner. The only time such a provision may possibly be allowed is when the partnership tax liabilities are due to the negligence or mismanagement of the general partner.

Purpose Clause

The partnership agreement may state that the purpose of the partnership is to own and operate a low-income housing project under IRC 42(g), or words to that effect.

- IRC 42(g) provides that a qualified housing project will satisfy either the 20-50 test or the 40-60 test, and that these units will be rent-restricted.
 - IRC 42(g) does not make a distinction between for-profit and exempt nonprofit housing entities.
 - Wording reflecting only the requirements of IRC 42(g) is not sufficient as a statement of charitable purpose. This purpose statement does not necessarily provide for charitable purposes nor does it place charitable purposes ahead of investment motives. Rev. Rul. 98-15; Redlands Surgical Services.
-

Continued on next page

Specific Problem Provisions in the Agreement, Continued

**Purpose
Clause,
continued**

- Rev. Proc. 96-32, which provides a safe harbor for meeting charitable purposes, tracks the language of IRC 42(g) in that it provides for the 20-50 or the 40-60 tests. It also adds the requirement that 75 percent of the units must also be occupied by residents that qualify as low-income.
 - The purpose clause should incorporate a reference to the more stringent requirements of Rev. Proc. 96-32. The purpose clause must also explicitly state that charitable purposes take precedence over profit motives.
 - Unlike IRC 501(c)(3), IRC 42 does not require that charitable purposes be met. It is not enough to simply satisfy IRC 42. IRC 501(c)(3) requirements must be met.
-

Conclusion

Remember the two-part analysis

In all joint ventures with private interests, the joint venture must further the exempt purposes of the exempt partner.

It is essential to exempt status that the exempt partner be able to ensure:

- its charitable assets are not at risk
 - its charitable goals are furthered; and
 - no more than incidental benefit is afforded the for-profit partners.
-

Be wary of guarantee provisions, return of capital provisions, indemnification provisions

When examining a low-income housing organization that fulfills its purposes through a partnership arrangement, the partnership agreement or operating agreement is critical to the analysis.

A proper purpose clause should be included. Guarantees, indemnifications, and return of capital provisions, among others, may result in undue benefit to the private investors. Such provisions require careful scrutiny because they could mean the exempt general partner does not have effective control over the activities of the partnership, or they could further a non-exempt purpose to obtain benefits to the limited partners to the detriment of charitable interests.
